Volume I, Original Pronouncements

FASAB

FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

Statements of Federal Financial Accounting Concepts and Standards

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Foreword

The *Statements of Federal Financial Concepts and Standards*, *Original Pronouncements ("Original Pronouncements")* contains the original text that currently constitutes the body of accounting concepts and standards for the U.S. government. Specifically, *Original Pronouncements* incorporates the following documents published through December 31, 2000:

- Statements of Federal Financial Accounting Concepts 1-4,
- Statements of Federal Financial Accounting Standards 1-25,
- Interpretations 1-6,
- Technical Bulletin 2000-1 through 2003-1 and
- Technical Releases 1-5.

Origins of the Documents

The concepts, standards, interpretations, technical bulletins, and technical releases presented in the *Original Pronouncements* were issued in accordance with policies and procedures approved by the Department of the Treasury (Treasury), the Office of Management and Budget (OMB), and the General Accounting Office (GAO) at the time of their issuance. These three central agencies, referred to collectively as the "sponsors," established the Federal Accounting Standards Advisory Board (FASAB) in 1990. The mission of the FASAB is to develop accounting standards and principles for the federal government, after considering the financial and budgetary information needs of congressional oversight groups, executive agencies, and the needs of other users of federal financial information.[1]

Concept Statements

Statements on concepts differ from statements of accounting standards. Statements on concepts are more general than statements on standards and do not contain specific authoritative requirements for federal agencies. After approval by the Board, concept statements provide general guidance to the Board itself as it deliberates on specific issues. They also are useful to the OMB in carrying out its statutory responsibilities, and others in understanding federal accounting and financial reports.

Standards

Using a due process and a consensus building approach, the Board promulgates accounting standards after considering the financial and budgetary information needs of Congress, executive agencies, other users of

[1]Mission Statement, Federal Accounting Standards Advisory Board. For a more extensive description of FASAB's role, refer to Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, Paras. 23-29.

federal financial information, and comments from the public. The Memorandum of Understanding dated May 7, 2003, is included in Appendix C and describes the Board's authorities and processes.

Interpretations

Interpretations clarify original meaning, add definitions, and provide other guidance for existing SFFAS. They are narrow in scope. FASAB will respond to requests for guidance by providing technical assistance, including, in some cases, interpretations. When drafting an interpretation the FASAB staff submits the request to the Board and reviews applicable literature and consults with knowledgeable persons, as appropriate. FASAB will consider the draft interpretation at an open meeting. Proposed interpretations are exposed for public comment for at least 30 days. Interpretations approved by a majority of the Board and not objected to by a Board member representing a principal within 45 days are published by FASAB.

Technical Bulletins

Technical bulletins provide guidance for applying statements and interpretations and resolving issues not directly addressed by them. Technical bulletins are used when the nature of an issue does not warrant more extensive due process. They are generally in question and answer format.

Technical Releases

The Accounting and Auditing Policy Committee (AAPC) provides implementation guidance for accounting standards, for the OMB's *Form and Content* guidance, and for audit issues. The AAPC provides guidance through technical releases that are reviewed and published by the FASAB and announced originally in the Federal Register. They are included here for ease of reference.

GAAP Documents

When adopted and issued, these documents become federal accounting standards and implementation guidance. It is expected that FASAB will continue to issue guidance through the documents described above. As new documents are adopted, the *Original Pronouncements* will be updated. Individual documents issued between updates are available through a variety of sources.

Purpose of the *Original Pronouncements*

The *Original Pronouncements* compiles and codifies the documents produced by the FASAB. It is designed to meet the needs of users for an authoritative reference to concepts, standards, interpretations, technical bulletins, technical releases, and other issuances. It contains extensive cross-referencing and indexing.

Organization of the *Original Pronouncements*

Original Pronouncements presents each concept statement and accounting standard as a separate chapter. The issue date and effective date of each statement and standard are presented first. Next, references to relevant sections within *Original Pronouncements* are provided. Any interpretations, technical bulletins, and technical releases that relate to the statements are also identified.

A brief summary of the statement and standard is presented. A table of contents referenced to both page and paragraph numbers follows the summary. Note that the paragraph numbering originally expressed in the individual statements is retained.

In some cases the statements have been affected by later statements or affect earlier statements. References are provided on the title page of each chapter to direct the reader to the affected paragraphs and indicate the source and nature of the change. Within the text of the statements, ellipses alert the reader that provisions have been deleted as a result of other statements. Original provisions modified or affected by a subsequent statement but not deleted are noted on the title page of the chapter and double underlined in the text. New provisions added by a subsequent statement are not inserted in the original statements. The reader can review the basis for conclusions of the amending standard for the rationale for the change.

Some standards contain illustrations, which are included in the *Original Pronouncements*. These illustrations are general in nature and may not apply to specific cases that appear similar but have unique circumstances. For specific cases, the objective should be to arrive at the specific answer that applies the body of accounting standards in that specific case.

The glossaries originally published with each statement have been codified in a single glossary. This glossary is presented as the last appendix to the *Original Pronouncements*.

Original Pronouncements also presents the following appendices:

Appendix A:	Topical Index
Appendix B:	Effective Dates of Statements, Interpretations, Technical Bulletins, and Technical Releases
Appendix C:	Memorandum of Understanding

Appendix D: Federal Accounting and Auditing Resources
Appendix E: Consolidated Glossary
Appendix F: Consolidated List of Acronyms

Materiality

The Board intends that the standards' application be limited to items that are material. "Materiality" has not been strictly defined in the accounting community; rather, it has been a matter of judgment on the part of preparers of financial statements and the auditors who attest to them. Presented below is the Board's position on the issue of materiality at this time.

> The accounting and reporting provisions of the Board's accounting standards need not be applied to immaterial items. The determination of whether an item is immaterial requires the exercise of considerable judgment, based on consideration of specific facts and circumstances.

Hierarchy of Generally Accepted Accounting Principles

The term "generally accepted accounting principles" has a specific meaning for accountants and auditors. The AICPA *Code of Professional Conduct* prohibits members from expressing an opinion or stating affirmatively that financial statements or other financial data "present fairly... in conformity with generally accepted accounting principles," if such information contains any departures from accounting principles promulgated by a body designated by the AICPA Council to establish such principles. The AICPA Council has designated FASAB as the body that establishes accounting principles for federal entities. The AICPA's hierarchy of generally accepted accounting principles in Statement of Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, governs what constitutes GAAP for all U.S. government reporting entities. The hierarchy lists the priority sequence of sources that an entity should look to for accounting and reporting guidance.

The FASAB standards provide GAAP covering most transactions for the federal government. However, agencies may engage in transactions that are not addressed by these standards. In that event, agencies should view the hierarchy as providing sources of GAAP for the federal government.

Statement of Federal Financial Accounting Concepts No. 1: Objectives of Federal Financial Reporting

Status

Issued	September 2, 1993
Volume I References	The objectives provide the framework for all standards; therefore, all SFFASs address objectives in the explanatory text.
Volume II References	
Interpretations and Technical Releases	
Affects	No other statements.
Affected by	SFFAC No. 3, Management's Discussion and Analysis, affects paragraph 81

Summary

This document is a conceptual statement on the objectives of financial reporting by the federal government. It focuses on the uses, user needs, and objectives of such reporting. The objectives are designed to guide the Board in developing accounting standards to enhance the financial information reported by the federal government to
(1) demonstrate its accountability, (2) provide useful information, and (3) help internal users of financial information improve the government's management. In addition to guiding the Board, the objectives may serve as useful guidance to others involved in federal financial reporting. For example, the objectives may be useful in developing accounting policy, designing reports, and writing narratives and notes to financial reports.

The objectives reflect the federal environment. They also consider many of the needs expressed by current and potential users of federal financial information. They provide a framework for assessing the existing financial reporting systems of the federal government and for considering how new accounting standards might help to enhance accountability and decision-making in a cost-effective manner.

The four objectives of Federal Financial Reporting are:

Budgetary Integrity—Federal financial reporting should assist in fulfilling the government's duty to be publicly accountable for monies raised through taxes and other means and for their expenditure in accordance with the appropriations laws that establish the government's budget for a particular fiscal year and related laws and regulations. Federal financial reporting should provide information that helps the reader to determine

- how budgetary resources have been obtained and used and whether their acquisition and use were in accordance with the legal authorization,
- the status of budgetary resources, and

- how information on the use of budgetary resources relates to information on the costs of program operations and whether information on the status of budgetary resources is consistent with other accounting information on assets and liabilities.

Operating Performance—Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities. Federal financial reporting should provide information that helps the reader to determine

- the costs of providing specific programs and activities and the composition of, and changes in, these costs;
- the efforts and accomplishments associated with federal programs and the changes over time and in relation to costs; and
- the efficiency and effectiveness of the government's management of its assets and liabilities.

Stewardship—Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial condition has changed and may change in the future. Federal financial reporting should provide information that helps the reader to determine whether

- the government's financial position improved or deteriorated over the period,
- future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due, and
- government operations have contributed to the nation's current and future well-being.

Systems and Control—Federal financial reporting should assist report users in understanding whether financial management systems and internal accounting and administrative controls are adequate to ensure that

- transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the purposes authorized, and are recorded in accordance with federal accounting standards;
- assets are properly safeguarded to deter fraud, waste, and abuse; and
- performance measurement information is adequately supported.

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Executive Summary

Introduction

1. This document is a conceptual statement on the objectives of financial reporting by the federal government. It focuses on the uses, user needs, and objectives of such reporting. Statements on concepts, such as this document, differ from statements of recommended accounting standards. Statements on concepts are more general than statements of standards and do not contain specific recommendations that would, when issued by the Board's sponsors, become authoritative requirements for federal agencies and auditors.

2. Instead, statements on concepts, after approval by the Board's sponsors, provide general guidance to the Board itself as it deliberates on specific issues. They also help others to understand federal accounting and financial reports.

3. The objectives are designed to guide the Board in developing accounting standards to enhance the financial information reported by the federal government to (1) demonstrate its accountability to internal and external users of federal financial reports, (2) provide useful information to internal and external users of federal financial reports, and (3) help internal users of financial information improve the government's management.

4. The objectives reflect the federal environment. They also reflect many of the needs expressed by current and potential users of federal financial information. They provide a framework for assessing the existing financial reporting systems of the federal government and for considering how new accounting standards might help to enhance accountability and decision-making in a cost-effective manner.

5. The FASAB notes that many information sources other than financial statements help to attain these objectives. The objectives relate to the management and financial reporting systems in the federal government in their entirely.

6. Listing the objectives does not imply a judgment about the extent to which they are now being attained. Indeed, it is presumed that the objectives are being met to some degree now. However, the federal government does not have an integrated mechanism for reporting

within the context of these objectives. The FASAB will consider where new accounting standards could make a useful and cost-effective contribution to improving the extent to which these objectives are attained.

7. The Department of the Treasury, the Office of Management and Budget, and the General Accounting Office expect that, to the extent possible, their reporting requirements will be aligned with the Board's objectives and standards.

Background and Rationale

8. The federal government derives its just powers from the consent of the governed. It therefore has a special responsibility to report on its actions and the results of those actions. These reports must accurately reflect the distinctive nature of the federal government and must provide information useful to the citizens, their elected representatives, federal executives, and program managers. Providing this information to the public, the news media, and elected officials is an essential part of accountability in government. Providing this information to program managers, executives, and members of Congress is essential to planning and conducting government functions economically, efficiently, and effectively for the benefit of society.

9. Financial reporting is not the only source of information to support decision-making and accountability. Neither can financial reporting, by itself, ensure that the government operates as it should. Financial reporting can, however, make a useful contribution toward fulfilling those goals.

10. The objectives apply to both internal and external financial reports. They are intended to improve the relevance,consistency, and quality of accounting and other data available for a wide variety of applications.

11. The FASAB and its sponsors believe that any statement of objectives of federal financial reporting must be based on the needs of those who use the reports. Those users include citizens, Congress, federal executives, and federal program managers. Current and potential users of federal financial information want information to help them assess how well the government is doing by answering questions regarding such topics as:

- **Budgetary integrity:** What legal authority was provided for financing government activities and for spending the monies? Were the financing and spending in accordance with these authorities?
- **Operating performance:** How much do various programs cost, and how were they financed? What outputs and outcomes were achieved? What and where are the important assets, and how effectively are they managed? What liabilities arose from operating the program, and how will they be liquidated or provided for?
- **Stewardship:** Did the government's financial condition improve or deteriorate? What provision was made for the future?
- **Systems and Control:** Does the government have cost-effective systems and controls to safeguard its assets? Is it able to detect likely problems? Is it correcting deficiencies when detected?

12. Concerns like these define the following objectives of federal financial reporting.

Objectives of Federal Financial Reporting

Budgetary Integrity

13. Federal financial reporting should assist in fulfilling the government's duty to be publicly accountable for monies raised through taxes and other means and for their expenditure in accordance with the appropriations laws that establish the government's budget for a particular fiscal year and related laws and regulations. Federal financial reporting should provide information that helps the reader to determine

    - how budgetary resources have been obtained and used and whether their acquisition and use were in accordance with the legal authorization,
    - the status of budgetary resources, and
    - how information on the use of budgetary resources relates to information on the costs of programs operations and whether information on the status of budgetary resources is consistent with other accounting information on assets and liabilities.

Operating Performance

14. Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity;[1] the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities. Federal financial reporting should provide information that helps the reader to determine

    - the costs of providing specific programs and activities and the composition of, and changes in, these costs;
    - the efforts and accomplishments associated with federal programs and the changes over time and in relation to costs; and
    - the efficiency and effectiveness of the government's management of its assets and liabilities.

Stewardship

15. Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial conditions have changed and may change in the future.

16. Federal financial reporting should provide information that helps the reader to determine whether

    - the government's financial position improved or deteriorated over the period,
    - future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due, and
    - government operations have contributed to the nation's current and future well-being.

Systems and Controls

17. Federal financial reporting should assist report users in understanding whether financial management systems and internal accounting and administrative controls are adequate to ensure that

    - transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the

[1]The FASAB has not yet considered criteria for defining, and terminology for describing, federal financial reporting components or units. In this document, therefore, the term "entity" is used in a generic way to refer, depending on the context, to the U. S. government as a whole; to organizational component units of the government, such as an agency; and to other kinds of potential reporting units, such as programs.

purpose authorized, and are recorded in accordance with federal accounting standards;
- assets are properly safeguarded to deter fraud, waste, and abuse; and
- performance measurement information is adequately supported.

Organization of the Statement

18. The first two chapters of this statement present background information on the Board and the federal environment. Chapter 3 identifies the four groups of current and potential users of federal financial reports and gives examples of some of their information needs. Chapter 4 states and explains the objectives of federal financial reporting in more detail than does this executive summary.

19. Chapter 5 explains some limitations of the standard-setting process within the context of user needs. Chapter 6 discusses the desirable qualitative characteristics of financial information. Chapter 7 explains how accounting supports federal financial reporting. Chapter 8 explains how financial reporting supports reporting on operating performance.

20. Appendix A sets forth the basis for the Board's conclusions. Appendix B presents a categorization of user needs according to types of information identified by the users rather than according to objectives. Appendix C lists some major federal reports that are regularly produced.

Chapter 1: Federal Financial Reporting And The Role Of The Federal Accounting Standards Advisory Board

21. Financial reporting by the federal government provides information for formulating policy, planning actions, evaluating performance, and other purposes. In addition, the processes of preparing and auditing financial reports can enhance the government's overall accountability structure by providing greater assurance that transactions are recorded and reported accurately, that consistent definitions are used to describe the transactions, etc. Thus, federal financial reporting helps to fulfill the government's duty to manage programs economically, efficiently, and effectively and to be publicly accountable.

22. Financial reporting is supported and made possible by accounting and accounting systems. "Financial reporting" may be defined as the process of recording, reporting, and interpreting, in terms of money, an entity's financial transactions and events with economic consequences for the entity. Reporting in the federal government also deals with nonfinancial information about service efforts and accomplishments of the government, i.e., the inputs of resources used by the government, the outputs of goods and services provided by the government, the outcomes and impacts of governmental programs, and the relationships among these elements.[2]

Role Of The FASAB In Federal Accounting And Financial Reporting

The mission of the FASAB is to recommend accounting standards [for the federal government] after ... considering the financial and budgetary information needs of congressional oversight groups, executive agencies, and the needs of other users of federal financial information.[3]

23. The FASAB and its sponsors believe that any description of federal financial reporting objectives should consider the needs of both internal and external report users and the decisions they make. This implies a different role for the FASAB than for the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The FASB sets financial

[2]Except where the context indicates otherwise, the term "government" in this document refers both to the U.S. government as a whole and to its component reporting entities, such as agencies and programs.

[3]From the FASAB Mission Statement, approved by the Board and by the Secretary of the Treasury, the Director of OMB, and the Comptroller General of the United States in l991.

reporting standards for privately owned entities in the United States. The GASB sets financial reporting standards for state and local governments.

24. Those Boards exist primarily to set standards for general purpose financial reporting to external users of financial reports. This is because those users, by definition, have limited ability to control the nature of the information made available to them. The FASB and the GASB do not need to weigh heavily managers' information needs because those individuals, by definition, are assumed to have ready access to the information they need about the financial transactions and events that affect the financial position, operations, and financial condition of the entities they manage.

25. The FASAB, on the other hand, considers the information needs of both internal and external users. In part, this is because the distinction between internal and external users is in many ways less significant for the federal government than for other entities. Officials who in theory should have ready access to information often find in practice that it is not available. Factors that contribute to this problem include the size and complexity of the government, the rapid turnover among senior political executives compared with the time required to install information systems in large bureaucracies, and the division of authority in the federal government.

26. The FASAB's dual concern, with both internal and external reporting, is the result of such factors and of the Board's mandate. The FASAB was created to advise OMB and Treasury (agents of the President) and the GAO (an agent of the Congress) on accounting standards for federal agencies and programs in order to improve financial reporting practices.

27. The Board's sponsors have separate constitutional and statutory authorities for setting accounting policy for the government. The division of powers in the U.S. government means that different policymakers with independent authority find it useful to have a mechanism to coordinate their accounting policy activities. The Board and its public deliberative process also provide a new arena for the participants to deliberate and to discover how federal accounting and financial reporting can be improved.

28. Just as the traditional distinction between internal and external report users is less useful in the federal context, some of the traditional ways of classifying financial *reports* are less relevant. Reports can be intended primarily for a designated special purpose or for general purpose use. In the federal government, as in most entities, internal financial reporting is designed for special purposes. Internal financial reporting helps managers to plan, conduct, and coordinate their activities and to evaluate the economy, efficiency, and effectiveness of their programs.

29. Much external federal financial reporting also is for special purposes, but some is for general purpose use; that is, it attempts to meet the common needs of many different users who have limited power to demand information directly. These reports are known as general purpose reports.[4]

Limitations Of Financial Reporting

30. The FASB and the GASB focus primarily on general purpose financial reporting because that is their mandate and reason for being. Even so, those Boards recognize that general purpose financial reporting is not the only source of financial information about such entities. In many cases, users of general purpose financial reports need to consult other sources to satisfy their information needs. This is no less true for the federal government.

31. While certain information is provided by general purpose financial reports, other information is better provided by, or can be provided only by, financial reporting outside such reports. Still other information is provided by nonfinancial reports or by financial reports about segments of the national society other than the federal government and its component entities (e.g., economic reporting).

32. Often, to satisfy the information needs of various individuals, it is necessary to combine and report financial and nonfinancial information. Often, combining information about the government with information about aspects of the national society is necessary to

[4]In state and local governmental accounting, the term "general-purpose financial statements (GPFS)" has a quite specific meaning. Standards published by the GASB define in detail the form and content of such reports. The term "general-purpose reports" is used in a more generic sense in this document to refer to a variety of federal financial reports.

assess past or planned governmental actions. For example, information about the number of people gainfully employed after participating in a vocational education program would be important both in assessing past governmental expenditures for training and in evaluating plans for similar new expenditures.

33. Some questions arise with special force regarding the nature of general purpose reports because, by definition, no user or potential user is able unilaterally to define the requirements for these reports. The FASAB is, by design, well constituted to consider the issues involved with such reports.

34. Federal accounting also must support special purpose reporting to the Congress, executives, and others that the FASAB represents. Indeed, most federal financial reporting is special purpose reporting. Also, the Board notes that traditional "general purpose" financial reports may serve a larger and more useful purpose for a variety of audiences if traditional designs for such reports are expanded to include a variety of reports addressing budgetary integrity, operating performance, stewardship, and control of federal activities.

Evolutionary Approach

35. The FASAB recognizes that developing and implementing standards that will contribute to achieving certain objectives may take considerable time. Time will be needed to establish information-gathering systems and to gain experience by experimenting with alternative approaches.

36. The FASAB expects that some of these objectives may best be accomplished through means of reporting outside general purpose financial reports. Indeed, the FASAB recognizes that information sources other than financial reporting, sources over which the FASAB may have little or no influence, also are important to achieving the goals implied by these objectives.

37. In developing specific standards, the FASAB will consider the needs of financial information users, the usefulness of the information in relation to the cost of developing and providing it, and the ability of accounting standards to address those needs compared with other information sources.

Background Information On Federal Financial Reporting

38. Different people are likely to talk about very different things when asked to describe federal financial reporting or federal accounting. A few examples will illustrate this point

39. **An economist**, when asked this question, is likely to refer to reports about the national society as a whole. Among the most important of such financial reports are the national income and product accounts (NIPA) that measure the nation's aggregate expenditures on currently produced output. Federal government expenditures, of course, constitute a significant fraction of the total expenditures in the economy. The NIPAs, as a system, emerged in the 1940s and were built on work done in the U.S. Department of Commerce beginning in the 1930s and earlier by private organizations.

40. The NIPAs provide a picture of the economic transactions that occur in an accounting period, such as a year. The approach is to provide such a picture through a set of accounts that aggregate the accounts belonging to the individual transactors in the economy—workers, businesses, and consumers, among others—whether or not formal accounting statements exist explicitly for all of them.

41. The NIPAs provide vital information to policymakers and others who are planning future actions and to individuals who would like to assess the effects of past actions. The NIPAs are recognized as an essential part of economic reporting by national governments. For this reason, the United Nations has developed the System of National Accounts (SNA). The SNA is a comprehensive, integrated, and internationally comparable statistical base for analysis in key policy-making areas, such as economic growth, inflation, and productivity.

42. This Statement does not deal directly with such accounts of the economic activity of the national society. The focus of this Statement is on accounting systems and financial reports that deal with the budgetary integrity, operating performance, and stewardship of the government as such; that is, of the government as a legal and organizational entity within the national society. However, to report on some aspects of the government's performance and stewardship, economic and other information about the national society is essential. Thus, the FASAB may consider whether such economic information should be included in certain financial reports, such as general purpose financial reports for the U.S. government as a whole.

43. **A financial analyst** on Wall Street, when asked about federal financial reporting, is likely to think of the "Daily Treasury Statement" and the "Monthly Treasury Statement of Receipts and Outlays of the United States Government." Some financial analysts study these Treasury reports regularly to assess the effect of cash flows on bank reserves and the size of the government's borrowing requirements. The federal government's borrowing is viewed as free of default risk because of the government's ability to tax and to create money. The power to tax depends on the government's willingness to tax and the strength of the economy.

44. From a longer-term perspective, it is true, however, that borrowers' expectations about such factors as future inflation and the relative value of the dollar compared with other currencies can influence the borrowing costs of the United States. Those expectations, in turn, may be influenced by the deficit reported or projected by the government, the current inflation rate, and other factors.

45. **Someone concerned with formulating or executing the U.S. budget**, when asked about the "federal accounting model," is likely to think of the budgetary accounting system. This is the system used to keep track of spending authority at various stages of budget execution from appropriation through apportionment and allotment to obligation and eventual outlay. This system is used by Congress and the executive branch for such purposes as "scoring" the budget and for assessing the economic implications of federal financial activity at an aggregate level. It also is used for planning and controlling government operations at more detailed, disaggregated levels. Of course, people involved with the budget also are informed by, and rely on, sources of information other than the budgetary accounting system, e.g., program evaluation and performance measures.

46. Although the FASAB does not recommend standards for the budget or budget concepts, part of its mission is to recommend accounting principles that will help provide relevant and reliable financial information to support the budgetary process. Furthermore, information about budget execution is essential to assessing budgetary integrity.

47. **Accountants working for the federal government, individuals auditing government programs, or students in a governmental accounting course** are likely to think first of what are known within

the federal government as the "proprietary" accounts and the reports prepared, in part, from information in them. These accounts are used to record assets and liabilities that are not accounted for in the budgetary accounts. These reports are said to present "financial position" and "results of operations" in accordance with some set of accounting standards. The FASAB is most directly concerned with these accounts and with the reports that are prepared, in large part, with information from them.

48. Attention to this and other aspects of federal accounting and financial reporting has been greatly increased by the Chief Financial Officers Act of 1990 (CFO Act). This act mandates improved financial management by requiring, among other things, (1) new financial organizations, (2) enhanced systems, and (3) audited financial reporting. However, the FASAB's area of concern is not limited to the reports required by the CFO Act.

Chapter 2: The Federal Accounting And Financial Reporting Environment

49. Financial reporting is an important, basic tool in the management and oversight of most organizations. It is particularly important for the federal government because of the government's fundamental nature and responsibilities and because the federal government operates with fewer external restraints than other entities. Federal accounting and financial reporting are shaped by, and need to respond to, the unique characteristics and environment of the federal government, as discussed below.

Sovereignty

50. The federal government is unique, when compared with any other entity in the country, because it is the vehicle through which the citizens of the United States exercise their sovereign power.[5] The federal government has the power through law, regulation, and

[5]The word "sovereign," much discussed by legal and political philosophers, is used here in its broad, popular sense to imply (1) internally that the people are the ultimate (if indirect) overseer or authority in the decision-making process of a democratic state and (2) externally that the state is autonomous or independent. As noted by one authority on the subject, either type of sovereignty, internal or external, implies that there is no higher agency. In a more limited sense, sovereignty is the power to make or change the law, a power exercised collectively by individuals and institutions operating in a complex system of relationships. See "Sovereignty," W. J. Stankiewicz, The New Encyclopedia Britannica, 15th. ed. (1976), vol. 17, pp. 309-313.

taxation to exercise ultimate control over many facets of the national economy and society. All other entities within the nation, both public and private, operate within the context of laws, oversight, and accountability established by the national government. The federal government is accountable only to its citizens. It is politically accountable to the electorate, but no higher agency has the power to demand an accounting from the government.

Separation Of Powers

51. Because of their concern about potential abuse of the national government's power, the founders designed a government characterized by the separation of powers. Each branch of government—legislative, executive, and judicial—is checked and constrained by the others. Paradoxically, this same separation of power can obscure responsibility and reduce accountability. The interrelated responsibilities of the legislative and executive branches, for example, can make it difficult to assign responsibility for the policies that are adopted.

Federal System Of Government

52. The federal system of government— comprising federal, state, and local levels of government—also makes it difficult to pinpoint accountability for many programs. The federal government's responsibility relative to that of the states has gradually expanded. The federal government has undertaken responsibilities in areas such as income redistribution, education, and health care. Often, however, the expansion has come without direct federal control over related operations. Responsibilities and financial resources of the three levels of government have become intermingled. Citizens are not clear about who is in charge, where to press for performance, and whom they should blame for bad results.

Responsibility For The Common Defense And General Welfare

53. The federal government is unique in that it has continuing responsibility for the nation's common defense and general welfare. As a result, the government's financial condition is necessarily a secondary consideration in many cases. For example, the nation would enter into military conflict to protect its vital national interests despite the fact that doing so would worsen an already large deficit. (Similarly, the government's greatest resource is one that it does not own but can tax: the national economy.)

54. Further, providing for the nation's general welfare is a broad responsibility that involves multiple goals. There is no single measure of success (like "return on investment" or "earnings per share"). Goals often are not explicitly defined in quantifiable terms and sometimes conflict with each other. Relevant measures of performance are usually nonfinancial. For example, many federal loan programs are charged with two conflicting goals: (1) to operate as a fiscally prudent lender and (2) to provide high-risk lenders with credit.

Power To Tax, Borrow, And Create Money

55. As stated, the federal government has unique access to financial resources and financing. It has the power to tax, to borrow, and to create money. These powers give the government a call on the underlying wealth of the United States—a vast but finite pool of resources.

56. There is no constitutional requirement to provide sufficient revenues to fund expenditures of the federal government. There is a statutory limit on the amount of U.S. debt. This limit is routinely increased by Congress and the President. The federal government's ability to finance its debt has not been constrained by capital market assessments of its creditworthiness. It is true, however, that the cost of servicing the U.S. debt now constrains the range of feasible fiscal and monetary policies more than was formerly the case.

57. The federal government—through the Federal Reserve—also has the power to create money and to control its supply.[6] This ensures that creditors will be repaid, at least in nominal terms. When the government's debt is large, it also provides a temptation to create money, as well as inflation.

Influence Of Organized Interests

58. Because of the size and nature of government programs, it is difficult for individuals to evaluate or to influence policies and actions of the federal government. Typically, individuals must organize to exercise influence. Small groups whose members are significantly affected by a common factor or concern can be organized relatively easily, but they may find it difficult to wield much influence. Large groups may be

[6]The Federal Reserve Board functions as a largely independent entity but is, of course, a government agency created by congressional action.

influential, but organizing them is difficult if the members have common but diffuse interests. Once organized, interest groups tend to perpetuate themselves.

59. As a result, most elected and appointed federal officials, and the groups to which they are responsive, have been interested primarily in information about individual government programs, functions, or activities. They have been less interested in information about the government as a whole and even less concerned about intermediate levels of reporting, such as individual departments.

Political System Versus Private Markets

60. The federal government is not subject to the discipline of competitive markets for private goods, services, and capital. Generally, transactions between citizens and the government are not individual exchanges between willing buyers and willing sellers. Taxpayers provide resources involuntarily, based on their consumption, wealth, or income rather than on their desire for particular government services. Even when user fees are charged, they often are not intended to represent market clearing prices—prices that would, in markets for private goods, balance supply and demand.

61. Thus, citizens as individuals have little say in selecting the public services they pay for. Decisions on what public services will be provided are collective decisions made through the political process. Politically influential recipients of benefits can force less influential non-recipients to bear the cost of the benefits.

62. Further, because most governmental revenues are not earned in individual, voluntary, exchange transactions, no private market directly measures the value of output. Consequently, the value added to society's well-being by government programs cannot be gauged by conventional measures of net income, nor is there much competitive market constraint on the quantity or quality of services provided. Instead, decisions about the quantity, quality, and value of public services are collective decisions made by the political process.

Assets

63. The government makes significant investments in assets, including public domain assets and large investments intended to produce growth (educational programs and research and development, for example).

64. In government, as in the private sector, assets are expected to provide benefits that outweigh costs. In the private sector, the notion of benefits is relatively straightforward: benefits are measured in terms of cash inflows. Assets are not acquired unless the value of expected cash flows exceeds acquisition costs.

65. In the government, this discipline does not usually exist. Expected benefits often are not cash inflows but rather are the services provided by the asset. Sometimes those services are provided to the government itself (e.g., government office buildings or motor pools). More often, the services are provided to the public (e.g., education and research and development).

Responsibility To The News Media

66. The federal government is subjected to, and should encourage, scrutiny by the news media. Because of the lack of external restraints and because the government's power ultimately resides in the citizens, it has a special responsibility to citizens and taxpayers to disclose its activities.

Importance Of The Budget

67. The budget is the most widely recognized and used financial report of the federal government. It is a principal surrogate for the missing external restraints discussed above. It is a vehicle for the political process to reach agreement on goals and to allocate resources among competing priorities. It provides a system for controlling expenditures. And it supplies information necessary for assessing the effect on the economy of the government's fiscal policies. The role of budgeting in financial reporting is discussed further in Chapter 7 under "Relationship of Financial Reporting to Budgeting."

Need For Special Control Mechanisms

68. The lack of external restraints noted above creates a need for special control mechanisms. Some mechanisms exist today. The most important, of course, are the political constraints and accountability imposed by regular elections and the separation of powers and the other constitutional constraints and accountabilities, such as the federal system and freedom of speech.

69. Accounting and financial reporting also play a role. Budgetary obligation accounting is used to control activities, primarily at the budget account level. Audited financial reports can provide users with

assurance that accounting systems are providing consistent and reliable data.

70. However, the need for improvement in financial reporting is widely recognized, as is the fact that financial information alone often is insufficient for decision-making. For example, financial information on costs often must be combined with nonfinancial information on performance to provide a basis for assessing the efficiency and effectiveness of government programs.

Chapter 3: Accountability And Users' Information Needs—the Foundation Of Governmental Financial Reporting

71. It may be said that "accountability" and its corollary, "decision usefulness," comprise the two fundamental values of governmental accounting and financial reporting. They provide the foundation for the objectives of federal financial reporting. Because a democratic government should be accountable for its integrity, performance, and stewardship, it follows that the government must provide information useful to assess that accountability. Similarly, because a democratic government is accountable for operating economically, efficiently, and effectively, for the purposes intended by citizens and their elected officials, certain other conclusions logically follow. Specifically, those who formulate, select, and implement government policies and programs need information useful for planning, controlling, and conducting government functions.

72. The assertion of accountability therefore leads to identifying, first, those to whom government is accountable and, second, the information needed to maintain and demonstrate that accountability. Accordingly, this Chapter first discusses the concept of accountability, then identifies the four groups of users of federal financial reports. It concludes by providing some examples of the information needs that may be addressed to some extent by federal financial reports.

Accountability

73. Several different kinds of accountability can be distinguished, and a given piece of information may be relevant in different ways to judgments about accountability. For example, one authority suggests that there are five levels or types of public accountability:

- Level 1 is policy accountability—selection of policies pursued and rejected (value).

- Level 2 is program accountability—establishment and achievement of goals (outcomes).
- Level 3 is performance accountability—efficient operation (efficiency and economy).
- Level 4 is process accountability—using adequate processes, procedures, or measures in performing the actions called for (planning, allocating, and managing).
- Level 5 is probity and legality accountability—spending the funds in accordance with approved budget and/or approved items (compliance).[7]

74. In a democracy, appointed officials are accountable to their superiors, and elected officials are accountable to the citizens for each of these kinds of accountability. Accounting and financial reporting can help elected and appointed officials to maintain and to demonstrate their accountability. The last kind of accountability listed, for "probity and legality," probably is the kind most often associated by the public with accounting. However, the accounting profession has long recognized that accounting can and should contribute to achieving and demonstrating several kinds of accountability, such as

- accountability for financial resources;
- accountability for faithful compliance or adherence to legal requirements and administrative policies;
- accountability for efficiency and economy in operations; and
- accountability for the results of government programs and activities, as reflected in accomplishments, benefits, and effectiveness.[8]

Users Of Federal Financial Reports

75. The Board believes that users of financial information about the federal government can be classified in four major groups: citizens, Congress, executives, and program managers.

[7]J. D. Stewart, "The Role of Information in Public Accountability," eds. Tony Hopwood and Cyril R. Tompkins, Issues in Public Sector Accounting (Oxford, Great Britain: Philip Allan, 1984), pp. 14-15, as cited by the GASB in its Preliminary Views on Service Efforts and Accomplishments Reporting (Dec. 1992).

[8]Report of the Committee on Concepts of Accounting Applicable to the Public Sector, American Accounting Association (1970-71), pp. 80-81, as cited by the GASB in Preliminary Views on Service Efforts and Accomplishments Reporting (Dec. 1992).

Citizens

76. This group includes individual citizens (without regard to whether they are taxpayers, voters, or service recipients). Citizens include the general news media and more specialized users, such as trade journals; public interest and other advocacy groups; state and local legislators and executives; and analysts from corporations, academe, and elsewhere.

77. Citizens are interested in many aspects of the federal government. They are concerned about individual programs, candidates for office, the services the government provides, and the fiscal responsibility of their elected and appointed representatives. Citizens receive and pay for government services and therefore are concerned with the outputs and outcomes of those services and the efficiency with which they are provided. Citizens are concerned about their families and, in particular, with the financial burden their children and grandchildren will inherit. As individuals, citizens typically have limited time and ability to analyze reports about their government; they want and rely on assurances that the government is functioning economically, efficiently, and effectively. As they are organized and represented by analysts working for interest groups and the news media, citizens want more information about the government's activities.

78. Citizens express their interest in the government by discussing issues, by voting, and by writing to their representatives about the quality and quantity of the services they receive. In some cases, citizens may decide whether and when to use services and products provided by the government. They may contribute to political campaigns, demonstrate support or opposition for individuals responsible for past and proposed government actions, and even run for office.

Congress

79. This group includes elected members of Congress and their staffs, including staff of the Congressional Budget Office (CBO) and the GAO. Congress is concerned with broad policies, priorities, and the programs that implement those priorities. It decides what taxes to impose, what funds should be spent, and for what purpose. Thus, Congress is concerned both with how to finance programs and with how they are executed.

80. Congress participates—along with the administration—in the basic decisions that describe the intent of government. Such decisions include passing laws in response to public demand, allocating resources among competing programs, and establishing policy that

affects various aspects of the country's economic and social life. These decisions often are influenced by assessing costs and benefits and by considering the effect of the government's aggregate financial requirements on the economy.

81. Congress also participates in monitoring government programs. It assesses the management performance of the executive branch and the efficiency and effectiveness of programs.

Executives

82. This group includes the President and those acting as his agents, i.e., program agency heads and their deputy, under, and assistant agency heads; heads of bureaus, administrations, services, and agencies; and the central agency officials in OMB and the Department of the Treasury.

83. Executives, like Congress, are concerned with the government's goals, objectives, and policies. Executives focus on the strategic plans and programs that are intended to achieve presidential and congressional goals and to implement their policies. In particular, they pay attention to budgets that, from the perspective of each agency, are the source of the resources needed to achieve goals and to implement policies. Executives are, of course, directly concerned about the management of programs, that is, with the actual delivery of services and with the efficiency and effectiveness of the delivery process.

84. Executives develop legislative proposals, recommend the necessary level of program funding, and formulate financing and revenue-raising strategies. They help select the method for delivering services. They determine whether program managers have been accountable for the resources entrusted to them and whether programs are operating efficiently and effectively. Executives also provide information that will enable the President and Congress to monitor programs.

Program managers

85. This group includes individuals who manage government programs. Their concerns include operating plans, program operations, and budget execution.

86. Program managers assist in the design of programs and organize the method selected for delivering services. They recommend program budgets based on detailed plans that set forth needs for money, staffing, facilities, and inventory.

87. Program managers establish operating procedures for their programs and manage them within the limits of the spending authority granted by Congress. They select, supervise, and evaluate personnel. They also make sure that program inventory and facilities are acquired economically, maintained adequately, and used efficiently. Program managers need to provide information to enable executives and Congress to monitor the programs.

The Needs Of Users Of Federal Financial Reports

88. While the financial information needs of these groups is more diverse than their membership, those needs can be categorized under four broad headings.

Budgetary Integrity

89. All user groups need information about the budget. For citizens, information about budget execution provides assurance that their elected and appointed representatives have fulfilled their most basic fiduciary responsibility: to raise and spend money in accordance with the law.

90. For the President's economic team and for congressional budget committees, information is needed on budget aggregates (total budget authority, total receipts and collections, and total outlays) to establish fiscal policy, including governmental financing needs. These officials need to know that prior-year "actuals" have been accurately recorded in accordance with the same budgetary principles used to prepare estimates.

91. To avoid violations of the Anti-Deficiency Act and the Impoundment Control Act, program managers need information about obligations incurred on their programs. They need periodic information about the status of budgetary resources, that is, the extent to which the resources have been used or remain available. They also want to know whether budgetary resources are available to be used for other purposes through reprogramming.

Operating Performance

92. Citizens want information about programs that affect them. Veterans, for example, want to know about new hospitals, and defense workers want information about contract awards (and cancellations). Retirees and people planning retirement—and their representatives in Congress—want to know that the Social Security Administration provides reliable services to the public.

93. Congress and executives want information about the comparative costs of programs (such as the per student cost of the Job Corps Program versus that of other job training programs). For comparisons to be valid, costs must be defined and measured alike.

94. Of course, information on the effectiveness of programs is also needed to make valid comparisons among programs. Information is needed about outputs (e.g., number of students who graduated) and outcomes (e.g., number of students who got and held jobs for which they were trained).

95. Executives and program managers need to know the cost of performing work reimbursed by other government entities or by nonfederal customers. Costs, in this case, would measure the resources (personnel, material, and equipment) used to accomplish the work.

96. Congress and executives often want cost information that would help to compare alternative courses of action. How much more or less would it cost if the Census Bureau used a new approach to taking the census? How much would be saved if an Army division were based in the United States rather than in Europe?

97. Program managers need information on the assets and liabilities related to operations. Managers of loan programs need information on the quality of their loan portfolios. Managers of repair depots want information on inventories, such as their value, quantity, location, age, and condition. Managers of government facilities need to know the facilities' condition and an estimate of future outlays made necessary by deferring needed maintenance.

98. Congress and executives need information about the market value of assets that could be sold, such as precious metals or other commodities.

Stewardship

99. Citizens, Congress, executives, and program managers need information to assess the effect of the government's activities on its financial condition and that of the nation. Information is needed about the financial outlook for both the short and the long term.

100. Information is needed on the government's exposure and risks associated with deposit insurance, pension insurance, and flood

insurance. People need to know about likely future expenditures for cleaning up nuclear weapons sites and military bases. They want information that will help them assess the likelihood and amount of future claims that might arise from government- sponsored enterprises.

101. All users need information on earmarked revenues recorded in trust funds. They want to know, for example, whether the Social Security Trust funds are likely, in the foreseeable future, to need infusions of new taxes to pay benefits. Citizens need to know the implications of investing trust fund revenues in government securities.

102. Users also need trend information on spending on investments in physical and human capital versus spending on consumption.

Systems and Control

103. Users at all levels need information on internal controls and the adequacy of financial management systems. Citizens want assurances that systems and controls are in place to protect the resources they supply to the government. They want to know that operating procedures and processes provide reasonable assurance that those resources are used economically and efficiently for the purposes intended. Congress, executives, and program managers need to demonstrate to those to whom they are accountable that they have, in fact, protected those resources and used them well. Users want to know, for example, that agency heads have determined that internal controls are adequate, that basic financial statements are auditable, and that high-risk areas have been identified and addressed.

104. The implications of these four broad categories of information needs for the objectives of federal financial reporting are discussed in more detail in the next Chapter.

Chapter 4: Objectives Of Federal Financial Reporting

105. The federal government derives its just powers from the consent of the governed. It therefore has a special responsibility to report on its actions and the results of those actions. These reports must accurately reflect the distinctive nature of the federal government and must provide information useful to the people, their elected representatives, and federal executives. Providing this information to the public, the news media, and elected officials is an essential part of accountability in government. Providing this information to program managers,

executives, and members of Congress is essential to planning and conducting the government's functions economically, efficiently, and effectively for the benefit of society.

106. Financial reporting is not the only source of information to support decision-making and accountability. Neither can financial reporting, by itself, ensure that the government operates as it should. Financial reporting can, however, make a useful contribution toward those objectives.

107. The objectives discussed below apply both to internal and to external financial reports. To some degree, they also apply both to special purpose and to general purpose reports. Users of general purpose financial reports may have difficulty obtaining relevant information to hold the federal government accountable if the government operates without appropriate reporting objectives and accounting standards. The Board also intends that these objectives and the ensuing standards will prove widely useful for other purposes, though they may not apply to every special report or every item in the accounting system. The objectives are intended to improve the relevance, consistency, and quality of accounting and other data available for a wide variety of applications.

108. The Board expects that its recommendations will be applied to improve information for program management and executive and legislative branch decision-making. The Department of the Treasury, OMB, and the GAO expect that, to the extent possible, their reporting requirements will be aligned with the Board's objectives and standards.

109. Four major objectives are proposed, around which accounting standards should be organized. These objectives are designed to help ensure the accountability of the federal government and to better inform decisions influenced by financial information about the government. Each objective reflects the federal environment and meets many of the needs expressed by current and potential users of federal financial information. Together, they provide a framework for assessing the existing accountability and financial reporting systems of the federal government and for considering how new accounting standards might be able to enhance those systems in a cost-effective manner.

110. Current and potential users of federal financial information want information to help them assess how well the government is doing by answering questions regarding topics like those below:

- **Budgetary Integrity:** What legal authority was provided for financing government activities and for spending the monies? Were the financing and spending in accordance with these authorities? How much was left?
- **Operating Performance:** How much do various programs cost, and how were they financed? What outputs and outcomes were achieved? What and where are the important assets, and how effectively are they managed? What liabilities arose from operating the program, and how will they be provided for or liquidated?
- **Stewardship:** Did the government's financial condition improve or deteriorate? What provision was made for the future?
- **Systems and Control:** Does the government have cost-effective systems and controls to safeguard its assets? Is it able to detect likely problems? Is it correcting deficiencies when detected?

111. Concerns like these define the objectives of federal financial reporting. In the following text, objectives and subobjectives are stated in bold italic type. Each of the objectives and subobjectives is followed by a commentary that explains some of the implications of the objective.

Budgetary Integrity

Objective 1

112. **Federal financial reporting should assist in fulfilling the government's duty to be publicly accountable for monies raised through taxes and other means and for their expenditure in accordance with the appropriations laws that establish the government's budget for a particular fiscal year and related laws and regulations.**

113. This objective arises generally from the responsibility of representative governments to be accountable for the monies that are raised and spent and for compliance with law. More specifically it arises from the requirement in Article I, Section 9 of the Constitution of the United States that "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular

Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." Its focus is the Budget of the United States Government, the President's annual budget submission to the Congress, which is the government's principal financial report, and the laws enacting budget authority for a given fiscal year. The Budget of the United States Government is the initial frame of reference within which Congress and the President enact the laws that require the payment of taxes and provide the authority to obligate and spend money.

114. The focus of this objective is retrospective. That is, the focus is on recording actual data from budget execution against appropriations made by Congress using existing budgetary standards. Thus, it would validate the "actual" column shown in the Budget of the United States Government. It would also provide data that could be shown in other reports as a statement of budget execution or a statement of the status of budgetary resources. The data also could be displayed in analytical tables showing, for example, the historical pattern of receipts and outlays.

115. Certain subobjectives arise from the basic objective of budgetary integrity, as discussed below.

Federal financial reporting should provide information that helps the reader to determine:

116. **1A. How budgetary resources have been obtained and used and whether their acquisition and use were in accordance with the legal authorization.**

117. Considering this objective in conjunction with the specific information needs identified by the Board suggests some examples of information that might help meet this objective:

- government receipts and offsetting collections reported in total and by composition;
- obligations according to the nature of services or items procured;
- information about the extent of compliance with the budget and laws, and whether money was expended as intended by the federal government and its grantees; and

- valid data on budget authority, obligations, and outlays by program and for all appropriation and fund accounts (summarized appropriately to fit the intended audience).

118. **1B. The status of budgetary resources.**

Examples of information that could help meet this objective include

- information about the sufficiency of budget authority for covering commitments and the status of obligated and unobligated balances of budgetary resources and
- assurances that funds authorized for a given purpose were actually spent for that purpose.

119. **1C. How information on the use of budgetary resources relates to information on the costs of program operations and whether information on the status of budgetary resources is consistent with other accounting information on assets and liabilities.**

120. This subobjective arises from the fact that accrual-basis measures of the cost of government programs, functions, and activities may differ from the amounts used in the budget for a variety of valid reasons.

121. Reports primarily intended to address objective 1 and its first two subobjectives would use budgetary measurement. Subobjective 1C would use both budgetary and accrual measures because reconciliation of the two is implied. The basic accounting unit for this objective would be the budget account, although accounts are often aggregated for some reporting purposes.

Operating Performance

Objective 2

122. **Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities.**

123. This objective arises from a democratic government's duty to be accountable to its citizens for managing resources and providing services economically and efficiently and for effectiveness in attaining

planned goals. Also, the government should be accountable for raising resources efficiently.

124. Because government services are not usually provided in exchange for voluntary payments or fees, expenses cannot be matched against revenue to measure "earnings" or "net income" as would be done in business accounting. Moreover, directly measuring the value added to society's welfare by government actions is difficult. Nonetheless, expenses can be matched against the provision of services year by year. The resulting cost can then be analyzed in relationship to a variety of measures of the achievement of results.

125. Certain subobjectives arise from the basic objective of reporting on operating performance, as discussed below.

Federal financial reporting should provide information that helps the reader to determine:

126. **2A. The costs of providing specific programs and activities and the composition of, and changes in, these costs.**

127. Examples of financial information that can help to address this objective include

- information on the costs of programs and activities;
- cost comparisons with estimates, with similar functions, with targets,[9] and over time; and
- relevant analyses of the composition and behavior of costs, such as full and incremental costs, fixed and variable costs, direct and indirect costs, and reimbursable and other costs, where appropriate.

128. **2B. The efforts and accomplishments associated with federal programs and the changes over time and in relation to costs.**

129. Examples of information that can help to address this objective include

[9]"Performance targets" specify the level of performance that is set as a goal by policy and program officials. Targets may be set in terms of outputs, outcomes, impacts, cost per unit of output, etc.

- financial and nonfinancial indicators of service inputs, outputs, and outcomes, including comparisons with goals;
- indicators of program efficiency and effectiveness;
- work load measures and unit costs; and
- total and marginal costs and benefits, the relationship of these to budget requests, and when the benefits will be realized.

130. **2C. The efficiency and effectiveness of the government's management of its assets and liabilities.**

131. This subobjective implies concern with the management of all federal assets and liabilities used by or under the control of agencies. Users of financial reports focus on the use of these resources in program operations, not solely on their financial value. Reports intended to address this objective would provide information to help users assess the efficiency and effectiveness with which

- cash is used;
- loan, loan guarantee, and other receivables programs are conducted;
- inventories of supplies, materials, and similar items are maintained; and
- forfeited and other tangible assets are handled.

132. Other examples of information relevant to this objective might include

- the service life and replacement cost of major systems and equipment;
- backlogs (and budgetary impact) of delayed maintenance, rehabilitation cost or replacement value of assets;
- the market value of forfeited and other assets, particularly those held for sale;
- the extent of unpaid expenses; and
- estimates (and ranges of estimates) of other known liabilities (such as leases or deposit and other insurance liabilities) and other exposures to loss.

133. Further discussion of performance measurement and how financial reporting can contribute to reporting on performance is provided in Chapter 8.

Stewardship

Objective 3

134. **Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial condition has changed and may change in the future.**[10]

135. This objective is based on the federal government's responsibility for the general welfare of the nation in perpetuity. It focuses not on the provision of specific services but on the requirement that the government report the broad outcomes of its actions. Certain subobjectives arise from the basic objective of stewardship, as discussed below.

Federal financial reporting should provide information that helps the reader to determine:

136. **3A. Whether the government's financial position improved or deteriorated over the period.**

Examples of information relevant to this objective include

- the amount of assets, liabilities, and net assets (or net position);
- an analysis of government debt, its growth, and debt service requirements;
- changes in the amount and service potential of capital assets; and
- the amount of contingent liabilities and unrecognized obligations (such as the probable cost of deposit insurance).

137. Assessing whether the government's financial position improved or deteriorated over the period is important not only because it has financial implications but also because it has social and political implications. This is because analysis of why financial position improved or deteriorated helps to explain whether financial burdens were passed on by current-year taxpayers to future-year taxpayers

[10]The concepts of "financial position" and "financial condition" are discussed in Chapter 7.

without related benefits. The latter notion is sometimes referred to as "interperiod equity."[11]

138. Viewed in this broader context, providing information to meet objective 3 and its subobjectives will help to satisfy the needs expressed by financial report users. It will also help to explain the issuance of new debt in relation to expenditures for activities with current benefits versus expenditures for investment-type activities that yield future benefits.

139. **3B. Whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due.**

140. Information about the results of past government operations is useful in assessing the stewardship exercised by the government. Users of financial reports also want help in assessing the likelihood that the government will continue to provide the current level of benefits and services to constituent groups, such as farmers, retirees, and the poor.

141. Information relevant to this objective may include disclosures of financial risks that are likely or reasonably possible from sources such as government-sponsored enterprises, deposit insurance, and disaster relief programs. It could also include information such as

- the long-term financial implications of the budgetary process,
- the status of trust funds, and
- backlogs of deferred maintenance.

142. Providing information of this kind may require the use of reporting mechanisms other than traditional financial statements. For example,

[11]In paragraph 61 of its first conceptual statement, *Objectives of Financial Reporting*, the GASB noted: "The Board believes that interperiod equity is a significant part of accountability and is fundamental to public administration. It therefore needs to be considered when establishing financial reporting objectives [for state and local governmental entities]. In short, financial reporting should help users assess whether current-year revenues are sufficient to pay for the services provided that year and whether future taxpayers will be required to assume burdens for services previously provided." GASB's Statement 11, *Measurement Focus and Basis of Accounting--Governmental Fund Operating Statements*, adds "Conversely, [a measure of interperiod equity] would show whether current-year revenues not only were sufficient to pay for current-year services, but also increased accumulated net resources."

special reports may have to be developed to demonstrate whether the level of a particular year's maintenance and rehabilitation expenditures resulted in an improvement or a deterioration of capital assets and infrastructure.

143. **3C. Whether government operations have contributed to the nation's current and future well-being.**

144. Objective 3, in general, and subobjective 3C, in particular, imply a concern with "financial condition," as well as "financial position." Financial condition is a broader and more forward-looking concept than that of financial position. Reporting on financial condition requires financial and nonfinancial information about the national economy and society, as well as about the government itself. For example, reports intended to help meet this objective might address users' needs for information about

- investments in (or expenditures for) research and development, military readiness, and education;
- changes in the service potential of infrastructure assets;
- spending for consumption relative to investments;
- opportunities for growth-stimulating activities; and
- the likelihood of future inflation.

145. Indicators of financial position, measured on an accrual basis, are the starting point for reporting on financial condition but must be supplemented in a variety of ways. For example, subobjective 3B might imply reporting, among other things, a current law budget projection under a range of alternative assumptions. Reports intended to achieve subobjective 3C might disclose, among other things, the contribution that the government is making to national wealth by financing assets that are not federally owned, such as research and development, education and training, and state-owned infrastructure. Information on trends in total national wealth and income is also important.

Systems And Control

Objective 4

146. **Federal financial reporting should assist report users in understanding whether financial management systems and**

internal accounting and administrative controls are adequate to ensure that

- **transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the purposes authorized, and are recorded in accordance with federal accounting standards;**
- **assets are properly safeguarded to deter fraud, waste, and abuse; and**
- **performance measurement information is adequately supported.**

147. This objective arises from the three preceding objectives, in conjunction with the fact that accounting supports both effective management and control of organizations and the process of reporting useful information. Indeed, accounting processes are an integral part of the management control system.

148. The ability to prepare financial reports that report all transactions, classified in appropriate ways that faithfully represent the underlying events, is itself an indication that certain essential controls are in place and operating effectively. The preparation of reliable financial reports also helps to ensure that reporting entities have early warning systems to indicate potential problems and take actions to correct material weaknesses or problems.

149. Sound controls over internal processes are essential both to safeguard assets and to ensure economy, efficiency, and effectiveness in many governmental programs.

150. Information relevant to this objective helps financial report users to determine whether the entity has established reasonable, cost-effective programs to safeguard assets, prevent and detect waste and abuse, and reduce error rates. An example of information that would address this objective is management's assertion about the effectiveness of the internal accounting and operational control system.

Chapter 5: Balancing Costs And Benefits In Recommending Standards

151. Users' information needs define financial reporting. Even so, the process of articulating financial reporting objectives and then recommending accounting standards is not a simple progression from canvassing users of federal financial information to recommending standards. This is partly because such users, when asked about their information needs, may give answers that are limited by their past needs and experiences. More fundamentally, it is because articulating objectives and recommending accounting standards necessarily involve judgments about the costs and benefits of producing more information or of reporting it differently.

152. The standard-setting process is further complicated by the fact that any given accounting standard can have many different kinds of effects that must be considered. For example, accounting standards can influence the activities of agency accountants and the auditors who review reports prepared by those accountants, as well as the decisions of those who read the financial statements. Thus, a standard may influence which physical assets are under accounting control and the extent of work the auditor does to provide assurance about those assets. The accountants' and auditors' reports, in turn, may influence various decisionmakers in different ways as they select policies regarding the assets and the systems used to control them, decide how to implement the policies, and evaluate the results.

153. The standard setter must, to some extent, be aware of these potential effects when considering the costs and benefits of any given accounting alternative. As an added complication, *the same piece of information* may be used in different ways for different decisions. In other words, there are different kinds of "use." In some cases, the information may be consciously used in well-defined ways; in other cases, it may subtly influence the way people see the world, understand their options, and assess their priorities.

154. For example, the size of the deficit may have a very specific meaning with quite explicit implications (e.g., sequestration) under certain rules for scoring the budget. The deficit may also influence the economy because it affects aggregate demand and the government's financing requirements in a variety of ways that economists can only partially explain and quantify. Finally, the deficit may influence people's perceptions of their own well-being or of the nation's financial condition in more subjective or symbolic ways that can affect both

private and collective behavior (e.g., willingness to undertake various new commitments, to pay more in taxes, or to accept reductions in program benefits).

155. Finally, as noted earlier, accounting and financial reporting cannot satisfy every need for information and accountability. For many purposes, other information sources and other techniques to maintain and demonstrate accountability are either essential or more cost-effective. This constraint pervades any discussion of the objectives of federal financial reporting.

Chapter 6: Qualitative Characteristics Of Information In Financial Reports

156. Financial reporting is the means of communicating with those who use financial information. For this communication to be effective, information in financial reports must have these basic characteristics: understandability, reliability, relevance, timeliness, consistency, and comparability.[12]

Understandability

157. Special purpose reports are prepared to meet the needs of specified users. Understandability is rarely a problem in such cases because mutual understanding of what information is needed can generally be assumed between report preparer and report user. Information in general purpose financial reports, however, should be expressed as simply as possible. Users of general purpose financial reports, including internal users, tend to have different levels of knowledge and sophistication about government operations, accounting, and finance.

158. To be publicly accountable, the federal government and its component entities should issue general purpose financial reports that can be understood by those who may not have a detailed knowledge of accounting principles. Those reports should include explanations and interpretations to help report users understand the information in the proper context. However, general purpose financial reports should not

[12]For the most part, these characteristics are similar to those described by the FASB and the GASB.

exclude essential information merely because it is difficult to understand or because some report users choose not to use it.

159. For reports to be understandable to different audiences, different reports may be necessary to provide information relevant to the needs of the expected report users, with suitable amounts of detail, explanation, and related narrative. To be fully intelligible, financial information in general purpose reports may need to be presented in relation to the goals, service efforts, and accomplishments of the reporting entity.

Reliability

160. Financial reporting should be reliable; that is, the information presented should be verifiable and free from bias and should faithfully represent what it purports to represent. To be reliable, financial reporting needs to be comprehensive. Nothing material should be omitted from the information necessary to represent faithfully the underlying events and conditions, nor should anything be included that would likely cause the information to be misleading to the intended report user. Reliability does not imply precision or certainty, but reliability is affected by the degree of estimation in the measurement process and by uncertainties inherent in what is being measured. Financial reporting may need to include narrative explanations about the underlying assumptions and uncertainties inherent in this process. Under certain circumstances, a properly explained estimate provides more meaningful information than no estimate at all.

Relevance

161. Relevance encompasses many of the other characteristics. For example, if the information provided in a financial report is not timely or reliable, it is not relevant. Information can, however, meet all other characteristics and still not be relevant. To be relevant, a logical relationship must exist between the information provided and the purpose for which it is needed. Information is relevant if it is capable of making a difference in a user's assessment of a problem, condition, or event. Relevance depends on the types of financial information needed by the various users to make decisions and to assess accountability.

Timeliness

162. In some circumstances, the mere knowledge that a report eventually will be made public can influence behavior in desirable ways, just as the knowledge that one's tax return might eventually be audited can influence the behavior of people when they report their income. In other circumstances, however, if financial reports are to be useful, they must be issued soon enough to affect decisions. Timeliness alone does not make information useful, but the passage of time usually diminishes the usefulness that the information otherwise would have had. In some instances, timeliness may be so essential that it requires sacrificing a certain amount of precision or detail; a timely estimate may then be more useful than precise information that takes longer to produce.

Consistency

163. Financial reports should be consistent over time; that is, once an accounting principle or reporting method is adopted, it should be used for all similar transactions and events unless there is good cause to change. The concept of consistency in financial reporting extends to many areas, such as valuation methods, basis of accounting, and determination of the financial reporting entity. If accounting principles have changed or if the financial reporting entity has changed, the nature and reason for the change, as well as the effect of the change, should be disclosed.

Comparability

164. Financial reporting should help report users make relevant comparisons among similar federal reporting units, such as comparisons of the costs of specific functions or activities. Comparability implies that differences among financial reports should be caused by substantive differences in the underlying transactions or organizations rather than by the mere selection of different alternatives in accounting procedures or practices.

Chapter 7: How Accounting Supports Federal Financial Reporting

165. This Chapter explains the focus of the FASAB's concern by showing how accounting supports financial reporting and thus how accounting standards recommended by the FASAB can influence federal financial reporting. This Chapter shows how the FASAB's recommendations can influence a wide variety of financial reports. Additionally, it lays a foundation for the discussion (in Chapter 8) of how financial reporting in general, and cost information in particular, contribute to

performance reporting. In effect, Chapter 7 outlines parts of a conceptual framework for federal accounting but is limited to those ideas, such as "financial position" and "financial condition," that will help readers understand the Board's proposed statement of objectives for federal financial reporting.

Financial Core Data

166. The accounting process begins with recording information about transactions between the government (or one of its component entities) and other entities, that is, inflows and outflows of resources or promises to provide them. These may involve flows of economic goods, cash, or promises. These comprise the "core" data of the accounting discipline. This initial step in the accounting process is depicted at the bottom of figure 1, in the box numbered 1. To enhance the usefulness of this core set of data about transactions with other entities, accountants make various accruals, classifications, interpretations, etc.

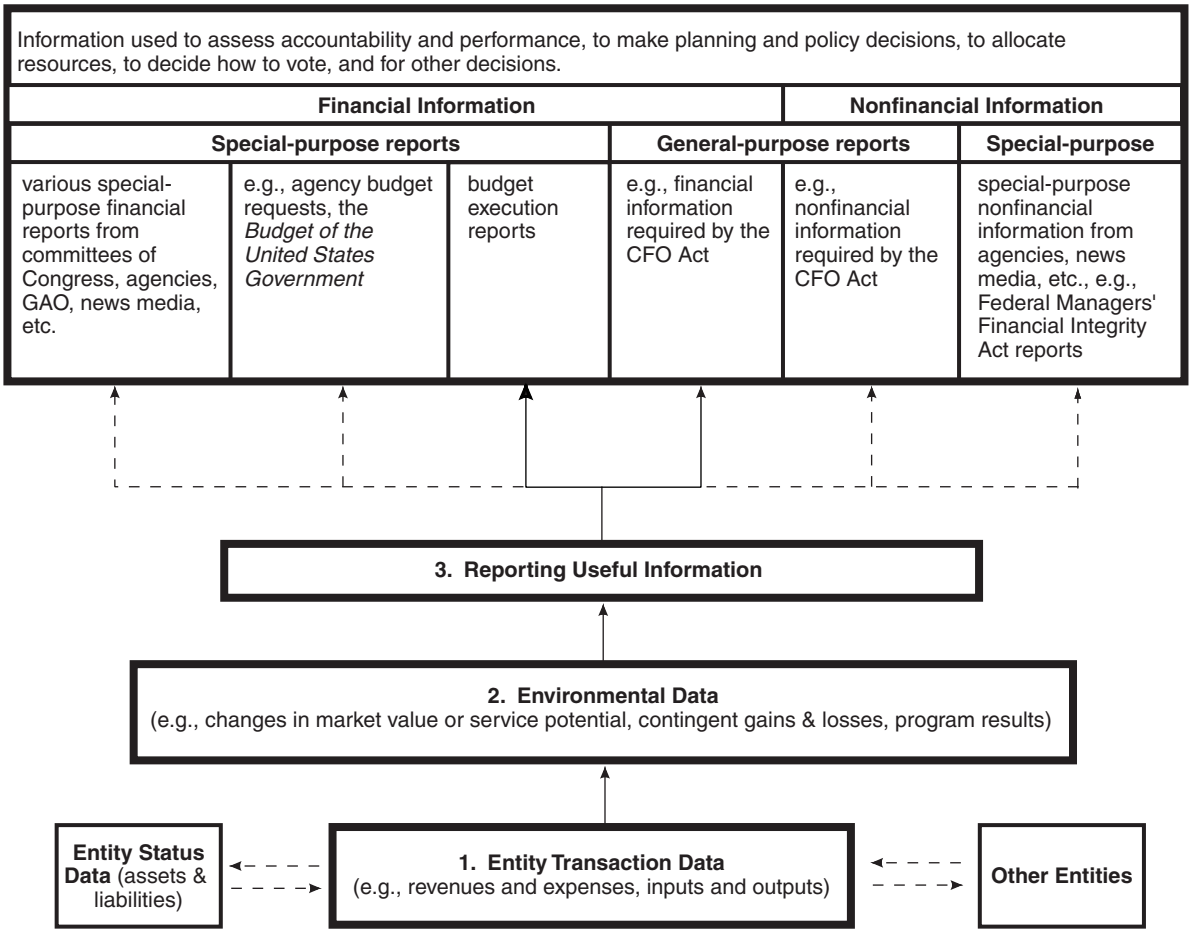
167. Many accounting entries recorded in the accountant's general ledger data base are such rearrangements of data about previously recorded transactions with other entities rather than new transactions involving flows of resources or promises between entities.[13]

168. In the branch of accounting called financial accounting, the most noteworthy interpretations or classifications are those about which data pertain to the past and which pertain to the future. In other words, financial accounting is largely concerned with assigning the value of past transactions to appropriate time periods.

169. Transaction data assigned to a period that has elapsed are said to be "recognized" in the statement of operations (or income statement), e.g., as an expense or a revenue of that period. Transaction data pertaining to the future are recognized in the statement of financial position (or balance sheet) as assets and liabilities.

[13]See William J. Schrader, Robert E. Malcom, and John J. Willingham, "A Partitioned Events View of Financial Reporting," *Accounting Horizons* (Dec. 1988), p 10-20. For a more academic exploration of the ideas involved, see Yuji Ijiri, "Theory of Accounting Measurement," S*tudies in Accounting Research #10*, American Accounting Association (1975).

Figure 1: How Accounting Contributes to Information Used by Citizens, Congress, Federal Exceutives, and Program Managers



170. Together with the statement of cash flows, the income statement (or statement of operations or activities) and the balance sheet comprise the three "basic" general purpose financial statements for privately owned entities. Other statements, such as a comparison of actual results with the budget, may be regarded as part of the basic statements for governmental entities.

171. At the initial stage of the accounting process, the information about assets and liabilities is merely the result of assigning all or part of the value of certain transactions to the future. "Assets" and "liabilities" at this stage are *not* statements about future benefits or sacrifices that can be proven or disproven. They are allocations of the cost of past transactions based on assumptions about future benefit and sacrifice.

172. This has been a common source of confusion when accountants communicate with nonaccountants, for whom the word "asset" typically implies something of value that can be sold or used. Much of the evolution of accounting under the FASB and the GASB has been to reduce this confusion, to improve communication, and to make financial reports more faithfully represent economic reality in terms meaningful to report users. This evolution has involved adding increasing amounts of information to the core set of transaction data. That process is discussed later.

173. In other words, the amount of "equity" or "net assets" based on the core data in a bookkeeper's trial balance is not a direct *measure* of either the market value or the service potential of the entity. In some circumstances, however, net assets can be a meaningful *indicator* of that value or potential. (The word "indicator" is used deliberately to avoid the implication of precision that may be associated with the word "measure.")[14]

174. Accounting data may be further assigned, allocated, or associated with units of activity or production, segments of organizations, etc., *within the same time period*. These kinds of *intraperiod* allocations are

[14]The term "measure" is commonly used in accounting literature regarding cost and in other literature (including the GASB's) regarding performance. This document follows that practice. In a conceptual discussion, however, it is important to note that "cost," "performance," and "financial condition" are all multidimensional concepts. It may be more precise to think in terms of multiple indicators that provide information about these concepts instead of a single-valued "measure" of any of them.

developed most extensively in the branch of accounting called cost or managerial accounting. Neither the FASB nor the GASB has devoted much attention to this branch of accounting, but the FASAB, because of its unique mission, will need to do so. One reason for performing cost accounting is to assist in performance measurement.

Nonfinancial Core Data

175. Traditionally, financial accountants record and describe transactions in terms of money. At the most detailed level, however, their records usually include information about the associated physical inputs and outputs of goods, labor, etc. This nonfinancial information is an important part of the data available for reporting and evaluating the economy and efficiency of the organization's performance.

Budgetary Core Data

176. In government the data on transactions with other entities include information on the budget authority, obligations, outlays, receipts, and offsetting collections for the transactions. This information is maintained in what are called budgetary accounts to distinguish them from the "proprietary" accounts that record other information on transactions. The budgetary and proprietary accounts at this level are said to be "integrated." In effect, they maintain information about different stages of a transaction.

Financial Environmental Data And The Concept Of Financial Position

177. The core set of accounting data is expanded with a variety of what may be called "environmental" data to distinguish them from the data that arise from transactions (flows of resources or promises) with other entities. Box 2 in figure 1 depicts this step of the accounting and reporting process. Many events within the environment of a reporting entity may have economic consequences for the entity. Examples of environmental data that may be relevant to financial reporting for some purposes include current market prices, net realizable values, changes in discount (interest) rates, and impairment of assets (either in terms of market value or in terms of service potential). Judgments about what environmental data should be added are made by considering the specific information needed for specific purposes.

178. At this level of the accounting and financial reporting process, the information reported in the balance sheet transcends bookkeeping. It can now represent more of what is known about future economic benefits and sacrifices. To the extent that this is accomplished, the

balance sheet may be said to represent the "financial position" of the reporting entity. The concept of financial position is that of a point-in-time snapshot of an entity's economic resources and the claims on those resources.

Nonfinancial Environmental Information

179. Nonfinancial information about program efforts, accomplishments, and outcomes may be collected and associated with the financial environmental data. This information is particularly important for governments because there is no direct analogue to "net income" or "earnings" to gauge the economy, efficiency, and effectiveness or net value of governmental activity.

The Concept Of Financial Condition

180. As more environmental data are added to the core data, a concept that is broader and more forward-looking than "financial position" emerges. That concept is "financial condition." For the U.S. government, the additional data could include financial and nonfinancial information about current conditions and reasonable expectations regarding the national and even the global society. For example, the expected implications of environmental degradation; the relative competitiveness and productivity of the U.S. economy; or expected changes in the population's composition in terms of age, gender, longevity, education, health, and income all might affect judgments about the government's financial condition.

181. Information about financial condition can be conveyed in a variety of schedules, notes, projections, and narrative disclosures. Among the most important of these is management's "discussion and analysis" of known trends, demands, commitments, events, and uncertainties. For federal reporting entities, management's discussion and analysis might address such topics as

- budgetary compliance;
- internal control systems;
- capital resources and investments;
- service efforts, accomplishments, and results of operations; and

- the reasonably possible future impact of known trends, risks, demands, commitments, events, or uncertainties that may affect future operations.[15]

182. Increasingly, managers and investors in the private sector are attending to other factors that may sometimes be useful indicators of an entity's financial condition, including such intangible factors as the quality of the entity's

- information and analysis capabilities,
- strategic planning,
- human resource development and management, and
- constituent satisfaction.

Similar factors may be relevant for many federal reporting entities.

Kinds Of Financial Information Needed And Provided

183. The information produced by these accounting processes supports the overall reporting process. Traditionally, the items of information included in financial statements are classified in various "elements" of financial reporting, such as "assets," "liabilities," "revenues," or "expenses." In future projects, the FASAB may consider the definition of elements of federal financial reporting. For the purposes of this Statement of Concepts, however, it is not necessary to do so. It is sufficient to note that needed financial information identified by some current and potential users of federal financial reports can be classified under six broad headings:

- information on the sources and uses of budgetary resources,
- information about operations and the related resources,
- information about the government's assets,
- information about the government's liabilities and financial responsibilities,
- information that addresses concerns with the future, and
- Information that discloses the levels of financial controls.

[15]Such a discussion and analysis is required in federal financial reports prepared pursuant to the CFO Act of l990. In these reports, the discussion and analysis is referred to as the "overview" section. OMB Bulletin 92-03 provides guidance on preparing the overview section.

184. Examples and further discussion of such information needs are provided in appendix B.

How This Information Flows Into Financial Reports

185. The core and environmental financial information, often supplemented with information from other sources, is the basis for a variety of general purpose and special purpose reports. For this reason, figure 1 culminates with the preparation of useful reports. A direct relationship exists between the accounting and reporting processes both for *general purpose* financial reports and for *budget execution* reports. The dotted line in figure 1 leading to other kinds of reports emphasizes that other kinds of information are often more heavily involved in producing them. Accounting contributes to these reports but has less influence over the nature, scope, and content of them. (Appendix C lists selected federal reports that are regularly prepared.)

Relationship Of Financial Reporting To Budgeting

186. "The budget" is a broad term that may include, among other things, a projection of spending authorities and means of financing them for a future period and a report of the actual spending and associated financing for a past period. The FASAB's recommendations may influence the reporting of actual budgetary data.

187. The Budget of the United States Government is the most widely recognized and used financial report of the federal government. The budget process is the government's principal mechanism for reaching agreement on goals, for allocating resources among competing uses, and for assessing the government's fiscal effects on economic stability and growth. Most attention is paid to these future-oriented roles of the budget.

188. Budget execution is designed to control and track tax receipts and the use of resources according to the purposes for which budget authority was approved. Actual receipts, obligations, and outlays are recorded by account, as is the status of budgetary resources at the end of each fiscal year.

189. Budgetary measurement is designed to assist in the control and allocation of resources by showing the cash outlays implied by each decision when the decision is made. In some cases, the budget now also includes accruals for costs in advance of the required cash outlay.

Budgetary concepts are under continual review. They may be changed by law or, after consultation with the Congress, in the annual revision of OMB Circular A-11, "Preparation and Submission of Budget Estimates."

190. The Board's authority does not extend to recommending budgetary standards or budgetary concepts, but the Board is committed to providing reliable accounting information that supports budget planning and formulation. The Board also supports efforts to ensure the accuracy and reliability of reporting on the budget.

191. The Board's own focus is on developing generally accepted accounting standards for reporting on the financial operations, financial position, and financial condition of the federal government and its component entities and other useful financial information. This implies a variety of measures of costs and other information that complements the information available in the budget. Together with budgetary reports, these reports will provide a more comprehensive and insightful understanding of the government's financial position, results of operations, and financial condition than either set of reports alone.

Chapter 8: How Financial Reporting Supports Reporting On Operating Performance

192. The second objective and its subobjectives concern reporting on performance. References to measuring cost pervade this objective and its supporting narrative. The topics of cost and performance measurement are related because it is by associating cost with activities or "cost objectives" that accounting can make much of its contribution to reporting on performance.

193. Setting performance targets is a function of management, not of accountants. That is, elected and appointed officials, including both program and policy officials, decide what the government will do, how much the government will do, and how it will be done. These officials consider the relevant constraints and other factors when establishing the performance targets. Measuring performance against those goals is an essential part of management. On the other hand, measuring cost is an important part of measuring performance, and measuring cost and reporting the results is a function of accounting and the financial reporting system. Financial reporting standards deal with what information is reported and how it is reported, not with the target levels of performance.

194. This Chapter first discusses cost measurement in general terms, then outlines a framework for reporting on performance to show how cost information can assist in that endeavor. Both cost measurement and performance measurement are complex subjects. Difficult problems arise during attempts to implement the ideas involved. For example, meaningful interpretation may require disaggregation of information, or adjustment of targets for differences in client characteristics, for local conditions, and for other factors beyond the government's control. Such problems are beyond the scope of this conceptual document. This Statement does not purport to present a comprehensive discussion of how to measure cost or performance. Neither does this Statement address the problems of implementation; it merely shows the relationship between financial reporting and performance reporting in conceptual terms.

Cost Measurement

195. As used in this Statement of Concepts, "cost" is the monetary value of the resources used. Thus far, the FASAB has considered the recognition and measurement of certain assets and liabilities that could influence the amount of cost recognized in a given period by a federal reporting entity. For example, the Board's Statement on *Accounting for Direct Loans and Loan Guarantees* implements accrual accounting for these programs, similar to the accrual budgeting mandated for them by the Credit Reform Act of l990.

196. A "cost objective" is a program, a function, an activity, an organizational subdivision, a contract, or another work unit for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capital projects, etc. The basic premise of cost accounting has been described by saying that the measurement, assignment, and allocation of costs to cost objectives should be based on the beneficial or causal relationship between those costs and the cost objectives. In defining the proper measurement, assignment, and allocation of cost for a given purpose, selecting the appropriate accounting method and whether to use full costing should be carefully considered.

Method of Accounting

197. The accrual basis of accounting generally provides a better matching of costs to the production of goods and services, but its use and application for any given purpose must be carefully evaluated.

Full Costing

198. Full assignment of all costs of a period, including general and administrative expenses and all other indirect costs, is an important basis for measuring cost of service. However, full cost is not necessarily the relevant cost for making all decisions. For example, incremental cost is more appropriate for many kinds of decisions, while opportunity cost is more appropriate for others. Similarly, cost that is controllable at a given management level is more appropriate for most evaluations of the performance of those managers. Accordingly, accounting systems should permit the calculation of the relevant costs needed for a range of decisions, as determined by the specific situation, and financial reports should reflect costs suitable to the purpose intended.

Performance Measurement

199. Performance reporting is broader than financial reporting, but good financial reporting is essential to support performance reporting. The GASB has identified three broad categories of measures for reporting on performance of state and local governmental entities: those that measure service efforts, those that measure service accomplishments, and those that relate efforts to accomplishments. Although some performance measures may not be clearly assignable to one of these categories, the categories are helpful for understanding how and where financial reporting can *contribute to* performance reporting by providing relevant financial information.

200. To clarify this relationship, the FASAB may wish to change or expand parts of the following discussion in future projects. At this time, however, the FASAB believes this basic framework is appropriate for the limited purpose of explaining how financial reporting can contribute to performance reporting.[16]

Measures of Efforts

201. Efforts are the amount of financial and nonfinancial resources (in terms of money, material, and so forth) that are put into a program or a process. Measures of service efforts also include ratios that compare financial resources with other measures that may indicate potential demand for services, such as the number of potential service recipients.

[16]The following discussion is based largely on the GASB's *Preliminary Views on Service Efforts and Accomplishments Reporting*, December, 1992.

202. **Financial information** includes financial measures of resources used. They include the cost of salaries, employee benefits, materials and supplies, contract services, equipment, etc., used in providing a service. The FASAB's exposure draft (ED) on *Accounting for Inventory and Related Property* is an example of how the FASAB's recommendations could affect information reported on resources used.

203. **Nonfinancial information** includes the following:

- Number of personnel: Because personnel are a major resource for many federal agencies and programs, indicators that measure the number of full-time equivalent employees or employee-hours used in providing a service often provide a significant measure of resources used.
- Other measures: These may include the amount of equipment (such as number of vehicles) or other capital assets used in providing a service. Because some federal programs use large amounts of capital assets, measures of the use of such assets can be important indicators of resources used.

Measures of Accomplishments

204. Measures of accomplishments report what was provided and achieved with the resources used. There are two types of measures of accomplishments—outputs and outcomes. Outputs measure the quantity of services provided. Outcomes measure the results of providing those outputs. For some kinds of programs, financial information can provide measures of accomplishments. For example, for some government business-type activities, just as for profit-seeking businesses, the revenue earned can be used as an indicator of accomplishments. In most government programs, however, the important indicators of accomplishments are based on nonfinancial information, as discussed below.

205. **Outputs**, which can be measured in these ways:

- Quantity of service provided: These indicators measure the physical quantity of a service provided.
- Quantity of a service provided that meets a certain quality requirement: These indicators measure the physical quantity of a service provided that meets a specified criterion or a set of criteria. (Quality requirements can also be defined and measured regarding inputs.)

206. **Outcomes**, for which indicators measure accomplishments or results that occur (at least partially) because of the service efforts. Some authorities use terms like "impact," "effect," or "results" to distinguish the change in outcomes specifically caused by the governmental activity from the total change in outcomes that can be caused by many factors. Though it is not always feasible, in theory performance evaluation should focus on results or effects in the sense of impacts, i.e., on the differences between program outcomes and the outcomes that would have occurred in the absence of the program. Results also include measures of public perceptions of outcomes.

207. Outcome measures are particularly useful when presented as comparisons with previous years, established targets, goals and objectives, generally accepted norms and standards (in the sense of "targets"), other parts of the entity, or other comparable entities.

208. Sometimes, the secondary and/or unintended effects of a service on the service recipients, community, or nation can be identified and may warrant reporting.

Measures That Relate Efforts to Accomplishments

209. For profit-seeking entities and for some business-type government programs, the amount of net income can be thought of as a single indicator that relates organizational efforts to accomplishments. For most government activities, however, relating efforts with accomplishments in a meaningful manner is more complex. Two types of such indicators are discussed below.

- Efficiency measures that relate efforts to outputs of services: These indicators measure the financial resources used or the cost (in dollars, employee-hours, or equipment) per unit of output. They provide information about the production of an output at a given level of resource use and demonstrate an entity's relative efficiency when compared with previous results, established goals and objectives, generally accepted norms or targets, or results achieved by similar entities.
- Effectiveness or cost-outcome measures that relate efforts to the outcomes or results of services: These measures report the cost per unit of outcome or result. They relate costs and results to help managers, executives, Congress, and citizens assess the value of the services provided by an entity.

210. As is evident, financial or cost information is an important component of both types of measures that attempt to relate efforts to accomplishments.

Limitations of Performance Measurement

211. Performance measurement is an essential part of good management, and performance reporting is an essential part of government accountability. Important limitations and difficulties associated with performance measurement and reporting should be noted, although they cannot be fully explored in a brief outline of the subject such as this. For example, performance usually cannot be fully described by a single measure, indicators of service efforts and accomplishments do not, by themselves, indicate why performance is at the level reported, and reporting quantifiable indicators can sometimes have unintended consequences.

212. For these and other reasons, the three categories of performance measures generally need to be accompanied by suitable explanatory information. Indeed, narrative information is an essential part of reporting on performance. Explanatory information includes both quantitative and narrative information to help report users understand reported measures, assess the reporting entity's performance, and evaluate the significance of underlying factors that may have affected the reported performance. (As noted, the reporting entity may be the federal government as a whole or any of its component reporting entities.) Explanatory information can include, for example, information about factors substantially outside the entity's control, as well as information about factors over which the entity has significant control.

Appendix A: Basis For Conclusions

Introduction

213. This appendix summarizes some of the considerations that were deemed significant by members of the Board in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and for rejecting others. Individual Board members gave greater weight to some factors than to others.

214. The Board used several methods to arrive at the knowledge base and conclusions that shape this Statement. Its staff conducted focus group discussions, interviewed users and preparers of financial information, and performed other research.

215. Based on this work, the Board published an exposure draft on January 8, 1993, as called for by the Board's rules of procedure. Forty-six letters were received in response. The Board also held a public hearing on the exposure draft on April 21-22, 1993, at which it received valuable comments.

216. The Board wishes to thank everyone who participated in the process.

Relationship Between Financial Reporting And The Budget

217. The Board considered whether it should modify the exposure draft's discussion of the relationship between financial reporting and the budget. Several respondents commented on this subject, but often in different ways. Some alluded to budgetary and proprietary (or "accrual" or "financial") accounting in a context that implied each should be on a different basis but reported in an integrated fashion. Others suggested that using the same basis for reporting and for budgeting was essential to achieve the objectives stated for federal financial reporting.

218. Many recommendations have been made over the years that information on expenditures be arranged to permit better perception of the relationship between the expenditures and national policy objectives. Some of those recommendations have related to the budget. Some have called for an "accrual-basis" budget. Those who would like to change the organization and/or the basis of the budget,

e.g., to more of a "program" organization or to more of an "accrual" basis, might regard financial reporting from a program perspective and/or on an accrual basis as a valuable first step before considering restructuring the budget.

219. Others may have fundamentally different views. For example, some believe there is merit in maintaining a distinction between accrual accounting and budgeting, except to the extent that those involved in preparing and approving the budget elect to use an accrual convention, as in the Credit Reform Act of l990. These persons believe that the budgetary basis of measurement should, in principle, sometimes be different from the accrual basis. They infer this from the different purposes of budgeting and financial reporting.

220. The Board concluded that there was no reason to change the discussion of this topic in this Statement, because the Board has no jurisdiction regarding the budget.

State And Local Governments And Other Nonfederal Entities

221. Some respondents expressed concern about the potential impact of federal accounting standards on state and local governmental accounting. These respondents would like to minimize the cost of compliance with federal requirements. To the extent possible, they would like to avoid the need to report on a basis different from that specified by the GASB. Presumably their comments dealt with general purpose reporting because grantees must now prepare various special purpose reports pursuant to the requirements of granting agencies, OMB, the Single Audit Act, etc.

222. The FASAB has no intent to recommend standards for general purpose external financial reporting by nonfederal entities. The FASAB's mission is to consider and recommend accounting principles for the federal government. The FASAB's work, therefore, will have no direct effect on nonfederal entities. It is true, however, that the FASAB's recommendations could eventually result in increased demand for information from recipients of federal funds. This could happen when such information was necessary for federal reporting entities to achieve the stated objectives of federal financial reporting. Such requirements would be "special purpose" reporting requirements, from the perspective of grant and contract recipients.

223. These requirements most likely would be imposed by program officials in contracts and grant agreements with the recipients of the federal funds. The Board acknowledges that the federal government has a responsibility to consider the cost imposed on nonfederal entities when making decisions to impose such requirements. At the same time, benefits to all entities and to all citizens involved also must be considered.

Reporting On Performance And Using Nonfinancial Information

224. Most respondents who addressed reporting on performance supported the exposure draft, but some thought the language was too encompassing. The Board concluded that their concern was stimulated in part by the wording of the first three objectives in the exposure draft. Each began with the phrase "federal financial reporting should assist . . ." However, each of these objectives subsequently included a phrase "Federal financial reporting should enable the reader to determine . . ." that perhaps implied more than the Board intended.

225. Accordingly, the Board substituted the phrase "provide information that helps the reader . . ." for "enable . . ." The Board also made certain other changes recommended by some respondents. In particular, the Statement now uses the phrase "performance target" to refer to desired levels of performance defined by elected and appointed officials. This term is used instead of "performance standard" to avoid possible confusion with "financial reporting standards," which deal with what information is to be reported in designated reports and with how it is reported.

226. The Statement also makes it clear that performance targets should be set by program and policy officials working together. Financial officials have a role to play in this process, especially where financial data are involved. That role is based on their expertise in cost measurement and their responsibility to ensure the integrity of the data.

227. One authority on public administration has explained the relationship in this way:

> Government accountants are responsible in part for capturing, reporting, and analyzing actual financial information important for both policy making and management. Policy analysts and

budget professionals deal primarily with what should occur and accountants deal primarily with capturing and recording what did occur. In addition, government accountants have auditors reviewing their work professionally to further ensure the integrity of the accounting process.[17]

228. The Board believes that accounting supports financial reporting and that, in the government, financial reporting goes hand in hand with accountability and performance evaluation. Financial accounting and financial reporting have a special role in assuring compliance with finance-related requirements for transactions. This is most directly relevant to objectives 1 and 4.

229. Financial reporting, however, also provides useful information about costs, assets, and liabilities. This information is especially relevant to objectives 2 and 3. Routine reporting of outputs, outcomes, and their costs is an important part of a performance monitoring system. Assessments of impacts (also referred to as effects, or results) specifically caused by governmental action are more likely to be performed in less-frequent program evaluations and special studies. Those studies draw upon the output, outcome, and cost information that is (or should be) more frequently published.

230. Federal accounting and financial reporting exist within the context of various laws intended to foster accountability and performance evaluation. Neither the FASAB nor federal financial reporting can independently accomplish the objectives of evaluating performance or assuring accountability, but they can contribute to achieving them. Furthermore, to make their essential contribution to these ends, accountants, auditors, and financial managers must understand the overall framework for achieving these objectives.

231. For nongovernmental entities, competitive markets for goods, services, and capital provide an independent assessment of the economy, efficiency, and effectiveness with which those entities use resources to meet their customers' needs. There is no similar proof of value for federal output independent of the political process. To report on the results of operations of a governmental entity, nonfinancial information is essential, in conjunction with financial information.

[17]Thomas D. Lynch, "President's Column," ASPA Times, vol. 16, No. 6 (June 1, 1993), p. 5.

232. In concept, this fact could imply that a complete financial report of a federal reporting entity should include indicators of economy, efficiency, and cost effectiveness if the report is to fairly present the entity's financial position and results of operations. Paragraph 164 notes that financial or cost information is an important component of both types of measures that attempt to relate efforts to accomplishments. In practice, the extent to which it is feasible and cost effective to present such information can be decided only after careful study of the specific circumstances.

233. While specific decisions will require further study, the Board notes its belief that any attempt to demonstrate accountability beyond probity (level 5) and process (level 4) requires performance measures.[18] The Board's user needs study, its public hearings, and similar sources of information suggest a widespread belief that the federal government needs to make a more systematic attempt to measure and report outputs, outcomes (including impacts), and the costs of producing them. To do this, the Board believes, accounting and financial reporting play an essential part throughout the cycle of planning, budgeting, financial management, and evaluation of federal activities.

Stewardship

234. A few respondents said that the stewardship objective described in the exposure draft was too broad. They felt that information on the effects on the nation of policy decisions was outside the scope of federal financial reporting. The Board concluded that this concern—like the preceding one regarding reporting on performance--stemmed in part from the wording and structure of the first three objectives in the exposure draft.

235. Accordingly, the Board substituted the phrase "provide information that helps . . ." for "enable . . ." As noted earlier, federal financial reporting cannot by itself accomplish the objectives of evaluating or assuring stewardship; it can only contribute to those goals.

236. The Board notes that the federal government has two levels of stewardship. One is for its own assets and liabilities and its ongoing ability to operate. The other is its constitutional responsibility for the nation's wealth and well-being. It is unique in this respect. If the

[18]Levels of accountability are discussed in Chapter 3.

nation's wealth and well-being are deteriorating, the government's financial condition is, or soon will be, deteriorating also—and vice versa. The financial condition of a sovereign national government and that of the nation itself are inextricably intertwined. Some information about the overall context must be provided, therefore, when reporting on the government as a whole, and perhaps when reporting on selected programs. As explained in Chapter 1, the FASAB does not recommend standards for economic reporting, but it may consider whether such information should be included in certain financial reports.

Systems And Control

237. Most respondents who addressed the fourth objective, originally titled "Deterring Fraud Waste and Abuse," supported the exposure draft, though some suggested that it could be phrased in a more positive fashion. Several emphasized the need for this objective and for standards to achieve it, but a few thought that internal control should not be regarded as an element of financial reporting. Others suggested that a separate objective on this topic was not necessary because it could be inferred from the other objectives.

238. The Board agreed that the objective should be stated in more positive terms. Accordingly, it replaced "Deterring Fraud, Waste, and Abuse" with the new heading "Systems and Control" and made other changes in wording the objective. With regard to the fundamental point, however, the Board continues to believe that systems and control are topics of sufficient importance and relevance to warrant addressing in their own right.

239. The Board's user needs study, public hearings, and other sources of information make abundantly clear that users want assurance that reported information is credible and reliable. They also want to know that reasonable controls are in place to deter fraud, waste, and abuse. Independent audit can help provide this assurance, but whether information is audited or not, effective systems and controls are essential to providing such assurance in a cost-effective way. Furthermore, effective systems and controls are essential to achieving the other objectives.

240. Perhaps the unique contribution of accounting-based reports for objectives 1 and 4 is the "core" accounting data base on transactions, especially on controlled transactions subject to finance-related

restrictions. Systems of accounting control are integral parts of this special role for financial reporting. Similarly, regarding objective 2 and, to some extent, objective 3, systems and controls are important because direct observation of outcomes and impacts is often infeasible or expensive. In these cases, reliance on accounting and administrative controls to ensure compliance with good practices and processes is often a cost-effective surrogate for trying to measure the value added by governmental activities.

241. Finally, the fundamental notion of accountability pervades the entire set of objectives. Effective systems and controls are essential prerequisites to accountable government. Thus, the Board regards systems and controls as an integral part of accounting, accountability, and financial reporting.

Dual Focus On Internal And External Users

242. Several respondents mentioned users, but no consensus about a change to the exposure draft was evident. For example, some respondents urged greater emphasis on the information needs of external users or on objectives of general purpose, external financial reporting. Others urged greater emphasis on information needs of lower-level program managers and employees. These comments are not necessarily contradictory, nor are the competing perspectives necessarily mutually exclusive. The Board continues to believe that it must consider both external and internal users. The Board itself is the agent of officials who, in turn, are agents of the public. This organizational fact contributes to the dual focus.

243. Also, as noted in Chapter 1, the distinction between internal and external users is not clear for the federal government. Except in degree of detail, virtually all federal financial information is of interest to at least some segments of the public.

244. The Board acknowledges that this dual focus will often create the need to balance various considerations to arrive at an optimal result. For example, as one respondent properly noted, there could be a danger of emphasizing what he termed “comparable consistency” for uniform reporting to users who want comparable information across agencies. He was concerned that this might interfere with “relevant customization” of information systems to meet the unique needs of agencies in response to their specific environments. It is understood

that "comparable consistency" of information is needed for some purposes and "relevant customization" for others.

245. The Board is primarily concerned with the former class of uses and reports, i.e., with ensuring the provision of comparable data where it is relevant and cost-effective to do so. Individual preparers often are not in a good position to judge the cost-benefit ratio of such information governmentwide. They are aware of the costs they incur to produce information, but they often are not aware of the potential benefit of producing that information. Neither are they in a position to establish standards that would produce such information.

246. On the other hand, there should be less need for outsiders like the Board or its sponsors to mandate relevant customization within agencies. Presumably each preparer can and will take care of that, provided that resources are available to do so and that there are no bureaucratic impediments.

247. In *concept*, therefore, there need be no conflict between "comparable consistency" and "relevant customization." Furthermore, in *theory*, properly designed accounting systems should facilitate both internal and external reporting. In *practice*, however, because administrative resources for information processing systems are limited and because new systems take time to install, externally-imposed requirements for comparable consistency could compete with addressing internally perceived needs for relevant customization. The Board acknowledges this trade-off. This is just one of many cost-benefit factors that the Board will need to consider as it addresses each specific issue in subsequent projects.

Objectives For Governmentwide And Component Entity Reports

248. Some respondents suggested there should be separate sets of objectives for governmentwide and component entity reports. Similarly, it might also be possible to distinguish objectives for reporting by organizational unit components from those for functional or program components. Alternatively, one might imagine separate sets of objectives for reports to different audiences. The Board concluded that different reports are likely to emphasize different objectives but that there is no need to prepare separate statements of objectives. The Board will give due consideration to variations in emphasis among the objectives for different types of reports in subsequent statements and projects.

Appendix B: Users' Information Needs Addressed By Federal Financial Reporting

249. This appendix is consistent with Chapter 3's discussion of users' needs for financial information. It represents an intermediate step in the Board's consideration of the financial reporting objectives implied by those needs. The appendix is included to aid the reader in understanding the reporting objectives by providing another perspective on the issues.

250. The financial information needs of the four user groups can be classified into six categories:

    1. Information on the sources and uses of budgetary resources
    2. Information about operations and the related resources
    3. Information about the government's assets
    4. Information about the government's liabilities and financial responsibilities
    5. Information that addresses concerns with the future
    6. Information that discloses the levels of financial controls

251. In some cases, the specific nature of the information would be basically the same for all four groups of users; only the level of detail would vary. For example, the amount of unobligated budgetary authority available to be obligated would be of interest to program managers wanting to avoid violations of the Anti-Deficiency Act and to executives wanting to know the availability of budgetary resources that can be reprogrammed for other purposes.[19]

252. In other cases, the specific nature of the information would vary, depending on the reporting entity, the report user and the use to which the information was put. For example, "error rates" could refer to errors in determining the monthly payment an individual was entitled to receive from the government or errors in calculating fees that a company was required to pay the government.

[19]"Obligations" has a meaning in federal accounting similar to that of "encumbrances" in state and local governmental accounting; that is, it reflects a reservation of appropriated spending authority that will be used to pay for a specific contract, a purchase order, or another item.

Information On The Sources And Uses Of Budgetary Resources

253. The budget is the starting point for the government's finances. All users want to know the makeup of the budget, i.e., the budget authority, the obligations, the outlays, the receipts and offsetting collections, etc. They want to know how the budget was executed and particularly whether it was executed in accordance with the appropriation statutes and other laws affecting the entity's finances. They want to know the status of the budgetary resources, including the extent of obligated and unobligated budget authority. Finally, they want to know the sufficiency of the budget authority for covering future commitments.

Information About Operations And The Related Resources

254. Accompanying the need for information about budgetary resources is a need for information about the operations of the government's programs. This includes information about the costs of the programs, classified in ways that provide further understanding, such as by program or activity, direct or indirect, fixed and variable, in comparison to estimates, or by object (e.g., personnel). Information that discloses unit, total, and marginal costs and changes in costs is also useful.

255. Cost information reflects the inputs for government services. Equally useful is information about the outputs, outcomes, efficiency, and effectiveness of government services, by themselves or in relation to a budget or goals, and any changes. This would include an identification of the periods in which the accomplishments would be realized. Such information helps form a basis for voting, funding, and management decisions.

Information About The Government's Assets

256. Financial statement users want considerable information about the government's assets. They want to know whether the balances in the trust and revolving funds will be sufficient for fulfilling the fund's purposes. They want to know the nature and amounts of receivables owed the government and whether the receivables will be paid. They are interested in the size and condition of the inventories and whether they can be used as intended or, if not, how much would be received for their disposition. There is much the users want to know about the government's physical assets: their value, their expected service life, the replacement costs, and the impact of the maintenance that has been deferred.

257. The government also holds assets as a custodian or only until the assets can be sold. Examples are seized or forfeited assets. Information about these assets helps to establish accountability for them and to make decisions about the best time and method for their disposal.

Information About The Government's Liabilities And Financial Responsibilities

258. Users want to know what the government owes and whether the amounts are short term and precisely definable, long term and only an estimate, or just a contingency related to an enterprise or activity that is not a direct and current government responsibility, e.g., government-sponsored enterprises. This information helps the reader assess the government's ability to continue to operate at its current levels over a period of time and/or whether a tax increase is likely.

259. The changes in the amounts owed from year to year are also important. The user often is willing to settle for (or may actually prefer) ranges rather than point estimates and/or net present values rather than nominal (undiscounted) amounts.

Information That Addresses Concerns With The Future

260. The federal government is responsible for the country's well-being. Its financial actions affect that well-being, both currently and in the future. Thus, users look not just for information to evaluate the condition of the trust funds upon which they rely for future security. They also want information to assess the likelihood of tax increases, service reductions, and changes in the inflation rate.

261. They therefore want information about possible sources of additional financial resources. They want to see the amounts of resources expended on consumption activities in comparison to investment activities, such as research and development. They want information on other growth-stimulating activities. On the other hand, they still want to be able to assess where spending can be reduced significantly.

262. Finally, they want to know the magnitude of the probable future deficits, the cost burden this will place on taxpayers, and the potential effect that this burden might have on the quality of life.

Information That Discloses The Levels Of Financial Controls

263. Because the government spends such large amounts of monies, taxpayers and other citizens are naturally concerned that the resources they supply are being protected from fraud, waste, and abuse and that the errors are minimal. They want to know that controls are in place and operating effectively and that problems are being quickly identified and corrected. They are particularly concerned that identified high risks are addressed and that adequate funds are devoted to eliminating the risk.

264. This concern is not just with the monies expended directly by the government. It also extends to the monies expended by the individuals and organizations that receive government contracts or grants.

Appendix C: Selected Federal Reports Prepared On A Recurring Basis

265. This appendix classifies some well-known reports according to the categories set forth in figure 1 in Chapter 7. Reports are classified according to whether they are primarily financial or nonfinancial and whether they have primarily a special or a general purpose. The classification is somewhat subjective. It is based on the general nature or emphasis of the reports. Many reports combine information and functions from different categories.

266. All these reports contribute to meeting the Board's reporting objectives for some users. However, many of the specific reports listed—economic reports dealing with the nation as a whole, for example—will be influenced only indirectly, if at all, by the Board's standards. Indeed, because they deal with transactors other than the government (such as private citizens and corporations, states and local governments, and not-for-profit entities), economic reports fit within the context of figure 1 only to the extent that they may provide information to assess the government's operating performance and stewardship.

Financial Information—Special Purpose

- Budget of the U.S. Government
- Analysis of the President's Budget Proposals (CBO)
- Economic and Budget Outlook Report (CBO)
- Economic and Budget Outlook Report Update (CBO)
- Midsession Review of the Budget
- Budget Enforcement Act Reports: Preview, Update, and Final Sequestration
- Request for Apportionment (SF 132)
- Report on Budget Execution (SF 133)
- Economic Report of the President
- Federal Reserve Bulletin
- OPM Forms 1351 A-D: Work years and personnel costs reports
- Prompt Payment Report

Financial Information—General Purpose

- Annual financial statement (principal financial statements, including footnotes and combining financial statements if applicable) required by the CFO Act on revolving funds, trust funds, substantial commercial functions, and pilot federal agencies
- Annual financial reporting by agencies required by Treasury (SF 220 series)

	• Prototype Consolidated Financial Statements of the U.S. • The U.S. Government Annual Report and Appendix (Treasury) • Monthly Treasury Statement of Receipts and Outlays of the U.S. • Monthly Statement of Public Debt • Daily Treasury Statement (on cash and debt)
Nonfinancial Information—General Purpose	• Annual departmental reports to the President and Congress • Nonfinancial information required by the CFO Act in the overview, supplemental information, and other portions of the reports
Nonfinancial Information—Special Purpose	• Reports required by the Federal Managers' Financial Integrity Act of 1982

Statement of Federal Financial Accounting Concepts No. 2: Entity and Display

Status

Issued	April 20, 1995
Volume I References	SFFAS No. 3, *Management's Discussion and Analysis* SFFAS No. 7, *Accounting for Revenue and Other Financing Sources*
Volume II References	
Interpretations and Technical Releases	
Affects	No other statement.
Affected by	Paragraphs 90-102, SFFAS No. 7, which affect paragraphs 64, 74, 105, 112 of this statement, and add Appendix I-G.

Summary

This concepts statement describes the basis for defining a reporting entity for the general purpose financial reporting performed by the Federal government and/or entities thereof. For any entity to be a reporting entity it should meet all of the following criteria:

- There is a management responsible for controlling and deploying resources, producing outputs and outcomes, executing the budget or a portion thereof (assuming that the entity is included in the budget), and held accountable for the entity's performance.
- The entity's scope is such that its financial statements would provide a meaningful representation of operations and financial condition.
- There are likely to be users of the financial statements who are interested in and could use the information in the statements to help them make resource allocation and other decisions and hold the entity accountable for its deployment and use of resources.

Criteria for including components in a reporting entity are also provided. A conclusive criterion establishes that any organization, program, or budget account (including off-budget accounts and government corporations) appearing in the Federal budget section currently titled "Federal Programs by Agency and Account" should be considered part of the Federal Government as well as part of the organization with which it appears. Indicative criteria are presented that should be considered when an organization is not listed in the "Federal Programs by Agency and Account" yet the general purpose financial statements might be misleading or incomplete if the organization where not included therein.

This concepts statement also describes the items that should be included in Federal financial reports and presents illustrative statements depicting desirable displays of financial information. The items include:

- management discussion and analysis;
- balance sheet;

- statement of net costs;
- statement of changes in net position;
- statement of custodial activities, when appropriate;
- statement of budgetary resources;
- statement of program performance measures;
- accompanying footnotes;
- required supplemental information pertaining to physical, human, and research and development capital and selected claims on future resources, when appropriate; and
- other supplemental financial and management information, when appropriate.

SFFAS No. 7, *Accounting for Revenue and Other Financing Sources*, amends the above list to include "statement of financing." SFFAS No. 7 also presents an illustrative statement of financing to amend the displays shown in Appendix A of SFFAC No. 2.

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Introduction

1. A basic postulate of accounting is that accounting information pertains to entities, i.e., circumscribed legal, administrative, fiduciary, or other organizational structures. Another basic postulate is that entities use financial reports to communicate financial and related information about the entity to persons concerned with the entity.

2. The purpose of this statement of accounting concepts is to provide guidance as to what would be encompassed by a Federal Government entity's financial report. The statement specifies the types of entities for which there ought to be financial reports (hereinafter called reporting entities), establishes guidelines for defining the makeup of each type of reporting entity, identifies types of financial reports for communicating the information for each type of reporting entity, and suggests the types of information each type of report would convey.

3. A statement of financial accounting concepts is intended to guide the members of the Federal Accounting Standards Advisory Board (FASAB) as they deliberate and recommend accounting standards for the Federal Government. It also would be useful to the Office of Management and Budget (OMB), when it carries out its statutory responsibilities for specifying who should prepare financial statements and the form and content of those statements;[1] and as broad guidance for preparers, auditors, and users of financial statements of Federal agencies. A statement of financial accounting concepts does not, in and of itself, represent standards that would be considered generally accepted accounting principles for Federal agencies to be followed for the preparation of financial statements.

4. This statement does not try to define which reporting entities must prepare and issue financial statements. That authority and responsibility resides with the Congress, OMB, and other oversight organizations and resource providers.

5. The specification of reporting entities intends to be suitable for all organizations within the Executive branch of the Federal Government,

[1]OMB specifies the form and content of agency and governmentwide financial statements, pursuant to authority assigned in the Chief Financial Officers Act of 1990, as amended (title 31, U.S. Code, section 3515(d) and section 331(e)(1)) through periodic issuance of OMB Bulletins. OMB intends to base the form and content on the concepts contained in this statement.

including the Departments, independent agencies,[2] commissions, and corporations. FASAB does not propose to recommend accounting concepts and standards for the Legislative and Judicial branches. However, the concepts recommended in this statement would be appropriate for those branches.

6. The concepts, as defined in this statement, are intended primarily for the general purpose financial reporting performed by Federal entities. This is the financial reporting that these entities would undertake to help meet the objectives defined in Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, "Objectives of Federal Financial Reporting." These objectives are as follows:

   - **Budgetary integrity.** Federal financial reporting should assist in fulfilling the government's duty to be publicly accountable for monies raised through taxes and other means and for their expenditure in accordance with the appropriations laws that establish the government's budget for a particular fiscal year and related laws and regulations.
   - **Operating performance.** Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities.
   - **Stewardship.** Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial conditions have changed and may change in the future.
   - **Systems and control.** Federal financial reporting should assist report users in understanding whether financial management systems and internal accounting and administrative controls are adequate to ensure proper execution of transactions, safeguard assets, and support performance measurement.

7. The concepts are also intended, as FASAB's mission statement requires, to help in meeting the financial and budgetary information

[2]"Independent agencies" is a term used to distinguish agencies that are independent of a Cabinet department from the agencies that are part of the Cabinet departments. Independent agencies report directly to the President and are part of the U.S. Government.

needs of executive agencies and Congressional oversight groups, and to strengthen the conceptual basis and consistency of Federal accounting data.

8. The entity and display concepts presented in this statement do not preclude the specification of ad hoc or temporary reporting entities to meet special reporting needs of users of Federal agencies' financial information. Nor do they preclude a reporting entity from preparing special purpose financial reports to meet the specific needs of persons in the reporting entity or in response to requests from persons outside the entity for certain financial information; or from preparing a so-called "popular report," which provides a simplified, highly readable, easily understandable description of a reporting entity's finances. These statements would not necessarily purport to be presented in accordance with generally accepted accounting principles.

Reasons For Defining Reporting Entities

9. The most basic reason for having an explicit understanding of what the reporting entity entails is to ensure that the users of the entity's financial reports are provided with all the information that is relevant to the reporting entity, subject to cost and time constraints. Clearly defining the boundaries of the reporting entity provides the users with a clear understanding of what the reporting entity encompasses. It helps to establish what information is relevant to the financial statements and what information is not.

10. Other reasons for having an explicit understanding of what the reporting entity entails are to:

- ensure that for the aggregation of information at each reporting level, no entity is omitted, and to provide for consolidations and/or combinations of information from reporting units at the same level, as appropriate;
- assist in making comparisons among comparable reporting entities by reducing the possibility of unintended or arbitrary exclusions or inclusions of entities;
- assist in making comparisons among alternative ways to provide similar services or products;
- be able to distribute costs properly and fully and to properly attribute the responsibility for assets and liabilities; and

- facilitate evaluating performance, responsibility, and control, especially where one agency is the provider or recipient of services attributable to or financed by another agency.

Structure Of The Federal Government

11. The Federal Government is an extremely complex organization composed of many different components. For accounting and reporting purposes, it may be viewed from at least three perspectives. However, the nature of each type of component and the relationships among the components and perspectives are not always consistent.

Organization Perspective

12. The first type of perspective is the **organization** perspective. The Federal Government is composed of organizations that manage resources and are responsible for operations, i.e., delivering services. These include the major Departments and independent agencies, which are generally divided into suborganizations, i.e., smaller organizational units with a wide variety of titles, including bureaus, administrations, agencies, services, and corporations. Many of these are further divided into even smaller suborganizations. On the other hand, there are small agencies for which division into smaller units is generally not considered appropriate.

Budget Perspective

13. From another perspective, the government is composed of accounts presented in the budget, hereinafter referred to as **budget accounts**. Budget accounts are composed of expenditure (appropriations or fund) accounts and receipt (including offsetting receipt) accounts. The size and scope of these accounts varies according to Congressional preference. They can vary from very small accounts, which are useful for constraining management, to very large accounts, which can be used to finance many activities.

14. Budget accounts are not the same as Treasury accounts. The latter are accounts established in the Treasury to, among other purposes, record the appropriations and other budgetary resources provided by statutes and the transactions affecting those accounts. For the most part, budget accounts are aggregations of Treasury accounts. Also, Treasury accounts include deposit accounts as well as budget accounts.

15. Nor are budget accounts the same as the uniform ledger accounts established by the U.S. Government Standard General Ledger (SGL). SGL accounts record specific homogeneous types of transactions and balances that aggregate to specific classifications on the financial statements. They have been established so that agencies can establish control over their financial transactions and balances, meet the basic financial reporting requirements, and integrate budgetary and financial accounting in the same general ledger.

16. A budget account may coincide with an organization or one or more of its suborganizations. Other times, several budget accounts need to be aggregated to constitute an organization or sub-organization.

17. Budget accounts are classified as federal funds or trust funds. Any account that is designated by the laws governing the federal budget as being a trust fund is so classified. Federal funds comprise the larger group and include all transactions not classified by law as trust funds. Three components make up federal funds: the general fund, special funds, and revolving funds. The definition of each of these categories can be found in the OMB circular A-11 and the GAO Glossary of Terms Used in the Federal Budget Process.

18. Care must be taken in determining the nature of all trust funds and their relationship to the entity responsible for them. A few trust funds are truly fiduciary in nature. Most trust funds included in the budget are not of a fiduciary nature and are used in federal financing in a way that differs from the common understanding of trust funds outside the federal government. In many ways, these trust funds can be similar to revolving or special funds in that their spending is financed by earmarked collections.

19. In customary usage, the term “trust fund” refers to money belonging to one party held “in trust” by another party operating as a fiduciary. The money in a trust fund must be used in accordance with the trust’s terms, which the trustee cannot unilaterally modify, and is maintained separately and not commingled with the trustee’s own funds. This is not the case for most federal trust funds that are included in the budget--the fiduciary relationship usually does not exist. The beneficiaries do not own the funds and the terms in the law that created the trust fund can be unilaterally altered by Congress.

20. Special funds and trust funds, except trust revolving funds, are aggregates of budget accounts. They normally consist of one or more receipt accounts and one or more expenditure accounts. Among the trust funds, social insurance programs (such as social security and unemployment compensation) have the largest amount of funds and federal employee programs (such as retirement and health benefits) the second largest. Together they make up about 90 percent of all trust fund receipts. Other trust funds include excise tax financed programs for highway construction, airports and airway operations, and other public works. Like other budget accounts, trust funds are usually the responsibility of a single organization, although sometimes they are the responsibility of more than one organization.

21. Budget accounts are also categorized, as mandated by law and defined by OMB, into functions and subfunctions that represent national needs of continuing national importance and substantial expenditures of resources. Examples of functions are national defense and health.

Program Perspective

22. From a third perspective, the government is composed of **programs and activities**, i.e., the services the organizations provide and the specific lines of work they perform. Each program and activity is responsible for producing certain outputs in order to achieve desired outcomes.

23. There is no firm definition for the term "program;" it varies in the eye of the beholder. For example, the Highway program could relate to the entire Federal highway program, the program to build interstate highways (in contrast to city streets, secondary roads, etc.), or a program to build a highway between two specific points. Moreover, in accordance with the sequester provisions of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, the House and Senate Appropriations Subcommittees annually define, in the Committee Reports, the meaning of "Programs, Projects, and Activities" as they relate to each of the Appropriations Acts.

24. The term "program" is also often used interchangeably with the terms "function" and "sub-function" (see paragraph 21). Generally, however, the term "function" would be used only for the functions defined in the budget. Otherwise, the term "program" would be used.

Intertwining Of The Perspectives

25. The programs are administered by the organizations and financed by the budget accounts. In a few instances, there is a one-to-one relationship among the three perspectives. A single budget account finances a single program and organization. Thus, the program is carried out only by the single organization and the organization performs only one program.

26. However, most programs are financed by more than one budget account, some of which might not be under the control of the organizational unit administering the program. Some programs are even administered by more than one organization. Likewise, a single organization or budget account could be responsible for several programs. In some instances, a program could also be considered an organizational unit, e.g., the Center for Disease Control and Prevention.

27. Furthermore, some of the support necessary to perform a program is frequently provided by other organizations and/or financed by other budget accounts. Examples are the computer support for a program that is obtained from a central unit within the department, or retirement health costs for a program's current and former employees.

28. This complex situation is the result of the evolution of Federal organizations, programs, and budgetary structures over many years. As Federal missions and programs have expanded and changed, new departments have been created, new organizations have been added to existing departments, and new duties have been assigned to existing organizations on the basis of various considerations. Similarly, the budget structure has evolved in response to the needs of the Congress; its committees and subcommittees; and various initiatives by the President, program managers, and interest groups.

Identifying The Reporting Entities For General Purpose Financial Reporting

29. As stated, reporting entities are entities that issue general purpose financial statements to communicate financial and related information about the entity. For any entity to be a reporting entity, as defined by this Statement of Federal Financial Accounting Concepts, it would need to meet all of the following criteria.

    - There is a management responsible for controlling and deploying resources, producing outputs and outcomes, executing the

budget or a portion thereof (assuming that the entity is included in the budget), and held accountable for the entity's performance.

- The entity's scope is such that its financial statements would provide a meaningful representation of operations and financial condition.
- There are likely to be users of the financial statements who are interested in and could use the information in the statements to help them make resource allocation and other decisions and hold the entity accountable for its deployment and use of resources.

30. Budget accounts, in and of themselves, do not meet the criteria in the preceding paragraph and, therefore, would not be considered a reporting entity for the purposes of issuing general purpose financial statements. Also, the size and scope of the budget accounts across all government agencies lack sufficient consistency for them to be universally considered as the reporting entity. Similarly, programs generally do not meet the criteria in paragraph 29 and, therefore, would not be a considered a reporting entity that prepares general purpose financial statements.

31. On the other hand, organizations, and particularly larger organizations, meet the criteria in paragraph 29. While the occasional overlap of programs and budget accounts among more than one organizational unit could complicate financial reporting, the association of data with the responsibility centers, revenue centers, profit centers, cost centers, etc. which managers typically use for organizing and operating permit the following:

    - aggregating information for not only the organization (and suborganizations), but also for one or more of the programs performed by the organization, and one or more of the budget accounts for which the organization is responsible, and
    - the subsequent arraying of the information not only by organization, but also by sub-organization, program, and/or budget accounts.

32. This approach to defining the appropriate reporting entities in the Federal Government supports establishment of accountability in the organizations (and suborganizations) while still enabling them to provide information pertaining to their programs.

33. Although a reporting entity might not control all the budget accounts used to finance one or more of the programs it administers, any revenues attributable to or costs incurred on behalf of the programs it administers should be associated with that reporting entity. This notion holds true regardless of whether the reporting entity maintains personnel on a payroll.

34. The departments and major independent agencies are organizational units and therefore would be the primary reporting entities. However, in many instances, financial statements that present aggregations of information into suborganization entities, i.e., bureaus, administrations, or agencies, may be more useful than statements that present only aggregations into organizational entities. The former can provide a better understanding of the financial results and status of the many individual suborganizations and programs constituting a department or major independent agency. They can reveal instances where programs are carried out by several suborganizations within the department or major independent agency.

35. Similar to other budget accounts, trust funds, special funds, and revolving funds are usually administered by a single organization. For financial reporting purposes, the organization would be the reporting entity; the trust fund or revolving fund would be a component of the organization that administers the fund in the same manner that a suborganization or other type of budget account is a component of the organization. This would not preclude separate reporting for the trust fund, special fund, or revolving fund by the managing organization, nor would it preclude disclosure of trust fund, special fund, or revolving fund information within the organization's report when there is sufficient interest.[3]

36. Likewise, some programs are coterminous, i.e., share the same boundaries, with an organization or sub-organization, while other

[3]For some trust funds, the collection of the revenues is performed by an organizational entity acting in a custodial capacity that differs from the organizational entity that administers the trust fund. In those instances, the organizational entity that collects the revenues would be responsible for reporting only the collection and subsequent disposition of the funds. The organizational entity responsible for carrying out the program(s) financed by a trust fund, or in the case of multiple responsible entities, the entity with the preponderance of fund activity, will report all assets, liabilities, revenues, and expense of the fund, notwithstanding the fact that another entity has custodial responsibility for the assets.

programs—such as student loan programs—are the component for which resources are deployed, are responsible for achieving objectives, and/or are of great interest to outsiders. In both instances, the financial operations and results of the program might warrant highlighting or even separate reporting by the organization or suborganization which manages the program.

37. Financial statements for organizationally-based reporting entities may be audited and issued to external parties, unaudited and used for internal management purposes, or, perhaps to be more relevant and meaningful, combined with financial statements from other organizationally-based reporting entities.

38. The ultimate aggregation of entities is into the entire Federal Government which, in reality, is the only independent economic entity—although some would say the entire country is the ultimate economic entity. The Federal Government entity would encompass all of the resources and responsibilities existing within the component entities, whether they are part of the Executive, Legislative, or Judicial branches (although, as noted in paragraph 5, FASAB's recommendations pertain only to the Executive Branch). The aggregation would include organizations for which the Federal Government is financially accountable as well as other organizations for which the nature and significance of their relationship with the government (see paragraphs 39 through 50) are such that their exclusion would cause the Federal Government's financial statements to be misleading or incomplete.

Criteria For Including Components In A Reporting Entity

39. Regardless of whether a reporting entity is the U.S. Federal Government, or an organization, suborganization, or program, there can be uncertainty as to what should be included and inconsistency as to what is included in the reporting entity. The identification and application of specified criteria can reduce this uncertainty and inconsistency.

40. The Governmental Accounting Standards Board (GASB) has established criteria for what would be included in a state or local government reporting entity. These criteria relate to financial accountability, which includes appointment of a voting majority of the organization's governing board, together with imposition of will, and financial benefit to or burden on a primary government. These criteria,

while in part relevant, must be tailored to the Federal Government environment. First, there are not as many different types of entities in the Federal Government as there are in state and local governments. Second, the Congress and others with oversight authority frequently establish explicit rules for what to include as part of a Federal reporting entity. Finally, as indicated, with the exception of the Federal Government as a whole, all the reporting units are components of a larger entity, namely the Federal Government, rather than independent economic entities.

Conclusive Criterion

41. There are two types of criteria that should be considered when deciding what to include as part of a financial reporting entity. The first is a **conclusive criterion**, i.e., an inherent conclusion that for financial reporting purposes, any organization meeting this criterion is part of a specified larger entity.

42. Appearance in the Federal budget section currently entitled "Federal Programs by Agency and Account" is a conclusive criterion. Any organization, program, or budget account, including off-budget accounts and government corporations, included in that section should be considered part of the U.S. Federal Government, as well as part of the organization with which it appears. This does not mean, however, that an appropriation that finances a subsidy to a non-Federal entity would, by itself, require the recipient to be included in the financial statements of the organization or program that expends the appropriation.

Indicative Criteria

43. There are instances when, for political or other reasons, an organization (including a government corporation), program, or account is not listed in the "Federal Programs by Agency and Account," yet the general purpose financial statements would be misleading or incomplete—in regard to the objectives for Federal financial reporting—if the organization, program, or account were not included therein. These organizations, programs, or accounts would normally be considered to be operating at the "margin" of what would be considered a governmental function in contrast to providing a more basic governmental function. Thus, in addition to the conclusive criterion, there are several **indicative criteria** that should be considered in the aggregate for defining a financial reporting entity in the Federal Government. No single indicative criterion is a conclusive

criterion in the manner that appearance in the "Federal Programs by Agency and Account" section of the budget is. Nor can weights be assigned to the indicative criteria. Thus, while the indicative criteria are presented in descending order of importance, judgment must be based on a consideration of all of the indicative criteria.

44. The indicative criteria for determining whether an organization not listed in the "Federal Programs by Agency and Account" section of the budget is nevertheless part of a financial reporting entity are as follows:

- It exercises any sovereign power of the government to carry out Federal functions. Evidence of sovereign powers are the power to collect compulsory payments, e.g., taxes, fines, or other compulsory assessments; use police powers; conduct negotiations involving the interests of the United States with other nations; or borrow funds for Government use.
- It is owned by the Federal Government, particularly if the ownership is of the organization and not just the property. Ownership is also established by considering who is at risk if the organization fails, or identifying for whom the organization's employees work.
- It is subject to the direct or continuing administrative control of the reporting entity, as revealed by such features as (1) the ability to select or remove the governing authority or the ability to designate management, particularly if there is to be a significant continuing relationship with the governing authority or management with respect to carrying out important public functions (in contrast to selections and designations in which there is little continuing communication with, or accountability to, the appointing official); (2) authority to review and modify or approve budget requests, budgetary adjustments, or amendments or rate or fee changes; (3) ability to veto, overrule, or modify governing body decisions or otherwise significantly influence normal operations; (4) authority to sign contracts as the contracting authority; (5) approval of hiring, reassignment, and removal of key personnel; (6) title to, ability to transfer title to, and/or exercise control over facilities and property; and (7) right to require audits that do more than just support the granting of contracts. (While many of these criteria exist in a client-contractor relationship, it is not necessarily intended that an entity's contractor be considered as part of the reporting entity.)

- It carries out Federal missions and objectives.
- It determines the outcome or disposition of matters affecting the recipients of services that the Federal Government provides.
- It has a fiduciary relationship with a reporting entity, as indicated by such factors as the ability of a reporting entity to commit the other entity financially or control the collection and disbursement of funds; and other manifestations of financial interdependency, such as a reporting entity's responsibility for financing deficits, entitlement to surpluses (although not necessarily the assets acquired from failed units), or the guarantee of or "moral responsibility" for debt or other obligations.

45. The entity or any of the above criteria are likely to remain in existence for a time, i.e., the interest in the entity and its governmental characteristics is more than fleeting.

46. In applying the indicative criteria, the materiality of the entities and their relationship with one another should be considered. Materiality should not be measured solely in dollars. Potential embarrassment to any of the entities' stakeholders should also be considered. Thus, a bias toward expansiveness and comprehensiveness would be justified, particularly if it could contribute to maintenance of fiscal control.[4]

Federal Reserve System

47. In establishing and monitoring monetary policy, the Federal Reserve System, i.e., the Board of Governors of the Federal Reserve System and the Federal Reserve Banks, could be considered as functioning consistent with the indicative criteria presented in paragraph 44. However, in the United States, the organization and functions pertaining to monetary policy are traditionally separated from and independent of the other central government organizations and functions in order to achieve more effective monetary and fiscal policies and economic results. Therefore, the Federal Reserve System would not be considered part of the government-wide reporting entity. Payments made to or collections received from the Federal Reserve System would be reported in the financial statements of the Federal

[4]Any uncertainty as to what to consider as a reporting entity would be resolved by OMB in consultation with the appropriate Congressional committees.

Government. Certain other disclosures might also be appropriate in the financial statement for the entire government.

Government Sponsored Enterprises

48. There are also several Federally chartered but privately owned and operated financial institutions that have been established as financial intermediaries to facilitate the flow of investment funds to specific segments of the private sector. These entities are called government sponsored enterprises (GSE). Examples are the Federal National Mortgage Association, the Farm Credit Banks, and the Federal Home Loan Banks. By law, each of these GSEs is subject to oversight from a specific Federal agency. However, they are not included in the Federal budget section entitled "Federal Programs by Agency and Account." Nor, as currently constituted, do they function in a manner consistent with the indicative criteria presented in paragraph 44. Thus they would not be considered part of the government-wide reporting entity nor the reporting entity to which they have been assigned for oversight.

49. On the other hand, there are "political expectations" associated with the GSEs, the most significant of which is an expectation that legislation would be enacted to support a GSE experiencing severe financial difficulties. (Political expectations are different than "moral obligations" established by many states. There is no statutory authority that defines whether and how a political expectation would be met. With a moral obligation, the manner in which it may be met is usually explicitly defined in statute.) Therefore, agencies assigned oversight responsibility for a GSE(s) would need to consider making disclosures of the government's relationship with the GSE(s) and other information that would provide an understanding of the possibility of a contingent liability.[5]

[5]The term government sponsored enterprise is also sometimes used in a broader manner to encompass other entities established by the Federal Government to further a public policy and that are also not included in the budget section "Federal Programs by Agency and Account." Examples are the Financing Corporation, Resolution Funding Corporation, Amtrak, and even, on occasion, the American National Red Cross. These entities have varied characteristics and different types of relationships to the Federal Government, and therefore, in some cases, may be included with the above mentioned GSEs in sections or tables of Federal budget documents. These entities need to be judged individually with respect to the indicative criteria presented in paragraph 39 in order to determine whether they should be considered part of a Federal reporting entity.

Bailout Entities

50. The Federal Government occasionally bails out, i.e., guarantees or pays debt, for a privately owned entity whose failure could have an adverse impact on the nation's economy, commerce, national security, etc. As a condition of the bail out, the Federal Government frequently obtains rights similar to the authorities associated with the indicative criteria presented in paragraph 44. The existence of these rights does not make the bailed out entity part of the Federal Government reporting entity or any of the other reporting entities that are part of the Federal Government. Disclosure of the relationship(s) with the bailed out entity(ies) and any actual or potential material costs or liabilities would be appropriate.

Other Aspects Concerning The Completeness Of The Entity

51. The application of specified criteria to delineate the reporting entity is one aspect of ensuring that the users of a reporting entity's financial reports are provided with all the information relevant to the reporting entity. However, because the only independent economic entity is the entire Federal Government, financial resources or free services are often provided from one component in the government to another component without a quid pro quo. For example, a portion of the retirement costs of Federal employees is reported by the Office of Personnel Management rather than the organizational entities employing the persons. Thus, within the parameters explained in paragraphs 52 and 53, it is important to ensure that the reporting entity's financial reports include amounts that are attributable to the reporting entity's activities, even though they are recorded elsewhere. This is particularly important for costs associated with the use of human resources; personnel services are such a major part of most government activities. It is also important for the costs of services provided by other reporting entities, such as computer services provided by another unit.

52. A process in which the reporting entity is billed and pays for the amounts attributable to its activities is normally the most desirable approach for recording and reporting these amounts. However, when this type of direct debiting or crediting is not done, the decision as to whether to capture and report attributable amounts would be based on such criteria as the magnitude of the attributable amounts, the decision usefulness of the information to its likely users, the costs of capturing the data, whether a decision would be made differently as a

result of having the information, and whether the information would have a policy impact.[6]

53. It might be appropriate to consider the interest expense inherent in devoting a sum of capital to an organization or program as part of the total costs incurred in operating the organization or performing the program. This principle has already been adopted for the accounting for loans and loan guarantees, whereby a loan program is charged for the cost of capital provided by the U.S. Treasury.[7]

Displaying Financial Information

54. Financial information is typically provided by or for a reporting entity through financial statements. Financial statements represent the principal means of communicating accounting information about an entity's resources, obligations, revenues, costs, etc. to those outside the entity. However, financial statements, and particularly those prepared for governmental and other not-for-profit organizations, may also contain information from sources other than accounting records. Also, management may communicate information to those outside the entity by means of financial reporting other than financial statements, either because the information is required to be disclosed by statute, regulation, or custom; or because management believes the information would be useful to those outside the entity and discloses it voluntarily.

55. To enhance confidence in the reliability of information presented in financial statements, the statements are often, but not always, audited by Inspectors General, independent accounting firms, or the General Accounting Office. Some financial reporting by management, both within and outside the financial statements, is audited, or is reviewed but not audited; and some information is presented by management without audit or review by persons independent of those who prepared the statements or information.

[6]The Board is developing a Statement of Managerial Cost Accounting Concepts and Standards. This document, when finalized, will address recognition of these amounts.

[7]The Board has decided to undertake a project addressing the types of capital for which it might be appropriate for a reporting entity to disclose the costs, the reasons thereof, and the manner in which to determine and report these costs. A determination of the appropriateness of considering interest expense as part of the costs incurred by an organization or program will be made by that project.

56. In the Federal Government, there are several types of reporting entities (organizations, suborganizations, programs, and the government as a whole) and several financial reporting objectives (budgetary integrity, operating performance, stewardship, and systems and control). Each of the reporting objectives can be met to a certain degree by the statements prepared by or for one type of reporting entity and to a greater or lesser degree by the statements prepared by or for the other types of reporting entities. For example, the objective of budgetary integrity can be best met with the program and financing schedules prepared for individual budget accounts. The objective of operating performance can be best met with financial statements from organizations/suborganizations and programs (although financial statements at this level can also help readers evaluate the reporting entity's budgetary integrity). The objective of stewardship can be best met with a financial statement for the entire government. Meeting the financial reporting objectives in their totality requires financial statements from all of the types of reporting entities.

Stock Statements

57. The financial reporting objectives are also met with different types of financial statements. A financial statement that presents financial information for an entity as of a particular point in time, however the information is measured, i.e., budgetary, cash, or accrual, is often characterized as a stock statement. An example of a stock statement is a **balance sheet**. It presents the total balances of assets, liabilities, and net position of an organization as of a specific time.

Flow Statements

58. Another type of financial statement provides information on an entity's flows of revenues, receipts, expenditures, expenses, gains, losses, and/or other changes of the entity's net resources during a period, however they are measured, i.e., budgetary, cash, or accrual. This type of financial statement is frequently characterized as a flow statement. The traditional flow statement is a statement of operations and changes in net position issued by private sector, profit seeking organizations. It presents the results of an entity's operations for a reporting period, including the changes in the entity's net position from the end of the prior reporting period. This type of statement is particularly useful for private sector, profit seeking organizations since their objective is to generate earnings and returns on investment. The statement of operations and changes in net position presents the revenues the entity receives, the expenses incurred to generate the

revenues, the amount left for the entity's owners, and the resulting effect on the owners' equity.

59. The Federal Government and most of the other reporting entities in the Federal Government are spending entities whose objective is to provide services, some of which are financed by revenues received from the recipients of the service, and some of which, if not all or most of which, are financed by taxes and other unearned revenues.[8] Thus, the most useful information a flow statement could present is the total and net costs of the services, i.e., how much of the services provided by the entity was financed by the taxpayers. This type of statement, which would be a **statement of net costs**, would support the achievement of Federal financial reporting objective 2A. Objective 2A states that "Federal financial reporting should provide information that helps the reader to determine the costs of providing specific programs and activities and the composition of, and changes, in these costs."

60. As indicated, revenues provided in exchange for the services, i.e., earned revenues, are not the only manner in which a Federal Government entity finances the services it provides. Other sources of financing are the appropriations received from the Congress, and such various non-exchange revenues as fines, donations, and transfers from other agencies. Therefore, another useful flow statement would be a **statement of changes in net position** that presents the manner in which the entity's net costs were financed and the resulting effect on the entity's net position. This also would be consistent with Federal financial reporting objective 2: "Federal financial reporting should assist report users in evaluating. . .the manner in which these efforts and accomplishments have been financed...."

61. The collection of the major sources of funds for the appropriations, e.g., taxes, royalty payments, and fines, is the responsibility of just a few reporting entities, especially the Internal Revenue Service, the Customs Service, and the Minerals Management Service. These entities are functioning in a custodial capacity and are required to turn the taxes or other monies they collect over to the Treasury or other

[8]The Board is currently developing an Exposure Draft entitled *"Revenue and Other Financing Sources"* which addresses more fully the types of revenues (i.e., exchange versus non-exchange and earned versus unearned revenues) discussed here.

organizations. The results of these entities' custodial activities could be reported in a flow statement that provides an understanding of from whom the taxes or other monies were collected and to whom they were distributed. This would be called a **statement of custodial activities**.

62. For many reporting entities, and particularly those engaged in reimbursable activities, it is useful to have an understanding of the sources and amounts of cash provided to the entity for operating, investing, and financing purposes and the major purposes for which the cash was used. This type of information can be displayed with a statement of cash flows, in accompanying footnotes, or as supplemental financial and management information.

Budget Statement

63. Meeting the first objective of SFFAC No. 1, "Objectives of Federal Financial Reporting," namely the budgetary integrity objective, necessitates that the reader receive assurance that

- the amounts obligated or spent did not exceed the available budget authority,
- obligations and outlays were for the purposes intended in the appropriations and authorizing legislation,
- other legal requirements pertaining to the account have been met, and
- the amounts are properly classified and accurately reported.

64. This information is provided in other reports, but there needs to be auditor involvement to provide assurance as to the reliability of the information. The assurance as to reliability of the information could be accomplished by including a **statement of budgetary resources** in the reporting entity's financial statements, recognizing that the statement will likely be subject to audit. The presentation of data could be for the reporting entity as a whole, for the major suborganization units (assuming there is congruity among the major suborganization units and the budget accounts), or for the aggregations of the major budget accounts, rather than for the individual budget accounts of the entity or other types of entities. Violations of budgetary integrity at the account level occurring during the current year could be disclosed on an exception basis. (Many violations of budgetary integrity would also be violations of the Anti-Deficiency Act. Disclosure in the financial statements

notwithstanding, these violations would also have to be reported as required by the Act.)

Performance Measures Statement

65. The second objective of Federal financial reporting states, in part, that Federal financial reporting should provide information that helps readers of the financial reports determine the efforts and accomplishments associated with Federal programs and the changes over time and in relation to costs. This suggests that a **statement of program performance measures**,[9] i.e., one or more statements presenting service efforts and accomplishments measures for each of a reporting entity's significant programs, is necessary.

66. The Federal Government is increasing its interest in measuring and reporting program performance, as evidenced by the enactment of the Government Performance and Results Act and increasing emphasis during budget reviews on program performance. Moreover, the ability to seek and obtain maximum return from increasingly limited resources can be enhanced by an understanding of the results of the programs for which budget resources have been expended. In the final analysis, the objective of the Federal Government is to provide services, in contrast to the objective of private sector organizations, which is to earn profits and enhance the return on investment, both of which are monetary objectives. All of these factors suggest that the statement of program performance measures is not only an appropriate statement, but likely to be the most important statement for those persons interested in how a Federal entity is using its resources.

67. For a statement of program performance measures prepared by an organization-level reporting entity, the outputs and outcomes would be related to the performance of the entity itself and its own programs, e.g., clients vaccinated, illnesses prevented. For the government-wide report, broader measures of outcomes and impacts that depended on the joint efforts of several reporting entities would be appropriate, e.g., state of the economy, national security, environment, personal health, social welfare, although some narrower outcome measures might also be included.

[9]The Board does not consider the Statement of Program Performance Measures to be a basic financial statement.

Other Information

68. Financial information is also conveyed with **accompanying footnotes**, which are an integral part of the financial statements. Footnotes typically provide additional disclosures that are necessary to make the financial statements more informative and not misleading.

69. It is also necessary to convey more general information about the reporting entity. This could entail such matters as a brief description of the reporting entity; its missions, goals, and objectives; the programs it provides and the major recipients for the program; its major sources of funding; the manner in which the reporting entity is organized; its personnel resources; highlights of the entity's accomplishments during the reporting period; selected measures of program performance abstracted from the statement of program performance; problems encountered or targets missed and the reasons why; financial highlights and trends; expected problems and challenges; future targets the entity is setting for itself; and any other information the agency head or CFO considers necessary to fully and fairly provide an understanding of the entity's financial affairs. This type of information is typically presented in what has come to be known as a **management discussion and analysis** or **overview** of the reporting entity.

70. The third objective of Federal financial reporting is that it "should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial conditions have changed and may change in the future.[10] This objective requires a reporting of information concerning investments in education, training, research, and development and certain types of property, plant, and equipment that can affect the nation's future wealth, and to the claims on future budgetary resources resulting from prior decisions and actions.

[10]A complete discussion of the third objective for Federal financial reporting, which is called the "stewardship objective," is contained in paragraphs 134 to 145 of Statement of Federal Financial Accounting Concepts No. 1, *"Objectives of Federal Financial Reporting."*

71. The information pertaining to the aforementioned investments, certain types of property, plant, and equipment,[11] and claims on future budgetary resources is maintained in part in the entities' general ledgers and, in part, external to the general ledgers. Some of the information is recorded in units other than dollars, e.g., acres, millions of square feet. Finally, some of the information is not subject to the types of controls present in a system of double entry recordkeeping. Accordingly, a more suitable way to fulfill the third reporting objective would be to display the appropriate information as **required supplemental information** rather than attempting to include it in financial statements.[12]

72. Finally, some reporting entities desire or need to report information to support information in the overview or to enhance the understanding of the entity's operations or financial condition. That additional information would not always be appropriate for the overview or the financial statements or accompanying footnotes. Examples are delivery times, turnover, and wastage of inventories; condition, maintenance, and expected replacement of physical capital; and delinquency, aging, and default rates for loan portfolios. This information is typically reported as **supplemental financial and management information**. It can be reported in the form of schedules, charts, tables, and/or narrative text.

73. The fourth objective, systems and controls, is fulfilled, in part, by the act of preparing the financial statements. Other ways the fourth objective could be fulfilled through the audited financial reporting process is by a management assertion that would accompany the financial statements and/or an auditor's attestation on the financial

[11]The Board is currently considering accounting standards for Federally-owned property, plant, and equipment. These standards will address placement of information related to various types of PP&E. The Board is considering placing information about some types of PP&E in footnotes with information about other types in required supplemental information. The Board's proposals will be presented in an exposure draft on stewardship reporting.

[12]Required supplemental information is information that would be reported outside the principal financial statements that the Federal Accounting Standards Advisory Board considers an essential part of a reporting entity's financial reporting, and therefore recommends authoritative guidelines for the measurement and presentation of the information. It is analogous to the required supplementary information discussed in Statement on Auditing Standards-AU Section 558.06, which addresses pronouncements of the Financial Accounting Standards Board and the Governmental Accounting Standards Board.

statements. The management assertion would be an acknowledgment of its responsibility for the accuracy of the information in the financial statements, the completeness and fairness of the presentation of the information, the accuracy of the information in all material respects, and the reporting of the information in a manner designed to fairly present financial position and results of operations. The assertion could also include a statement regarding the adequacy of the entity's systems and controls, accompanied by the auditor's concurrence with the assertion.

Financial Reporting For An Organizational Entity

74. Meeting the four objectives of Federal financial reporting in the most efficient manner suggests that reporting entities issue a financial report that would include the following:

- management discussion and analysis;
- balance sheet;
- statement of net costs;
- statement of changes in net position;
- statement of custodial activities, when appropriate;
- statement of budgetary resources;
- statement of program performance measures;[13]
- accompanying footnotes;
- required supplemental information pertaining to physical, human, and research and development capital and selected claims on future resources, when appropriate; and
- other supplemental financial and management information, when appropriate.

75. With some organizations, and even suborganizations, the activities of one or more programs or other components are as important to the readers of the financial statements as are the activities of the entity as a whole. This would be particularly true for a Department composed of many bureaus, administrations, agencies, services, etc., and particularly if their programs are dissimilar. In those instances, consideration should be given to the preferability of reporting the assets, liabilities, revenues, expenses, etc. of both the significant components individually and of the entity in its entirety. Hence, larger

[13]The statement of program performance measures is not a basic financial statement. Nevertheless, it is an important component of the financial reports.

organizations, and particularly those composed of many bureaus, administrations, agencies, etc., would prepare not only consolidated financial statements for the organizational entity, but also provide information pertaining to their individual significant components.[14] The information for the individual components could be provided with separate columns in consolidating financial statements[15] (with the information for the less significant components, and possibly the entity's management component, aggregated into a single separate column), in separate financial statements for each significant component, or in the accompanying footnotes. The significant components can be suborganizations or programs. If they are suborganizations, information regarding programs should be provided in some manner.

76. Furthermore, there are frequently instances when one or more of the suborganizations conduct a very visible or critical activity and there is a high level of public interest, e.g., Internal Revenue Service tax collection activity; maintains complex accounts with large fund flows, e.g., Defense Business Operations Fund; has major responsibilities for the appropriate use of earmarked taxes, e.g., Health Care Financing Administration; or its financial viability is of special concern to the Executive Branch or the Congress, e.g., deposit insurance funds. In those situations, it may be desirable for the sub-organization to prepare and issue a separate financial statement that is consistent with the concepts presented in this concepts statement.[16] In doing so, it would need to identify the parent entity and describe the sub-organization's relationship to the parent.

[14]Such components are similar to responsibility segments as referred to in FASAB Exposure Draft, *"Managerial Cost Accounting for the Federal Government"* (see pages 26-30). Responsibility segments are used to accumulate costs and outputs for major lines of activity.

[15]A **consolidated financial statement** presents the transactions and balances for a reporting entity's components in a single column. In arriving at the consolidated amounts, the transactions and balances among the entities are eliminated. A **consolidating financial statement** presents the information for the reporting entity's components as well as the consolidated amounts in individual columns. The elimination of the inter-entity transactions and balances needed to arrive at the consolidated amounts might or might not be presented in a separate column.

[16]Sub-organizations required by statute to prepare and issue a separate financial statement would, by definition, also need to do so.

77. The components of any reporting entity are likely to conduct transactions with other components in the reporting entity, other Federal entities, and persons and organizations outside the Federal Government. Likewise, they are likely to have assets due from and liabilities due to other Federal components and entities and to non-Federal persons and organizations. In reporting the transactions and balances of a Federal reporting entity in its entirety, it is conceptually desirable, although not always practicable, to eliminate the intra-entity transactions and balances. Factors to consider are the utility of the information for the entity in its entirety if the intra-entity balances are not eliminated, the misunderstanding that might result if the balances are not eliminated, and the cost-benefit of making the eliminations.[17]

78. Some of a reporting entity's components are likely to be required by law or policy to prepare and issue financial statements in accordance with accounting standards other than those recommended by FASAB and issued by OMB and GAO, e.g., accounting standards issued by the Financial Accounting Standards Board or accounting standards established by a regulatory agency. Those components should continue to issue the required reports. The reporting entities of which the components are a part can issue consolidated, consolidating, or combining statements that include the components' financial information prepared in accordance with the other accounting standards. They need to be sensitive, however, to differences resulting from applying different accounting standards that could be material to the users of the reporting entity's financial statements. If these differences are material, the standards recommended by FASAB and issued by OMB and GAO should be applied. The components would need to provide any additional disclosures recommended by FASAB and included in the OMB-issued standards that would not be required by the other standards.

[17]A reporting entity that eliminates none of the intra-entity transactions or balances and still desires to present the information for its individual components in separate columns could do so by preparing and issuing a **combining financial statement.** If the individual columns are added to a total column without elimination of the intra-entity transactions or balances, the total column would have to be labeled "Memorandum Only" to signify that it is not net of eliminations. Recognizing that the U.S. Standard General Ledger does not presently provide accounts for identifying intra-entity transactions, the decision as to when the information for a reporting entity other than the Federal Government as a whole should be presented in a consolidating financial statement rather than a combining financial statement would be specified by OMB in a Form and Content Bulletin.

Financial Reporting For The Entire Government

79. Readers of the financial statements for the entire government are likely to be concerned primarily with whether the government has been a proper steward. This can best be achieved with the preparation and issuance of the following:

- management discussion and analysis;
- balance sheet;
- statement of operations or net costs;
- statement of program performance measures;
- accompanying footnotes;
- required supplemental information pertaining to physical, human, and research and development capital and selected claims on future resources; and
- other supplemental financial and management information, when appropriate

80. The readers should be made aware of whether the financial statements for the entire government exclude any significant entities that are included in the budget or include significant entities that are not included in the budget.

81. Readers of the financial statements for the entire government are also likely to be concerned with the results of the budget process. This interest can be fulfilled by providing a comparison of budgeted and actual use of resources, presented on the same basis as the budget is accounted for; and a reconciliation of accrual-based operating results to the budget-based operating results. The budget would be the amounts included in the President's Budget or the Mid-session Review of the budget, whichever is appropriate.

82. The financial statements for the entire government could also be used to provide information on Presidential initiatives or crosscutting programs that is not available in financial statements for individual organizations or programs.

83. Because the government is a complete and integral economic entity, in contrast to the departments and major agencies whose components frequently have nothing in common other than belonging to the same department, it would be appropriate that the financial statement for the entire government be a consolidated financial statement. However, it might also be appropriate to display selected information for the components, funds, etc., either within the consolidated financial

statement, in accompanying footnotes, and/or as supplemental information.

Recommended Contents For The Recommended Displays

Balance Sheet

84. The elements most likely to be presented in the balance sheet of a Federal suborganization/organization, program, or the entire government would be as follows:

- **Fund Balance with Treasury**. This represents the amount in the entity's accounts with the Treasury that is available only for the purposes for which the funds were appropriated. It would also include balances held by the entity in the capacity of a banker or agent for others. (This classification would not be included in the financial statements of the U.S. Government.)
- **Cash and other monetary assets**. Cash consists of coins, paper currency and readily negotiable instruments, such as money orders, checks, and bank drafts on hand or in transit for deposit, amounts on demand deposit with banks or other financial institutions, cash held in imprest funds, and foreign currencies.
- **Investments**. While Federal agencies have the authority to invest, they are typically limited to investing in securities issued by the Department of the Treasury or other Federal entities. There could be instances, however, when an agency owns property or securities issued by state or local governments, private corporations, or government sponsored enterprises, primarily for the purpose of obtaining a monetary return.
- **Receivables**. These are the amounts that the entity claims for payment from others. Receivables can result from such activities as the sales of goods or services, the non-payment of taxes, the making of loans or loans assumed from defaults on previously made loan guarantees, the earning of interest, the advance or prepayment of monies, etc.
- **Inventories and related properties**. Inventories consist of tangible personal property held for sale, in the process of

production for sale, or to be consumed in the production of goods for sale or in the provision of services for a fee. Related properties that could be owned by a Federal program, suborganization or organization, or the entire government include operating materials and supplies, stockpile materials, seized property, forfeited property, and goods held under price support and stabilization programs.

- **Property, plant, and equipment**. Property, plant, and equipment (PP&E) have been defined in the Federal Government as tangible items owned by the Federal Government and having an expected useful life of greater than two years. Some PP&E are held by the Federal Government but not used to provide a service. They are in themselves a service. Examples are heritage assets such as monuments and museum collections; the service is the sense of tradition, understanding, and pride visitors receive visiting these sites. Information pertaining to these assets would not necessarily be displayed in the balance sheet, but rather as required supplemental information.[18]
- **Liabilities**. These are the amounts the reporting entity owes to others for goods or services received, progress in contract performance, defaulted guarantees, funds held as deposits etc. Because no liability can be paid without an enacted appropriation, some liabilities are funded while others are unfunded. Also, because the Federal Government is a sovereign entity, it can abrogate at any time many of its liabilities arising from other than contracts. This does not, however, eliminate the existence of, and therefore the need to report, liabilities incurred by the reporting entity.
- **Net position**. Net position is the residual difference between assets and liabilities. It is generally composed of unexpended appropriations and the cumulative results of operations. Included in the former would be appropriations not yet obligated or expended, including undelivered orders. Included in the latter would be the amounts accumulated over the years by the entity from its financing sources less its expenses and losses, which

[18]The Board issued an Exposure Draft, *Accounting for Property, Plant, and Equipment* (PP&E ED), on February 28, 1995 addressing those items of PP&E that would be reported on the balance sheet. The PP&E ED also proposes definitions for categories of PP&E that would not be reported on the balance sheet. In a separate ED, the Board will address other means of reporting on the non-balance sheet categories--possibly including separate basic financial statements and required supplemental information.

would include donated capital and transfers in the net investment of the Government in the reporting entity's assets; and an amount representing the entity's liabilities for such things as accrued leave, credit reform subsidies, and actuarial liabilities not covered by available budgetary resources.

85. Assets the reporting entity holds and has the authority to use in its operations should be displayed separately from assets the entity holds but does not have the authority to use. Likewise, liabilities for which budgetary authority has been received for liquidating the liabilities should be displayed separately from liabilities for which budget authority has not been received (even if the authority is expected). Assets and liabilities arising from transactions among Federal entities should be displayed separately from assets and liabilities arising from transactions with non-Federal entities.

Statement Of Net Costs

86. The main purpose of a statement of net costs is to provide an understanding of the net costs of each organization and each program that the government supports with taxes and other unearned monies. Another important purpose for the statement is to provide gross and net cost information that can be related to the amounts of outputs and outcomes for the programs and/or organization. Thus the statement of net costs should present the amounts paid, the consumption of other assets, and the incurrence of liabilities as a result of rendering services, delivering or producing goods, or carrying out other operating activities.

87. The costs can be classified in a reporting entity's statement of net costs by sub-organization (assuming the reporting entity is an organization), by program, or by object class, or any combination thereof. Object class, also referred to as a "natural" classification, represents the nature or types of goods or services acquired without regard to the organization involved or the program for which they were used. Reporting of the sub-organization incurring the costs and/or the purposes for which the costs were incurred generally provides more useful information than reporting on the types of goods or services acquired.

88. The statement of net costs should also present the revenues earned by each program and organization. The manner in which the earned

revenues would be presented would depend on the purpose of the program and the reasons why the revenues are present.

89. Some programs are established with generation of revenue as a primary consideration or purpose. One example would be when the goods or services provided by the organization are also available from the private sector and not charging a fee for the goods or services would be unfair competition. Another example would be when it is deemed appropriate that the persons or organizations receiving the goods or service pay for the goods or services, usually to be able to ascertain the true cost of the activity using the goods or services, e.g., the Defense Business Operations Fund, Postal Service. Still another example is when revenues are imposed to limit the unnecessary consumption of the goods or services. In each of these instances, the revenues earned by the program(s) should be considered a deduction from the total costs of the program(s).

90. With other programs, the revenues are generated from administering an inherently governmental service, which means the revenues are not a primary consideration for the program. Rather, the revenues are a means to recover all or most of the costs of administering the program, e.g., the Securities and Exchange Commission. In those instances, the revenues should be considered a deduction from the total costs of the organization, not the program.

91. In still other instances, an organization's revenues can be generated by providing a specific program, but the revenues are not a primary consideration in the conduct of the program; they are incidental to the purpose of the program, e.g., the sale of maps by the Geological Survey. In those instances, it would be appropriate to consider the earned revenues as a deduction from the incremental costs that need to be incurred in order to provide the goods or services that generate the incidental revenues, to the extent that the incremental costs are measurable and relevant to decision making. Otherwise the revenues should be considered a deduction from the program's or organization's total costs.

92. Earned revenues that are insignificant in amount can be netted into the costs of the programs with the amounts disclosed in accompanying footnotes, if appropriate.

93. An organization or sub-organization could receive different types of revenues for different purposes and/or reasons. Each of the revenues and associated costs would be displayed in accordance with the concepts presented in paragraphs 89 through 92.

94. The costs associated with and displayed for each program should reflect costs that can be directly traced to the program, assigned to the program based on cause and effect, or allocated to the program on a reasonable and consistent basis, consistent with the premise that any costs reported for a program should be controllable by the program to at least some degree. Those costs that are not directly traceable, assignable, or allocable could be considered program or management support costs that are incurred by the reporting organization or another organization to administer the reporting organization's or program's activities. For example, in a reporting entity that provides social services, the program costs would be the cash payments and the salary and other costs, e.g., rent, supplies, directly associated with persons providing counseling to the recipients of the cash payments. The organizational support costs would be the costs of the organizational structure required to administer the organization, i.e., not directly attributable to the programs provided by the organization.

95. Organizational and program management costs are necessary costs of operating an organization and programs. Not displaying these costs because of a belief that an allocation for these activities would be eliminated or reduced in order to obtain a reduction of the cost of the entire organization or program is illogical. The alternative concept, which is burying the management costs with the program costs, increases the likelihood that the management activity will be subject to reductions imposed on the program delivery activities. Separately identifying the management costs enables the use of resources for these activities to be justified on their own merit. The costs for managing the organization and/or program can therefore be displayed on the face of the financial statements or in accompanying footnotes, particularly when it would assist in evaluating operating performance and is cost-effective. Disclosure of what the support costs entail would be appropriate.

96. The total costs displayed in a reporting entity's financial statements should be the same as the total costs recorded by an organization in its cost accounting system. If, for financial reporting purposes, the organization does not allocate organizational management costs

among the programs, the total costs displayed for any one program in the entity's financial statements could be different than the costs recorded for that program in the cost accounting system.

97. Other earned revenues would include revenues not attributable to a specific program.

98. Costs and revenues arising from transactions with other Federal entities should be displayed separately from transactions with non-Federal entities.

99. The decision as to how to display total program costs, earned revenues, net program costs, and organizational and program management costs should be based, in part, on a consideration of what the Congress, management, and others might want to know about the costs of providing an organization's programs.

Statement Of Changes In Net Position

100. The appropriate elements for a statement of changes in net position would be as follows:

- **Net costs** display the amount that had to be financed by other than earned revenues.
- **Appropriations used** represent the amount of budget authority, including transferred budget authority, used by the organization to finance its operations.
- **Non-exchange revenues** include dedicated taxes, fines, and other revenues the Government is able to obtain due to its sovereign powers.
- **Donations** are monies and materials given by private persons and organizations to the Government without receiving anything in exchange.
- **Transfers in** are amounts of cash or other capitalized assets received by one Government entity from another Government entity without reimbursement.
- **Transfers out** are amounts of cash or other capitalized assets provided by one Government entity to another without reimbursement.
- **Imputed financing sources** are of two types: amounts equal to the costs that have been incurred by the reporting entity but financed by another entity, e.g., retirement costs; and amounts representing costs that are attributable to the reporting entity's

activities but that do not require a direct out-of-pocket payment, e.g., the interest costs associated with carrying inventory or investing in physical assets.[19]

- **Prior period adjustments** are corrections of prior period results of operations.
- **Increase (decrease) in unexpended appropriations** is the change in appropriated capital, including transferred budgetary resources, that does not affect the net cost of operations but does affect net position.
- **Net position-beginning of the period** is the total unexpended appropriations and cumulative results of operations held by the entity at the beginning of the reporting period.
- **Net position-end of the period** results from adding and netting the various amounts associated with the operations of the entity during the reporting period, including the net position-beginning of the period and any prior period adjustments. The amount will thus equal the total unexpended appropriations and cumulative results of operations held by the entity at the end of the period.

Statement Of Custodial Activities

101. A separate statement of custodial activities would be appropriate for those entities whose primary mission is collecting taxes or other revenues, particularly sovereign revenues that are intended to finance the entire Government's operations, or at least the programs of other entities, rather than their own activities. The revenues should be characterized by those agencies as custodial revenues. The statement should display the sources and amounts of the collections of custodial revenues, any increases or decreases in amounts collectable but not collected, the disposition of the collections through transfers to other entities, the amounts retained by the collecting entity, and any increase or decrease in the amounts to be transferred.

102. Custodial collections do not include deposit funds, i.e., amounts held temporarily by the government (e.g., bidders' earnest money or guarantees for performance) or amounts held by the Government as an agent for others, (e.g., state income taxes withheld from Federal employees' salaries that are to be transferred to the states). Both of

[19]The Board plans to undertake a project on the interest cost associated with investing in operating assets. At this time, no decision has been made on the recognition by individual entities of these types of costs.

these types of collections can be considered assets and liabilities until they are returned to the depositor or forwarded to the organization entitled to the funds.

103. Organizations that collect custodial revenues that are incidental to their primary mission do not need to report the collections and disposition of these revenues in a separate statement. The disclosure of the sources and amounts of the collections and the amounts distributed to others could be disclosed in accompanying footnotes.

Statement Of Budgetary Resources

104. The appropriate elements for a statement of budgetary resources prepared for a reporting entity would be as follows:

- **Budgetary resources made available** is the amount available to enter into obligations that will result in immediate or future outlays involving Federal Government funds. The resources should be relevant to the reporting period. The components of budgetary resources would include budget authority (i.e., appropriations, borrowing authority, and contract authority) and unobligated balances of multi-year and no-year money remaining from prior reporting periods. Budgetary resources would also include reimbursements and other income (i.e., spending authority from offsetting collections credited to an appropriation or fund account) and adjustments (e.g., recoveries of prior year obligations).
- **Status of Budgetary Resources** displays the disposition of the budgetary resources made available. It consists of the obligations incurred; the unobligated balances of multi-year and no-year budget authority that are available; and the unobligated balances of one-year and multi-year lapsed budget authority that are not available, but have been carried forward to be used only to record, adjust, or liquidate obligations chargeable to the appropriation. The total amount displayed for status should be equal to the total amount displayed as being made available.
- **Outlays** are payments to liquidate obligations, net of offsetting collections. Obligations are usually liquidated by means of cash payments (currency, checks, or electronic funds transfers), but in certain cases obligations are liquidated and outlays recorded even though no cash is disbursed. It would be appropriate, in displaying outlay information, to tie it to the obligations incurred

by also displaying the transfers of obligations and the obligated balances at the beginning and end of the period.

105. Budgetary resources, obligations, outlays, and receipts are reported in the Treasury's Annual Report and Monthly Treasury Statement and in the President's Budget, although not all these publications report all these measures. These documents are usually issued prior to the issuance of financial statements prepared in accordance with generally accepted accounting principles applicable to the Federal Government. In preparing these statements, significant differences should be noted between amounts reported in the former documents and amounts reported in the subsequently prepared financial statements. Such differences should be adjusted in the records of the reporting entity and in the related records maintained by the central agencies, and the correct amounts reported in the financial statements. It would also be desirable to provide a reconciliation for significant differences appearing in the two types of statements.

Statement Of Program Performance Measures

106. The statement of program performance measures should include measures for each of the major programs the reporting entity operates. The preferred types of measures are (1) output measures, i.e., the quantity of a service or product provided or the percentage of the target group provided the service or product, and that ideally meets a certain quality requirement; and (2) outcome measures, i.e., the accomplishments or results that occurred because of the services or outcomes provided. Outcome measures could address either the ultimate program outcome or intermediate outcomes, e.g., accuracy of, timeliness of, or satisfaction with the services provided. Workload, process, and input measures should be in the minority. Explanatory information that helps the readers understand the reported measures, assess the entity's performance, and evaluate the significance of underlying factors that may have affected the reported performance is appropriate. Comparative measures from prior years or similar programs and industry standards are also appropriate. They help to provide a better understanding of the level of the reporting entity's performance.[20]

107. The measures selected for reporting should relate to the programs' purposes and goals. It would be particularly useful to include measures previously included in budget documents and other materials released to the public. It would also be useful to base the selection of measures on discussions with budget examiners, Congressional staffs, and other users of the entity's financial statements.

108. The statement of program performance measures should not be cluttered with trivial measures. Measures selected should be considered important by decisionmakers and particularly the resource providers that are likely to use the financial statements. Also, relevant measures should be reported, without regard to whether they portray positive or negative performance. The most significant measures should be extracted for highlighting in the management discussion and analysis.

109. Other characteristics to consider for reporting program performance measures are as follows :

- **Completeness**. The measures, in the aggregate, should cover all aspects of the reporting entity's mission.
- **Legitimacy**. The measures should be accepted as relevant both inside the reporting entity and by the external stakeholders and others, e.g., the central management agencies, Congress, interest groups, the public.
- **Understandability**. The measures should communicate the performance of the entity in a readily understandable manner to any reasonably informed and interested party.
- **Comparability**. The measures should provide a frame of reference for assessing, and comparing, if appropriate, the

[20]The acceptance of a statement of program performance will increase in relation to the users' perception of the relevance and reliability of the reported information. These perceptions can be enhanced to the extent there are independent assessments of the appropriateness of the measures, the completeness of the data, the actual occurrence of the reported events, and the values assigned to the data. Auditors of Federal agency financial statements are currently required (by an OMB Bulletin) to evaluate the underlying control structure for program performance measures included with the financial statements. The extent to which auditors will be expected to expand the scope of their involvement with program performance measures to include the aforementioned independent assessments would be specified by OMB consistent with government audit standards.

performance of the entity and entities with similar programs for both the immediate period and over time.

- **Ability to relate to cost**. The measures should be such that a cost can be defined for each unit of output, outcome, input, etc.
- **Timeliness**. The measures should be available to users of the financial statements before they lose their capacity to be of value in assessing accountability and making decisions. The value of timeliness should not preclude the use of important measures for which results are not immediately available.
- **Consistency**. The measures should be reported consistently from period to period to allow users to have a basis for comparison and to gain an understanding of the measures being used and their meaning (recognizing that the measures should be reviewed regularly and modifications made to reflect changing circumstances).
- **Reliability**. The information should be derived from systems that produce controlled and verifiable data, although at times it may be necessary to rely on secondary sources of data.[21]

110. Since many Federal Government programs have counterpart programs at the state and local government level, for those programs, it would also be appropriate to consider the measures states and local governments use to report performance.

111. Numerical measures are not the only way to report program performance. In some instances, it may be more meaningful and practicable to report performance with other than numerical measures.

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112. Example formats for displaying the recommended elements are provided in appendix 1. These formats are illustrative and provided

[21]The Public Management Committee of the Organization for Economic Cooperation and Development, which is comprised of the twenty four democratic nations with advanced market economies, has been studying performance management systems. It has concluded, based on the experiences of countries that have implemented such systems, that performance measures should reflect three important characteristics: validity, continuity, and legitimacy. These characteristics, while intended to guide management systems in their totality, rather than simply inclusion in financial statements, have nonetheless been incorporated into the above characteristics.

solely to help readers of this document better understand the recommended concepts for displaying financial and related information. In exposing proposed standards, the Board might portray other formats. The ultimate specification of the form and content for financial statements for Federal agencies is defined by OMB.

Appendix 1-A: Balance Sheet

Example Financial Statement Formats

BALANCE SHEET - as of September 30, 19X4 - ASSETS

	Suborganization A	Suborganization B	Suborganization C	Total FY 19X4	Total FY 19X3
Entity assets:					
Fund balance with Treasury	$xxx	$xxx	$xxx	$xxx	$xxx
Cash (and other monetary assets)	xxx	xxx	xxx	xxx	xxx
Investments:					
Intragovernmental	xxx	---	xxx	xxx	xxx
With the public	xxx	xxx	xxx	xxx	xxx
Receivables:					
Intragovernmental	xxx	xxx	xxx	xxx	xxx
With the public	xxx	---	xxx	xxx	xxx
Inventories and related properties	xxx	xxx	xxx	xxx	xxx
Physical assets	xxx	xxx	xxx	xxx	xxx
Total entity assets	**xxx**	**xxx**	**xxx**	**xxx**	**xxx**
Non-entity assets:					
Fund balance with Treasury	xxx	xxx	xxx	xxx	xxx
Cash	xxx	xxx	xxx	xxx	xxx
Receivables:					
Intragovernmental	xxx	xxx	xxx	xxx	xxx
With the public	xxx	xxx	xxx	xxx	xxx
Total non-entity assets	**xxx**	**xxx**	**xxx**	**xxx**	**xxx**
Total assets	**$xxx**	**$xxx**	**$xxx**	**$xxx**	**$xxx**

BALANCE SHEET - as of September 30, 19X4 - LIABILITIES AND NET POSITION

	Suborganization A	Suborganization B	Suborganization C	Total FY 19X4	Total FY 19X3
LIABILITIES					
Liabilities covered by budgetary resources:					
Intragovernmental liabilities:					
Payables	$xxx	$xxx	$xxx	$xxx	$xxx
Governmental liabilities:					
Payables	xxx	xxx	xxx	xxx	xxx
Total liabilities covered by budgetary resources	**xxx**	**xxx**	**xxx**	**xxx**	**xxx**
Liabilities not covered by budgetary resources:					
Intragovernmental liabilities:					
Payables	xxx	xxx	xxx	xxx	xxx
Governmental liabilities:					
Payables	xxx	xxx	xxx	xxx	xxx
Amounts held for others	xxx	---	xxx	xxx	xxx
Total liabilities not covered by budgetary resources	**xxx**	**xxx**	**xxx**	**xxx**	**xxx**
Total liabilities	**xxx**	**xxx**	**xxx**	**xxx**	**xxx**
NET POSITION					
Unexpended appropriations	xxx	xxx	xxx	xxx	xxx
Cumulative results of operations	xxx	xxx	xxx	xxx	xxx
Total net position	**xxx**	**xxx**	**xxx**	**xxx**	**xxx**
Total liabilities and net position	**$xxx**	**$xxx**	**$xxx**	**$xxx**	**$xxx**

Note: The above balance sheet format is for an organization composed of three significant suborganizations. An organization deciding to forego presenting the information pertaining to the suborganizations would provide only the information contained in the last two columns.

Appendix 1-B: Statement of Net Costs

Example Financial Statement Formats

STATEMENT OF NET COSTS - For the year ended September 30, 19X4

	Suborganization A	Suborganization B	Suborganization C	Total FY 19X4	Total FY 19X3
COSTS:					
Program A:					
Intragovernmental	$xxx	$---	$---	$xxx	$xxx
With the public	xxx	---	---	---	---
Total	xxx	---	---	---	---
Less earned revenues	xxx	---	---	xxx	---
Net program costs	**xxx**	**---**	**---**	**xxx**	**xxx**
Program B:					
With the public	---	xxx	xxx	xxx	xxx
Less earned revenues	---	xxx	xxx	xxx	xxx
Net program costs	**---**	**xxx**	**xxx**	**xxx**	**xxx**
Program C:					
Intragovernmental	xxx	xxx	---	xxx	xxx
With the public	xxx	xxx	---	xxx	xxx
Net program costs	**xxx**	**xxx**	**---**	**xxx**	**xxx**
Program D:					
Costs with the public	---	xxx	---	xxx	xxx
Cost not allocated to programs	xxx	xxx	xxx	xxx	xxx
Less other earned revenues	**---**	**---**	**xxx**	**xxx**	**xxx**
NET COST OF OPERATIONS	**$xxx**	**$xxx**	**$xxx**	**$xxx**	**$xxx**

Appendix 1-C: Statement of Changes in Net Position

Example Financial Statement Formats

STATEMENT OF CHANGES IN NET POSITION - For the year ended September 30, 19X4

	Suborganization A	Suborganization B	Suborganization C	Total FY 19X4	Total FY 19X3
NET COST OF OPERATIONS	**$(xxx)**	**$(xxx)**	**$(xxx)**	**$(xxx)**	**$(xxx)**
FINANCING SOURCES					
Appropriations Used	xxx	xxx	xxx	xxx	xxx
Taxes (non-exchange revenue)	xxx	xxx	xxx	xxx	xxx
Donations (non-exchange revenue)	---	xxx	xxx	xxx	xxx
Imputed Financing	xxx	xxx	xxx	xxx	xxx
Transfers-in	xxx	---	xxx	xxx	xxx
Transfers-out	---	(xxx)	---	(xxx)	---
NET RESULTS OF OPERATIONS	xxx	xxx	xxx	xxx	xxx
PRIOR PERIOD ADJUSTMENTS	xxx	xxx	---	xxx	xxx
NET CHANGE IN CUMULATIVE RESULTS OF OPERATIONS	xxx	xxx	xxx	xxx	xxx
INCREASE (DECREASE) IN UNEXPENDED APPROPRIATIONS	xxx	(xxx)	xxx	xxx	xxx
CHANGE IN NET POSITION	xxx	xxx	xxx	xxx	xxx
NET POSITION-BEGINNING OF PERIOD	xxx	xxx	xxx	xxx	xxx
NET POSITION-END OF PERIOD	**$xxx**	**$xxx**	**$xxx**	**$xxx**	**$xxx**

Note: The above statement of changes in net position format is for an organization comprised of three significant suborganizations. An organization deciding to forego presenting the information pertaining to the suborganizations would provide only the information contained in the last two columns.

Appendix 1-D: Statement of Custodial Activities

Example Financial Statement Formats

STATEMENT OF CUSTODIAL ACTIVITIES - For the year ended September 30, 19X4

	FY 19X4	FY 19X3
Collections:		
Income Taxes	**$(xxx)**	**$(xxx)**
Estate and gift taxes	xxx	xxx
Excise Taxes	xxx	xxx
Employment Taxes	xxx	xxx
Penalties and Interest	xxx	xxx
Total collections	**xxx**	**xxx**
Refunds and other payments	(xxx)	(xxx)
Net collections	xxx	xxx
Accrual adjustment	xxx	(xxx)
Total revenues collected	**xxx**	**xxx**
Disposition of revenues collected:		
Transferred to others:		
Department of the Treasury	xxx	xxx
Department of Labor	xxx	xxx
Environmental Protection Agency	xxx	xxx
Total transfers	xxx	xxx
Retained by the entity	xxx	xxx
Increase (decrease) in amounts to be transferred	xxx	(xxx)
Total disposition of revenues collected	**xxx**	**xxx**
Net custodial collections	**$000**	**$000**

Appendix 1-E: Statement of Budgetary Resources

Example Financial Statement Formats

STATEMENT OF BUDGETARY RESOURCES - For the year ended September 30, 19X4

	Suborganization A	Suborganization B	Suborganization C	Total FY 19X4	Total FY 19X3
Budgetary resources made available:					
Budget authority	$xxx	$xxx	$xxx	$xxx	$xxx
Unobligated balances-beginning of period	xxx	xxx	xxx	xxx	xxx
Reimbursements and other income	xxx	xxx	xxx	xxx	xxx
Adjustments	xxx	xxx	xxx	xxx	xxx
Total, budgetary resources made available	**xxx**	**xxx**	**xxx**	**xxx**	**xxx**
Status of budgetary resources:					
Obligations incurred (gross)	xxx	xxx	xxx	xxx	xxx
Unobligated balances-end of period	xxx	xxx	xxx	xxx	xxx
Unobligated balances-not available	xxx	xxx	xxx	xxx	xxx
Total, status of budgetary resources	**xxx**	**xxx**	**xxx**	**xxx**	**xxx**
Outlays					
Obligations incurred, net	xxx	xxx	xxx	xxx	xxx
Obligations balance transferred	xxx	xxx	xxx	xxx	xxx
Obligations balance-beginning of period	xxx	xxx	xxx	xxx	xxx
Less: obligations balance-end of period	xxx	xxx	xxx	xxx	xxx
Total, outlays	**$xxx**	**$xxx**	**$xxx**	**$xxx**	**$xxx**

Appendix 1-F: Statement of Program Performance Measures

Example Financial Statement Formats

Statement of Program Performance Measures[22] - For the year ended September 30, 19X4

	FY 19X4	FY 19X3	FY 19X2
Sub-organization A			
Program			
Performance Measure	xxx	xxx	xxx
Performance Measure	xxx	xxx	xxx
Program			
Performance Measure	xx%	xx%	xx%
Performance Measure	xxx	xxx	xxx
Program			
Performance Measure	xxx	xxx	xxx
Performance Measure	xx%	xx%	xx%
Sub-organization B			
Program			
Performance Measure	xxx	xxx	xxx
Performance Measure	xx%	xx%	xx%
Program			
Performance Measure	xx%	xx%	xx%
Performance Measure	xxx	xxx	xxx
Sub-organization C			
Program			
Performance Measure	xxx	xxx	xxx
Performance Measure	xx%	xx%	xx%

Note: Sub-organizations A, B, and C are equivalent to responsibility segments for which cost and financial data are collected. (See FASAB Exposure Draft, "Managerial Cost Accounting for Federal Government", pages 26-30.)

[22]Although this example contains only numerical measures, the performance for some programs might be reported with other than numerical measures.

Appendix 2: List of Acronyms

See Consolidated List of Acronyms in “Appendix F: Consolidated List of Abbreviations” on page 1327.

Statement of Federal Financial Accounting Concepts No. 3: Management's Discussion and Analysis

Status

Issued	April 1999
Volume I References	SFFAC No. 2, *Entity and Display* SFFAS No. 3, *Management's Discussion and Analysis* SFFAS No. 17, *Accounting for Social Insurance*
Volume II References	Management's Discussion and Analysis (M10)
Interpretations and Technical Releases	
Affects	No other statement. SFFAC No. 3 affects SFFAC No. 1, paragraph 181.
Affected by	No other statement.

Summary

This document describes the concepts on which the Board relied in recommending standards for Management's Discussion and Analysis (MD&A) to be included in general purpose federal financial reports (GPFFR).[1] Concepts Statements are not authoritative in the sense that they do not establish standards or principles. Preparers may find them useful, but these concepts are not "prescribed guidelines" for required supplementary information as discussed in section 558 of the *Codification of Statements on Auditing Standards* published by the American Institute of Certified Public Accountants. No standards or prescribed guidelines for MD&A are presented in this statement of concepts.

MD&A is an important vehicle for (1) communicating managers' insights about the reporting entity, (2) increasing the understandability and usefulness of the GPFFR, and (3) providing accessible information about the entity and its operations, service levels, successes, challenges, and future. Some federal agencies also refer to MD&A as the "overview."

The basic concept that underlies the standards for MD&A is:

> Each general purpose federal financial report (GPFFR) should include a section devoted to management's discussion and analysis (MD&A). It should address the reporting entity's performance measures, financial statements, systems and controls, compliance with laws and regulations, and actions taken or planned to address problems. The discussion and analysis of these subjects may be based partly on information contained in reports other than the GPFFR. MD&A also should address significant events, conditions, trends and contingencies that may affect future operations.

[1] The term general purpose financial report, abbreviated "GPFFR," is used as a generic term to refer to the report that contains the entity's financial statements that are prepared pursuant to federal accounting principles.

A separate document titled *Standards for Management's Discussion and Analysis* presents the standards for MD&A. The standards for MD&A say that MD&A should address:

- the entity's mission and organizational structure;
- the entity's performance goals and results;
- the entity's financial statements;
- the entity's systems, controls, and legal compliance; and
- the possible future effects on the entity of existing, currently-known demands, risks, uncertainties, events, conditions and trends.

The discussion and analysis of these subjects may be based on information in other discrete sections of the GPFFR or it may be based on reports separate from the GPFFR. The standards require MD&A to be included in each GPFFR as required supplementary information (RSI).

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Statement Of Concepts

Basic Concept

1. Each general purpose federal financial report (GPFFR, see figure 1 on 127) should include a section devoted to management's discussion and analysis (MD&A).[2] MD&A should address the reporting entity's program and financial performance measures, financial statements, systems and controls, compliance with laws and regulations, and actions taken or planned to address problems. The discussion and analysis of these subjects may be based partly on information contained in reports other than the GPFFR. MD&A also should address significant events, conditions, trends and contingencies that may affect future operations.

Discussion and rationale

2. A typical GPFFR is a highly summarized profile of a complex entity. It is based on conditions that exist at the reporting date and events that occurred in the preceding period. It shows what has happened, but it does not explain why it happened or what may reasonably be expected to happen in the future.

3. Financial reports have two key roles. One is a feedback role to provide information used for evaluating past decisions, expectations, and trends. Another is a predictive role to provide information used for formulating expectations and making decisions about the future. Both roles can be enhanced by insights and interpretations from an entity's management.

[2]The term general purpose federal financial report, abbreviated "GPFFR," is used as a generic term to refer to the report that contains the entity's financial statements that are prepared and audited pursuant to the CFO Act of 1990, as amended. entities may refer to these reports using different terms, such as "Annual Report," "Accountability Report," "Financial Management report," etc. Paragraphs 54-112 and Appendix 1 of Statement of Federal Financial Accounting Concepts 2, *Entity and Display*, describe and illustrate the contents of the GPFFR. For more information on the "Accountability Report" see paragraph 59 and the glossary. (Other words defined in the glossary are marked with an asterisk.) See also *Toward a Report to Citizens on the State of their Nation and the Performance of Their Government: proceedings of the AGA Task Force on a Report to Citizens on the State of the Nation*, Association of Government Accountants, 1994.

4. The managers of an entity have detailed knowledge of the transactions, events, and conditions reflected in the entity's financial report and of the policies that govern the entity's operations. The managers also have informed expectations regarding the future based on that knowledge. As a part of their stewardship responsibility, managers should explain the significance of key financial and nonfinancial information shown in the report, the strategies that led to the results reported, and the implications for future operations of events that have occurred or are likely to occur. The distinction between "financial" and "nonfinancial" information is arbitrary and often tenuous, but in this context "nonfinancial information" can include information on systems, controls, compliance with laws and regulations, and performance.

5. A Federal reporting entity's GPFFR should be understandable and useful to a wide audience, not just members of the entity's management and specialized analysts working for special interest groups, corporations, and other entities affected by the Government's actions. Therefore, the report should be accompanied by a concise narrative discussion and analysis. Even insiders and specialized analysts often need such a discussion and analysis to understand the report. Communication with a wide audience may require effective use of colors, graphs, photographs, and charts. Reporting understandable, accessible information on the Government's actions and the effects of its actions helps assure accountability and provides a more "level playing field" on which the public interest can best be served.

Background

6. The Securities and Exchange Commission (SEC) has for many years recognized the importance of such a narrative discussion of the financial statements. To serve the interests of investors and creditors, the SEC requires such a narrative discussion and analysis from management of companies under its purview. The SEC wants MD&A to help readers understand the entity's financial position and results of operations with the benefit of management's understanding and perspective. The SEC also wants MD&A to go beyond the basic financial statements, to include relevant forward-looking information. Research on MD&A for companies registered with the SEC shows that

MD&A adds value to the financial statements. Forward-looking information, for example, can be an important contribution.[3]

7. Several factors suggest that MD&A may be even **more** important for Federal reporting entities than for those in the private sector and may need to be more extensive in scope. These factors include the complexity of Federal operations, the myriad objectives they pursue, and the diverse nature of the groups affected by and interested in the Government's activities. Fundamentally, the Government's objective is to provide for the common defense and to promote the general welfare, not to earn a profit. Therefore, reporting on performance and other matters in a way that is understandable to diverse audiences is important. For these reasons, both SFFAC 1, *Objectives of Federal Financial Reporting*, and SFFAC 2, *Entity and Display*, refer to MD&A in concept as part of the general purpose federal financial report.

8. Page 127 presents a schematic diagram of a sample GPFFR. It is schematic because the information called for by the statements of federal financial accounting standards should be located in the report in a logical sequence, not necessarily in the order shown. MD&A for the reporting entity as a whole normally will be located immediately after the agency head's letter. Reporting entities that organize their GPFFR by responsibility segment may combine MD&A regarding each segment; alternatively, they may have MD&A for each responsibility segment located separately in each of the respective subsections of the report. Preparers have flexibility to structure their report in the manner most appropriate under the circumstances. This diagram, the entire statement of concepts, and the accompanying standards for MD&A are intentionally written in general terms, in light of the evolving practice of performance reporting and accountability reporting in the federal government. The standards for MD&A define in general terms required supplementary information that should accompany financial statements prepared in conformance with federal accounting principles.

[3]Research on MD&A in private sector financial reporting suggests that forward-looking information in MD&A, in particular, is a significant source of added value for financial analysts. See Stephen H. Bryan, "Incremental Information Content of Required Disclosures Contained in Management Discussion and Analysis," *The Accounting Review* Vol. 72 No. 2, (April 1997), pp. 285-301.

FIGURE 1: Schematic Diagram of a Sample General Purpose Federal Financial Report

Agency Head's Letter					
Management's Discussion and Analysis (RSI)					
<----- Other Elements of the General Purpose Federal Financial Report ----->					
1. Basic financial statements and notes, with auditor's report if audited	2. Required Supplementary Stewardship Information (RSSI)	3. Required Supplementary Information (RSI)	4. Performance Information	5. Other Accompanying Information (OAI)	6. Management's assertions and reports on controls, compliance, and corrective actions under FMFIA and FFMIA (or portions of these assertions and reports)

The GPFFR is represented by MD&A plus columns 1-6 of the diagram. (The agency head's letter is part of the GPFFR by general practice, though it is not required by federal accounting principles.) This is not a literal depiction of the organization of a report. Information should be presented in a logical arrangement. MD&A will address major issues that are typically reported in more detail in the discrete sections of the GPFFR or in other publicly available reports that the GPFFR incorporates by reference. Incorporating another report by reference does not, by itself, mean that the separate report is subject to audit.

Unless law or managerial action requires more extensive audit review or examination of the material incorporated by reference, the FASAB expects that the auditor of the financial statements will treat the material incorporated by reference as other accompanying information, although it does not physically accompany the GPFFR. OMB has authority to provide specific guidance on the auditor's minimum responsibility regarding this material. OMB may, for example, direct auditors to treat the material incorporated by reference as if it were other accompanying information in an auditor-submitted document.

SFFAC 2 (paragraphs 106-111 and Appendix 1-F) calls for a "Statement of Performance Measures" as part of the GPFFR, but FASAB has not yet recommended standards for it. Other titles may be used for this section of the GPFFR. Performance indicators included in the GPFFR will either be those in the entity's annual performance report under the Government Performance and Results Act of 1993 (GPRA or the Results Act) or a subset of them.

Alternatively, that report may be incorporated by reference. Until further guidance is available, the agency should select the indicators to report in consultation with OMB.

The assertions and report on control called for by the Federal Managers Financial Integrity Act (FMFIA or Integrity Act) would not be stated in full in MD&A. They would be reported in a discrete section of the GPFFR or incorporated in the GPFFR by reference. They are within the scope of MD&A because highly important aspects of systems, compliance, and internal controls should be discussed in MD&A. "Highly important" in this context may imply a higher threshold than "materiality" for the financial statements.

If the report also includes financial statements for component entities (bureaus, responsibility segments, etc.), management should use its judgment in organizing the report. The component entities' financial statements may be discussed in separate sections of the report or as subsections of MD&A of the consolidated entity.

9. MD&A should address:

- the entity's structure, mission, goals, and objectives, with indicators[4] of its performance;
- actions taken or planned to improve performance, when appropriate;
- the financial statements;
- systems, internal controls[*5] and legal compliance, including corrective action taken or planned; and
- the future effects of existing, currently- known demands, risks, uncertainties, events, conditions and trends. MD&A may also address the possible future effects of anticipated* future demands, events, conditions, trends, etc. that management believes would be important to the reader of the report.

10. MD&A should address these subjects even if, as will be true for many Federal reporting entities, separate documents report much of the information in more detail. Information about these subjects is essential to address the objectives of federal financial reporting regarding performance, stewardship, budgetary integrity, and systems and controls.

The following paragraphs explain the implications of this.

11. Regarding the entity's mission and performance, MD&A should inform the reader how well the reporting entity is doing. This means that it should tell the reader what the reporting entity and its programs have accomplished, and how well the entity is managing its programs. To do this, MD&A should answer such questions as:

- What do we need to know to gauge operating success?
- How do we measure what we accomplished?
- What do the measurements show?

[4]This document uses the terms "performance measure" and "performance indicator" synonymously. Some people use the term "performance indicator" instead of "performance measure" because the performance of government programs typically involves several factors or dimensions, and many of these dimensions of performance cannot be measured precisely.

[5]Words marked with * are defined in the glossary.

12. To understand the information on performance, systems, controls, and legal compliance, it typically is necessary to understand something about the reporting entity's organizational structure, mission, and strategic plan. Accordingly, MD&A should concisely inform the reader about these topics.

13. Reporting information that helps people assess the performance of the Government's programs and organizations is an important objective of Federal financial reporting. For governmental entities, in contrast to profit-seeking entities, the financial result of governmental-type activities is rarely an adequate indicator of performance. (For a few governmental entities, mainly those that conduct primarily business-type instead of governmental-type activities, the financial results of operations may be an important, albeit rarely sufficient, performance indicator.) To assess performance, people need additional information on the consequences of the Government's activities. For a competitive, profit-seeking entity, the value of its products or services is measured by the amount of money customers are willing voluntarily to pay for them. In such a situation, the traditional income statement reports on both the efforts (measured by expenses incurred) and the accomplishments (measured by revenue earned) of the entity. For government, expense reflects efforts, as it does in the private sector, but indicators other than revenue must be used to report on accomplishments. A discrete section of the GPFFR therefore presents indicators of accomplishments (such as indicators of outputs and outcomes) and other indicators of performance. Alternatively, the GPFFR incorporates performance indicators by reference to a separate report such as the Annual Performance Report required by the Results Act. Either way, performance information is an integral part of the GPFFR and should be discussed in MD&A. Management's discussion and analysis should therefore address the most important facets of performance as well as the financial statements and supplementary information.

14. Regarding the financial statements, MD&A should answer questions such as the following, to the extent that they are relevant and important for the entity:

- What is the entity's financial position? What is its financial condition?[6] How did this come about?
- What were the significant variations:
  - from prior years?
  - from the budget?[7]
  - from performance plans, long-term plans, or other relevant plans in addition to the budget?
- What is the potential effect of these factors, of changed circumstances, and of expected future trends? In other words, to the extent that it is feasible to project the effects of these factors, will future financial position, condition, and results, as reflected in future financial statements, probably be different from this year's and, if yes, why? (Any such discussion should acknowledge that the future is unpredictable and will be influenced by factors outside the reporting entity's control, including actions by Congress.)

15. Regarding systems and controls, MD&A should tell the reader whether internal accounting and administrative controls (some authorities prefer the term "management controls") are adequate to ensure that:

    - transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the purposes authorized, and are recorded in accordance with Federal accounting standards;
    - assets are properly acquired and used, safeguarded to deter theft, accidental loss or unauthorized disposition, and fraud; and
    - performance measurement information is adequately supported.

16. Reporting information that helps people assess the condition of the entity's management systems and of the relevant internal controls is an important objective of Federal financial reporting. The relevant internal controls for this purpose are those that support reporting on financial and operating performance and reporting on compliance

[6]The traditional concepts of "financial position" and "financial condition" are typically applicable to revolving funds, Government corporations, and other reporting entities that are intended to be self-financing. The concepts may be less relevant, or may require some qualification or modification, for other kinds of Federal reporting entities.

[7]Management should use its judgment to decide what variances are relevant for MD&A. It will not always be essential or appropriate to discuss all variances.

with applicable laws.[8] The great diversity of people (often with competing interests) affected by governmental action, and the fact that governments function within and by means of a framework of laws, mean that more attention to these matters is necessary than in financial reports for profit-seeking entities.

17. An entity's ability to prepare auditable financial statements and other reliable reports for management from the entity's books and records is a positive signal about the finance-related systems and controls of that entity. By themselves, however, the financial statements of a governmental entity do not provide adequate information about the status of the entity's management systems and internal controls that support reporting on financial and operating performance and reporting on compliance with applicable laws. For these reasons, the GPFFR of a Federal reporting entity should include information about systems, internal controls, and legal compliance, in addition to the basic financial statements. This information—like the information on performance—is presented in a discrete section of the GPFFR; alternatively it may be incorporated in the GPFFR by reference to separate reports such as those required by the Integrity Act. MD&A should therefore address the most important facets of this information on systems, controls and legal compliance, as well as the financial statements, supplementary information, and performance information.

Relationship to other reports

18. The information in the GPFFR about systems, internal controls, and legal compliance (column 6 in figure 1) may include the assertions and a summary of the reports on controls, legal compliance, and corrective actions pursuant to the Integrity Act and the Federal Financial Management Improvement Act (FFMIA), or those reports may be incorporated by reference. This information should be presented in conformance with guidelines published by OMB. MD&A, in turn, should discuss the most important aspects of the information on these

[8]Internal controls are also relevant to other objectives. For example, controls help management assure efficient and effective use of resources for the purpose intended. They also support preparation of performance reports pursuant to GPRA. See, for example, paragraph 40.

topics. Referring to separately-issued reports on systems and controls does not eliminate the need to discuss these topics in MD&A.[9]

19. The performance information (column 4 in figure 1) may include the indicators in an entity's performance report pursuant to the Results Act or a selection of the most important performance indicators. Alternatively, a separate performance report may be incorporated by reference. This information should be presented in conformance with guidelines published by OMB. MD&A, in turn, will discuss the most important aspects of the performance information. Reference to a separately-issued performance report does not eliminate the need to discuss performance in MD&A.

20. The performance reports required by the Results Act may be voluminous for some agencies. In such cases, it may not be desirable to include all this information in the GPFFR. It is necessary to include at least some information about performance with the financial statements, however, so that people who use the GPFFR can understand why the costs reported in the financial statements were incurred and the consequences of doing so.

21. In the same way, the GPFFR by itself may not provide a comprehensive report on systems, controls and legal compliance. There may be voluminous reports from management and auditors on these topics. It is necessary to include at least some information about these topics, however, so that users of the GPFFR can understand whether the resources on which it reports were properly safeguarded and used for the purposes intended, whether reliable reports can be prepared, and whether the other objectives of internal controls are being met. This information is important both to provide a basis for understanding the financial statements themselves and to address the objectives of federal financial reporting.

22. Combining information on these topics adds value by putting the information about performance, internal controls, and systems in the context of audited financial statements. For example, the quality of

[9]Note that the purpose of the pilot Accountability Reports is to eliminate the need for numerous separate reports and to include the information required by those reports in a single report. For example, the Integrity Act requires an assertion on controls by the agency head. Pilot agencies are including this assertion in the Accountability Report.

information on the cost of outputs and outcomes of programs is enhanced by linking these indicators to the audited Statement of Net Cost. This is true even though the Statement of Net Cost may be too highly aggregated to identify separately all the programs reported on for the Results Act. Similarly, the auditor's tests of transactions and controls in connection with the audit of the financial statements provide information about the condition of the systems and controls used to safeguard resources and to assure that they are used for the intended purposes, in conformance with law. (Paragraphs 15 and 40-49 say more about the discussion and analysis of systems, controls, and performance.)

Authoritative status of accounting concepts

23. This Statement of Federal Financial Accounting Concepts describes ideas and goals to guide the Board in its work. Concepts are not authoritative in the sense that they do not constitute accounting standards or principles for federal reporting entities. In particular, they are not "prescribed guidelines" for required supplementary information as discussed in section 558 of the Codification of Statements on Auditing Standards published by the American Institute of Certified Public Accountants.

Topics For MD&A

24. This section provides specific suggestions for the content of MD&A. Like the other sections of this document, this material does not constitute accounting standards or principles for federal reporting entities. Except to the extent that OMB may issue supplementary mandatory guidance regarding the content of MD&A, the following items should be read as suggestions to be considered, not as prescriptive rules that must be followed.

Mission and Organizational Structure

25. MD&A should contain a brief description of the mission(s) of the entity and describe its related organizational structure.

Discussion and Analysis of the Financial Statements

26. Financial Results, Position and Condition[10]—MD&A should help those who read it to understand the entity's financial results and financial position and the entity's effect on the financial position and condition of the Government.[11] It should give readers the benefit of management's understanding of the significance and potential effect from both a short- and a long-term perspective of:

- the variations discussed in paragraph 14 in terms of major changes in types or amounts of assets, liabilities, costs, revenues, obligations and outlays;
- particular balances and amounts shown in the basic financial statements, including the notes, such as those dealing with dedicated collections or trust funds, if relevant to important financial management issues and concerns; and
- the entity's required supplementary stewardship information (because RSSI describes economic conditions that cannot be expressed in the basic financial statements).

27. Only those variations, balances and amounts, and stewardship matters of potential interest to readers who are not part of agency management should be discussed. Not all changes that are material to the GPFFR are sufficiently important to be included in MD&A. A line-by-line analysis of the financial statements is not generally appropriate. Instead, MD&A should summarize the most important items, explain the relevant causes and effects, and place them in context.

28. Budgetary Integrity—MD&A should concisely explain how budgetary resources have been obtained and used, instances in which their acquisition and use were not in accordance with legal authorization, the status of budgetary resources, and how information on the use of budgetary resources relates to information on the cost of program operations. MD&A should explain when major support for cost of a program or activity is provided outside the reporting entity's budget

[10]For many readers program performance information is more important than the financial statements. The order in which topics are discussed in this document does not imply that performance information is of secondary importance. See paragraphs 43 and following.

[11]Materiality of effects to be discussed should be evaluated in the context of the specific reporting entity, not the Government as a whole.

and when the entity's budget supports a program primarily reported by another entity. The discussion should describe major financing arrangements, guarantees, and lines of credit, including those not recognized in the basic financial statements.

29. MD&A should explain major changes during the period to the budget originally approved, major failures to comply with finance-related laws, and other matters management believes necessary. These could include:

- unfunded liabilities that may require appropriations;
- assets that could be sold to augment future budgetary resources;
- amounts of payments that have not been matched with obligations;
- anticipated increases in the cost to complete long-term projects in progress that may require additional obligations or appropriations.

30. Use of Estimates—MD&A should concisely explain the use of estimates where that is important to understand issues discussed in MD&A, such as the major risks and uncertainties mentioned in paragraph 31 or the key forward-looking information discussed in paragraph 32. For example, the future expenses and the long term obligations[12] associated with major social insurance programs such as Social Security and Medicare should be discussed in MD&A of the financial report of the relevant reporting entities. These estimates are inherently imprecise and sensitive to several assumptions. Such factors would, therefore, be worthy of discussion in MD&A.

31. Current Demands, Risks, Uncertainties, Events, Conditions, and Trends—MD&A should describe important existing, currently-known demands, risks, uncertainties, events, conditions and trends--both favorable and unfavorable--that affect the amounts reported in the financial statements and supplementary information. The information called for by this paragraph and paragraph 32 is closely related. Preparers should combine the presentation of this information in whatever fashion is appropriate under the circumstances that apply to the reporting entity.

[12]The term "obligations" is used here in the customary sense, not as it is used in budgetary accounting.

32. Future Effects of Current Demands, Risks, Uncertainties, Events, Conditions and Trends—The discussion of these current factors should go beyond a mere description of existing conditions, such as demographic characteristics, claims, deferred maintenance, commitments[13] undertaken, and major unfunded liabilities, to include a discussion of the possible future effect of those factors. (This discussion of possible future effect of existing, currently-known factors is required pursuant to the standards in *Standards for Management's Discussion and Analysis*.)

33. Future Effects of Anticipated Future Events, Conditions, and Trends—To the extent feasible and appropriate, the discussion should also encompass the possible future effects of anticipated future events, conditions, and trends, although this additional information is not required by the standards for MD&A.[14] For example, MD&A might discuss the possible future effect of anticipated trends in the cost of inputs that may significantly affect future output costs. Other examples include the future effect of anticipated demographic trends, such as declining mortality rates, and the future effects of potential changes in behavior that may be caused by changes in Government programs. Such behavioral changes can greatly affect the future cost of some Governmental programs. For example, such effects can arise if subsidized insurance encourages the people or entities most at risk to participate in insurance programs ("adverse selection") or encourages risky behavior ("moral hazard").

34. An anticipated condition such as a prospective demographic trend or potential behavioral change may not, in itself, constitute a contingency or assumed risk that must be recognized, disclosed, or reported pursuant to SFFAS 5. Likewise, it may not be something that must be discussed in MD&A pursuant to the *Standards for Management's Discussion and Analysis*. Even so, if there is a reasonable prospect of a major effect on the reporting entity due to the anticipated condition, then MD&A should include this information to the extent feasible.

[13]The term "commitments" is used here in the customary sense, not as it is used in budgetary accounting.

[14]Some projections that could involve consideration of anticipated factors would be presented as required supplementary stewardship information pursuant tot he standards exposed for comment in FASAB's exposure draft Accounting for Social Insurance, February, 1998.

35. Where appropriate, the description of possible future effects of both existing and anticipated factors should include quantitative forecasts* or projections*. Such forecasts or projections can show the implications of existing policies and conditions in light of anticipated or reasonably possible future conditions. For example, for MD&A of the Government-wide financial statements, long-term projections of the deficit or surplus may be important indicators of financial condition and sustainability. For insurance programs, this kind of projection—which actuaries sometimes call "dynamic analysis"—would consider possible interactions among current assets, reserves, policies in force, expected future business or populations covered by the insurance, and potential behavioral changes such as adverse selection and moral hazard, if appropriate. Some programs are interrelated among themselves and/or with conditions in the private sector. For example, flood insurance programs and disaster assistance programs may be related to such an extent that analysis of programs individually would not provide a good idea of their potential impact on the Government. To the extent feasible, projections should consider the potential implications of such relationships.

36. The future implications of current or anticipated factors often can better be expressed as a range of possible outcomes and associated probabilities than as a single point estimate. Sometimes the implications may best be discussed in nonfinancial as well as financial terms. Forward-looking information can be highly useful, but management should avoid turning this part of MD&A into mere "lobbying" for more budgetary authority.

37. Understanding Financial Reporting—MD&A should make federal financial statements understandable to a wide audience, not just to users who are specialized analysts or members of the entity's management. There may be many potential sources of misunderstanding. Management should try to identify those sources of misunderstanding that may be important and deal with them in MD&A. Some of these are general and pervasive, such as those that may arise in the minds of new users of federal financial statements. New users may have been budget-oriented rather than accrual-accounting oriented, or may be accustomed to seeing financial statements prepared on the basis of private sector accounting standards. A general discussion and reference to the Statement of Financing and the basis of accounting footnote may be sufficient for such users, although more specific treatment may be appropriate where the

resulting differences in the reported amounts may be important to the understanding of users.

38. Emphasis that may be given in the financial statements to the costs of suborganizations and programs may require cautionary discussion of the relevance and utility of cost information. When MD&A itself discusses the cost of program outcomes, the problems of associating costs with outcomes may need to be discussed. In addition, the possible imprecision of cost information should be mentioned when it could be relevant to users' understanding. Similarly, any account-level discussion in MD&A of variations, balances, and amounts in the basic and stewardship information made in response to paragraphs 26 and 27 may require mention of the imprecision of amounts cited.

39. Exceptions and disclaimers in the auditor's report should be mentioned in MD&A, and management should respect the auditor's professional judgment if management expresses disagreement with auditor's findings. (This does not mean that management must refrain from stating views that differ from the auditor's; e.g., different views as to whether a weakness in control is material.) There may be other sources of misunderstanding. Management should be sensitive to them and guide the user to a better understanding when the problem could significantly affect the conclusions and judgments of substantial numbers of users.

Discussion and Analysis of Systems, Controls and Legal Compliance

40. The schematic diagram of a sample GPFFR on page 127 includes a discrete section that reports on the status of the entity's management systems and internal controls that support (1) preparation of financial statements and performance information in accordance with Federal Accounting Standards and management's criteria, respectively, and (2) the entity's compliance with applicable laws.[15] That section also

[15]These responsibilities are defined in numerous laws and administrative requirements, including the Federal Financial Management Improvement Act, OMB Circulars A-123 and A-127, and OMB Bulletin 98-08. a law of special importance in this connections is the Federal Managers' Financial Integrity Act of 1982 (FMFIA or the Integrity Act). the Integrity Act requires, in part, that "internal accounting and administrative controls of each executive agency shall be established.. and shall provide reasonable assurance that --
(i) obligations and costs are in compliance with applicable law;
(ii) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
(iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets.

describes material problems revealed by audits or otherwise known to management, and the corrective actions taken or planned regarding material problems.

41. Where relevant, management should discuss the results of audits of non-Federal entities such as those pursuant to the Single Audit Act as amended and OMB Circular A-133. MD&A should also discuss actions taken, in progress, or planned to address systemic problems in program design that contributed to the audit findings. Where relevant, management should describe the methods used to limit, detect, and recover improper payments; to assure that grantees and other nonfederal recipients of Federal funds use the funds as intended; and to assure that Federal and nonfederal entities comply with finance-related laws and regulations. MD&A should include a concise description of any major problems in these areas and of the corrective action taken or planned.

Discussion and Analysis of Performance

42. Performance Measurement—The objectives and needs of the Federal Government are markedly different from the objectives and needs of non-governmental organizations. This difference extends to the needs of those who use financial statements of governmental organizations. Their needs are different in many ways from the needs of investors, which the SEC's requirements address. In particular, reporting on the performance of governmental programs, organizations, and activities requires information that goes beyond the change in net assets and, indeed, beyond financial information.

43. The actual outcomes, accomplishments, or degree to which predetermined objectives are met provide indicators or measures of some aspects of effectiveness.[16] MD&A should objectively discuss the entity's program results and indicate the extent to which its programs

[16]SFFAC 1, paragraph 206 notes that, to the extent feasible and practical, effectiveness evaluation should focus on program results or effects in the sense of "impacts*," i.e., the difference between what actually occurred and what would have occurred in the absence of the program. Assessing impacts of Governmental action in this sense typically requires program evaluations or other techniques that transcend annual performance reporting, although these techniques often will avail of information i the annual performance reports. Valid and reliable evaluations of program impacts are not feasible for some programs. When they are conducted, they often require several years of data, are expensive, and typically are not performed on an annual basis for a given program.

are achieving their intended objectives.[17] Efficiency and effectiveness are important elements of performance measurement, and measuring cost is an integral part of assessing the efficiency and effectiveness of programs. Relating outputs (the quantity of services provided) to inputs (the cost incurred to provide the services) provides an indicator or measure of one aspect of efficiency. Information about effectiveness is often combined with cost information to help assess "cost effectiveness."

44. The entity's financial performance should be summarized to provide significant indicators of its financial operations for the reporting period. Indicators of financial performance are presented in notes and supplementary information as well as on the face of the principal financial statements, e.g., information about management of loans and accounts receivable. Financial performance is only one aspect of performance for governmental entities. Financial performance should be discussed to the extent relevant for the entity, in a way that appropriately balances the discussion of financial and nonfinancial performance relevant to the program or other reporting entity.

45. The discussion of performance should relate to major goals and objectives from the agency's strategic plan and to the indicators reported pursuant to the Results Act. It should explain what key performance indicators say about program performance. The summary discussion of performance in MD&A should:

- discuss the strategies and resources the agency uses to achieve its performance goals;
- provide a clear picture of actual and planned performance across the agency; and
- explain the procedures that management has designed and followed to provide reasonable assurance that the reported performance information is relevant and reliable.

46. The discussion of performance should:

- include both positive and negative results;

[17]Paragraphs 106-111 and Appendix 1-F of Statements of Federal Financial Accounting Concepts 2, *Entity and Display,* discuss and illustrate reporting on performance in the GPFFR.

- present historical and future trends, if relevant (see paragraphs 31-36 regarding projections of the financial effects of known and anticipated demands, commitments, events, risks, uncertainties or trends for which a material financial effect is reasonably possible);
- be illustrated with charts and graphs, whenever helpful, for easy identification of trends;
- explain the significance of the trends;
- provide comparison of actual results to goals or benchmarks;
- explain variations from goals and plans; and
- provide other explanatory information that management believes readers will need to understand the significance of the indicators, the results, and any variations from goals or plans.

47. To further enhance the usefulness of the information, agencies should include an explanation of what needs to be done and what they plan to do to improve program performance.

48. Understanding Performance Reporting—Important limitations and difficulties associated with performance measurement and reporting should be noted to the extent relevant to the vital performance indicators discussed in MD&A. The relevant limitations will vary from program to program, but some common factors that may need to be discussed include the following:

- performance usually cannot be fully described by a single indicator;
- indicators of performance do not, by themselves, say why performance is at the level reported; and
- focusing exclusively on quantifiable indicators can sometimes have unintended consequences.

49. For these and other reasons, performance indicators generally need to be accompanied by suitable explanatory information. Explanatory information helps report users understand reported indicators, assess the reporting entity's performance, and evaluate the significance of underlying factors that may have affected the reported performance. Explanatory information may include, for example, information about factors substantially outside the entity's control, as well as information about factors over which the entity has significant control.

This Statement of Recommended Concepts was adopted unanimously by the eight members of the Federal Accounting Standards Advisory Board serving on the Board in April 1999.

Appendix A: Basis For Conclusions

Background and Project History

50. The Board identified MD&A as a topic for its agenda shortly after the Board's inception. The Board deferred work on this topic, however, until it completed recommendations for an initial set of basic accounting standards. FASAB published an initial exposure draft on MD&A in January, 1997. The Board received comment letters on the initial exposure draft from the following sources:

	Federal (internal)	Nonfederal (external)	Total
Users, Academics and Others[18]		4	**4**
Auditors	7	3	**10**
Preparers and Financial Managers	16		**16**
Totals	**23**	**7**	**30**

51. The basic rationale for MD&A has not changed since the initial exposure draft. As a result of its deliberations after receiving comments on the 1997 exposure draft, however, the Board made certain changes. The more significant changes are discussed below.

Concepts and Standards

52. The initial exposure draft was presented as a statement of recommended concepts. The Board proposed that it would deal with MD&A conceptually, with the understanding that OMB would provide authoritative guidance on MD&A to implement the concepts. This approach would have been similar to the one used to deal with the topics of entity and display. The Board dealt with those topics conceptually in SFFAC 2. OMB then provided authoritative guidance in its Bulletin on Form and Content. The 1997 exposure draft asked respondents whether all or part of its provisions should be issued as recommended standards rather than recommended concepts.

[18]This category include representational organizations, retired federal employees, federal employees responding as individuals, and federal contractors, as well as academics and other GPFFR users.

Responses were mixed; most of those who commented on this question favored concepts, but a significant number expressed the view that standards would be appropriate.

53. The Board concluded that, given the importance of MD&A as an integral part of the GPFFR, it would be appropriate to recommend standards for MD&A. At the same time, however, the Board concluded that for now this information should be treated as required supplementary information. The Board also agreed that no detailed requirements or guidelines for MD&A should be incorporated in federal accounting standards at this time beyond those proposed in the subsequent exposure draft (discussed below) titled *Standards for Management's Discussion and Analysis*. In other words, the Board agreed, a discussion and analysis that addresses the topics listed in the proposed standards should be an essential part of a complete GPFFR. At the same time, management should have great discretion about what to say regarding those topics, subject only to the criteria proposed in the exposure draft *Standards for Management's Discussion and Analysis* and the pervasive requirement that MD&A not be misleading. Because of this change, the Board decided to expose separately for further comment the proposed new standards and concepts. The exposure drafts were issued in October 1998; responses were requested by January 1999.

Responses to Second Exposure Draft

54. The Board received comment letters on the second exposure draft from the following sources:

	Federal (internal)	Nonfederal (external)	Total
Citizens, Users, Academics and Others		3	**3**
Auditors[19]	3	3	**6**
Preparers and Financial Managers	11		**11**
Totals	**14**	**6**	**20**

[19]Includes the AICPA's Federal Accounting and Auditing Subcommittee and the Comptroller General's Advisory Council on Government Audit Standards.

55. Most comments were generally favorable, but comments were mixed regarding some points. A few auditors and preparers expressed some concern about requiring forward-looking information as RSI. Others expressed support for doing so. After considering these responses, the Board agreed to defer the recommended implementation date of the standard by one year and to make minor editorial changes to the standards and concepts that were exposed for comment.

Incorporation of Guidance in OMB Bulletin 97-01

56. This document, like both exposure drafts, integrates some of the guidance in OMB Bulletin 97-01 for preparing the "Overview" of the financial report with some of the guidance proposed in FASAB's initial exposure draft for MD&A. Some portions of the guidance regarding performance measurement in 97-01's discussion of the "Overview" have been omitted. As an interim step prior to implementation of the Results Act, OMB and many agencies used the Overview as a major vehicle for reporting on performance, not just as a summary and analysis. With the full implementation of the Results Act in FY 1999, however, it will be appropriate to implement the financial reporting model contemplated in SFFAC 2. This contemplates a discrete section of the GPFFR focused on performance. Alternatively, performance information may be incorporated in the GPFFR by reference to another report or reports.

Management's Assertions

57. Senior management of the reporting unit is responsible for the content of the GPFFR, including MD&A. Consistent with that, the initial exposure draft included the following paragraph:

> MD&A should include a discrete section with management's explicit assertions that it is responsible for maintaining internal accounting and administrative controls that are adequate to ensure that
>
> - transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the purposes authorized, and are recorded in accordance with Federal accounting standards;
> - assets are properly safeguarded to deter fraud, waste, and abuse; and
> - performance measurement information is adequately supported. [footnote omitted]

58. This paragraph, which was based on the language of objective four in SFFAC 1, was modified after the first exposure. The Board concluded that such assertions should be presented in a separate section of the GPFFR, not in MD&A. Alternatively, management's assertions about internal control and related information about systems, controls, and compliance may be incorporated in the GPFFR by reference to another report or reports. (As noted previously, pilot agencies are including these assertions in their accountability reports.) FASAB expects to consider whether a new statement of standards is needed to assure that Federal financial reports adequately address objective four of Federal financial reporting, "Systems and Controls." As noted in paragraph 41, MD&A should include a description of any major deficiencies in the management systems and internal controls designed to provide reasonable assurance that management responsibilities are satisfactorily carried out. It also should describe the corrective action planned.

Accountability Reports

59. The Board notes that the concept and practice of the "Accountability Report" continue to evolve through the pilot project voluntarily undertaken by several agencies. The Board supports this evolution and encourages agencies to participate in the pilot project. The concepts and standards FASAB recommends are intended to be applicable to the GPFFR of Federal entities, whether those reports are prepared pursuant to the Chief Financial Officers Act, the Government Management Reform Act, or some future law that might establish a statutory basis for Accountability Reports. In the event of such future legislation, OMB will need to resolve any questions about how to apply existing Federal accounting standards in the context of new legislative requirements.

Incorporation by Reference

60. Some respondents were disturbed by the notion of providing program performance information through reference. Some were concerned that, if readers are merely directed to other reports for this information, the GPFFR will become irrelevant. They believe that the GPFFR should contain information about program performance, systems, and controls, not only in MD&A but also in discrete sections, such as the Statement of Program Performance discussed and illustrated in SFFAC 2, paragraphs 106-111 and Appendix 1-F.

61. The Board agrees that, as is stated in paragraph 20, "it is necessary to include at least some information about performance with the

financial statements . . . so that people who use the GPFFR can understand why the costs reported in the financial statements were incurred and the consequences of doing so."

62. The Board acknowledges that SFFAC 2 calls for and illustrates a Statement of Program Performance Measures. (Footnote 13 in SFFAC 2 explains that this statement is not "basic" information as that term is used in audit standards: "The Statement of program performance measures is not a basic financial statement. Nevertheless, it is an important component of the financial reports.") The Board continues to believe that performance information is a vital, integral part of general purpose financial reporting. It should be noted, however, that SFFAC 1 and SFFAC 2 were issued before the performance planning and reporting requirements of GPRA became effective. The Results Act creates an elaborate new planning and reporting environment that is still evolving. Some details of the reporting model that were envisioned conceptually in SFFAC 2 may accordingly need to be revised slightly.

63. This statement of concepts is intended to be consistent with the previously stated goals and concepts of the Board, while recognizing that some details of how best to achieve those goals in the new context still need to be defined. OMB will play a key role in this process; FASAB may also provide further guidance in future projects. FASAB agrees that the GPFFR should not address performance, systems, and controls only by means of reference to other reports. The standards for MD&A require that MD&A do more than refer to other documents.

64. Others expressed concern that, if MD&A is to be regarded as RSI, audit problems might arise from "incorporation by reference" in MD&A of information drawn from other sources that might not be subject to audit or review as basic or required supplementary information, and for which authoritative guidance had not been provided by a standard setter. The Board noted that most of those who commented, including most auditors, did not appear to be greatly concerned about this potential problem. The Board concluded, therefore, that any such problems were not likely to be insurmountable. The Board did, however, agree to defer by one year the implementation date of the standard to allow OMB and GAO time to resolve any audit issues that may arise.

Appendix B: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273.

Statement of Federal Financial Accounting Concepts No. 4: Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government

Status

Issued	March 2003
Volume I References	The objectives provide the framework for all standards; therefore, all SFFASs address objectives in the explanatory text.
Volume II References	None.
Interpretations and Technical Releases	None.
Affects	None.
Affected by	None.

Summary

In this Statement of Concepts, the Federal Accounting Standards Advisory Board (FASAB) has identified the intended or primary audience for the Consolidated Financial Report (CFR) of the US Government. FASAB also has described the characteristics of the audience and the qualitative characteristics FASAB believes will aid in meeting financial reporting objectives for the CFR. The concepts in this document are intended to help the Board as it develops accounting standards and the accounting and reporting framework for the Federal Government.

To provide guidance on the CFR, the Board reviewed its existing technical guidance on Federal financial reporting to discern how to apply that guidance to the CFR. It also researched other pertinent studies, and considered its experience with Federal accounting principles and the evolution of the CFR. The Board developed its assessment of who should be the general primary audience for the CFR. As a result of that review and assessment, the Board has identified five audiences for the CFR: Citizens, Citizen Intermediaries, Congress, Federal Executives, and Program Managers. However, the Board believes that the external user groups, Citizens and Citizen Intermediaries, are the primary audiences for the CFR.

The Board will rely on qualitative characteristics from SFFAC 1 in developing accounting standards for the CFR that will effectively meet the needs of the intended audience. These Qualitative Characteristics include: understandability, reliability, relevance, timeliness, consistency and comparability. While all these characteristics are important, given the intended audience for the CFR, understandability and timeliness are particularly fundamental to the usefulness of the CFR.

This concepts statement provides that the CFR should be a "general purpose" report directed to external users (citizens and their intermediaries), should address the Board's objectives,[2] should have highly understandable information, and should be timely.

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[2] Statement of Federal Financial Accounting Concepts 1, *Objectives of Federal Financial Accounting Concepts* (SFFAC 1) defines those objectives in terms of user needs as 1) budgetary integrity, 2) operating performance, 3) stewardship, and 4) systems and control. See Appendix A for a description of these objectives.

Introduction

1. **Relation of Federal Accounting Concepts and Standards to Governmentwide Consolidated Reporting.** The Federal Accounting Standards Advisory Board's (FASAB or "the Board") first Statement of Federal Financial Accounting Concepts, SFFAC 1, *Objectives of Federal Financial Reporting*, provides the foundation for generally accepted accounting principles, or GAAP, and for the Federal accounting and reporting framework. SFFAC 1 provides that Federal accounting and reporting should address four broad objectives: 1) budgetary integrity; 2) operating performance; 3) stewardship; and 4) systems and controls. [2] These objectives were developed based on studies of users' needs done during FASAB's initial years of operation and apply to all entity level reporting including agency, department, bureau or project level, and the Government as a whole. In addition to reporting objectives, SFFAC 1 established qualitative characteristics for information in financial reports (see pars. 156 to 164 of SFFAC 1).

2. Because of increased experience with, and interest in the US Government's primary consolidated financial report, the *Consolidated Financial Report of the US Government* (CFR), the Board has determined that concepts specifically directed to that report would be helpful. Such concepts would help guide the Board as it develops future standards and changes in its framework for financial accounting and reporting. This document provides concepts related to the primary audience for the CFR and identifies qualitative characteristics for the CFR. The Board may decide in the future to address other aspects of the CFR.

3. **Governmentwide Consolidated Reporting**. The preparer of the CFR, is the United States Department of the Treasury. Prior to any formal guidelines, Treasury voluntarily produced its first "prototype" governmentwide consolidated financial reports in 1976 for fiscal year 1975. The Government Management Reform Act of 1994 required the consolidated financial report of the US to be audited. Treasury's 1997 annual consolidated financial report was the first CFR to be issued pursuant to the Act and to undergo an audit. Since that time, Treasury has continued to refine the preparation and presentation of the CFR.

[2] See Appendix A for a full description of these four objectives from SFFAC 1, *Objectives of Federal Financial Accounting Concepts*.

4. Currently, the CFR is an extensive, informative document that includes highlights of summarized agency level activity, consolidated financial statements, and some accompanying information whose source is not agency level entity reporting. The CFR includes both financial and non-financial information and has been focused on presenting understandable data for a variety of audiences. As a result, the report has grown in size and complexity. Some have questioned whether the CFR is trying to satisfy too many audiences with different needs in one format. Others believe that the information to be presented would depend on the needs of users and that identifying the primary users might better focus the CFR.

5. The Board determined that it would be beneficial to designate the intended or primary audience[3] and qualitative characteristics for the CFR that would be most useful for that audience.

Concepts: Intended Audience and Related Qualitative Characteristics for the CFR

6. The CFR should be a general purpose statement of accountability to the public. A general purpose report should be easily understandable to the "average citizen"[4] who has a reasonable understanding of Federal Government activities and is willing to study the information with reasonable diligence.[5] Moreover, the CFR is a general purpose report that is aggregated from agency reports and tells users where to find information in other formats, both aggregated and disaggregated, such as individual agency reports, agency websites, and the President's Budget.

7. The CFR should generally be directed to five user groups: Citizens, Citizen Intermediaries, Congress, Federal Executives, and Program Managers. However, citizens and citizen intermediaries should be the audience to whom the CFR is primarily directed.

[3] The Board acknowledges that this concepts statement addresses only some aspects of CFR reporting. It may address further aspects as more experience is gained in CFR reporting.

[4] *Toward a Report to Citizens on the State of Their Nation and the Performance of Their Government: Proceedings of the AGA Task Force on a Report to Citizens on the State of the Nation*, November 1994, p.12 The report did not define "average citizen."

[5] Based on the definition of a general user as described in the Financial Accounting Standards Board Concepts Statement 1. The FASAB narrowed the definition to make it specific to the Federal Government.

8. The CFR should provide information that addresses the areas of the Board's objectives as identified in SFFAC 1: 1) budgetary integrity, 2) operating performance, 3) stewardship, and 4) systems and control. The Board does not intend that the CFR should satisfy all of the Board's objectives for all audiences. It earlier provided that each of the reporting objectives could be met to a greater or lesser degree by different statements prepared by different entities. For example, program and financing schedules for individual budget accounts could help address budgetary integrity, and financial statements from organizations could help address operating performance. [6]

9. SFFAC 1 also provides that information should be reliable, relevant, consistent, comparable, understandable and timely. While all of these characteristics are important for all reports and all users, it is particularly fundamental that the CFR be timely and understandable for citizens and citizen intermediaries. The content and structure of the CFR should be clear and complete to citizens and citizen intermediaries and the CFR should be available on a timely basis. For example, to be timely, the CFR should be issued not less than annually and as close to the end of the fiscal year as is possible. [7]

Basis for Conclusions

Intended Audience for the Consolidated Financial Report (CFR)

10. This appendix does not constitute authoritative guidance for those who prepare and audit general purpose federal financial reports. It summarizes important matters that the FASAB members considered as they deliberated on this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

11. FASAB published the exposure draft, *Target Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government*, March 19, 2002. There were 12 respondents as described in the table below:

[6] Statement of Federal Financial Accounting Concepts 2, *Entity and Display*, par. 56.

[7] The Board understands that the preparer's ability to meet this goal is beyond the Board's purview. Guidance on reporting deadlines is provided by the Office of Management and Budget.

Category	Federal (Civilian)	Federal (Military)	Non-federal
Users, academics, and others (includes professional organizations			5
Preparers and Financial Managers	6	1	
Totals	6	1	5

12. In general, respondents agreed with the Board's identification of the primary audience as citizens and citizen intermediaries. Other respondent comments are addressed in the discussions that follow.

13. In providing guidance on the CFR, the Board primarily relied on its earlier conclusions supporting decisions on SFFAC 1, *Objectives of Federal Financial Information*. It then filtered into those conclusions its years of experience subsequent to its earlier conceptual work and other pertinent literature that describes user groups of government-level financial information. In particular, the Board relied on one of the most extensive studies on user needs for Federal Government financial information, the joint US-Canadian user needs study, Federal Government Reporting Study of March 1986. In this study, conducted by the US Comptroller General and the Auditor General of Canada, the researchers identified similar groups of users as those the Board had identified in SFFAC 1 and in this document.

14. The Board agreed that, in general, users of Federal financial information fall into the four categories identified in SFFAC 1: Citizens, Congress, Executives, and Program Managers.[8] However, for information at the more highly summarized governmentwide or consolidated level the Board divided those four groups identified in SFFAC 1 into two major groups: external users (Citizens), and internal users (Congress, Executives, and Program Managers).

15. The Board believes that citizens should be the primary audience for the CFR. This is based on the notion that citizens as compared to the other groups do not have ready access to more detailed Federal financial reports on which to make decisions. Moreover, they may not

[8] SFFAC 1, par. 88-104.

have the knowledge or desire to take the time to understand more sophisticated reports, preferring instead to look to a more summarized report for highlights of interest. Thus, the Board believes that the CFR should not attempt to meet all users needs for all objectives. Instead it should focus on meeting the basic needs of citizens for highly summarized information.

16. Further, for the CFR the Board believes that the Citizen user group identified in SFFAC 1 has two different sets of needs and therefore should be divided into two groups: Citizens and Citizen Intermediaries. Citizen needs are more specifically targeted to issues of general interest and to broad indicators of the overall financial health of the Government. On the other hand, Citizen Intermediaries devote more time to reading, analyzing, and interpreting more detailed information that they then analyze, summarize, and pass on to Citizens for further application. For these reasons, the Board expanded its original four groups of users to five user groups for the CFR. The group characteristics are summarized in the paragraphs that follow.

External Users

17. *Citizens*. This group includes individuals outside the Government who are interested in information that supports their goals of generating and preserving income and savings, and improving their standard of living.[9] Citizens are interested in many aspects of the Federal Government. They are concerned about individual programs, candidates for office, the services the Government provides, and the fiscal responsibility of their elected and appointed representatives. Citizens receive and pay for Government services and therefore are concerned with the outputs and outcomes of those services and the efficiency with which they are provided. Citizens are concerned about their families and, in particular, with the financial burden their children and grandchildren will inherit.[10] These users are interested in a "comprehensive but concise…report [that would provide] a broad and complete picture of the Government's…many and varied activities and resulting overall financial position."[11]

[9] *Federal Government Reporting Study: A Joint Study by the Office of the Auditor General of Canada and the US General Accounting Office*, March 1986, p.10.

[10] SFFAC 1, par. 77.

18. Citizen Intermediaries. This group also includes individuals from outside the Government. It includes, among others, individuals such as: the media; public interest and advocacy groups; state and local legislators and executives; and analysts from corporations, academe and elsewhere. As citizens typically have limited time and ability to analyze reports about their government, they want and rely on assurances that the government is functioning economically, efficiently, and effectively.[12] However, citizens, for the most part, " would look to analysts in the media, financial institutions, policy institutes, etc., to do such analysis for them."[13] Citizen intermediaries would analyze and interpret the more detailed information to deliver it to citizens. They also would provide more in-depth analysis that citizens may not have the desire or the ability to perform. Citizen intermediaries typically have more skill, time and ability to gather and analyze detailed data from alternative sources.

19. Intermediaries are interested in all of the major facets of each of the Board's objectives, including individual programs; Government services and activities; fiscal responsibility of elected and appointed representatives; program outputs and outcomes; and assurances of Government economy, efficiency and effectiveness. Intermediaries, therefore, are interested in a wider array of information on all aspects of budget, program operations, the Federal Government's stewardship, and systems and controls. "Media and analysts are the most frequent direct users of Federal Government financial reports, the major source of information about the Government for citizens and corporations, and an important source of information for legislators."[14] The Board believes that intermediaries may rely on the CFR as a starting point but that they will seek more detailed reports.

20. The Board agrees with the conclusion of the Federal Government Reporting Study. A significant finding was that "users depend on each other for the communication of financial information about the Federal Government. Legislators - generally considered to have a

[11] *Federal Government Reporting Study*, p.v.

[12] SFFAC 1, paragraph 77.

[13] ibid. p.5.

[14] ibid. pp.5-6.

primary role in the use of Federal Government financial information - depend to a considerable extent on the interpretations of information by analysts and the media to provide them with the understanding they need. This also applies to citizens and corporations. Thus, needs of analysts and the media are considered crucial because, if they are not well served, the understanding of government activities by others will suffer."[15]

Internal Users

21. Internal users are those groups inside the Federal Government who typically have more access to the myriad of Federal Government information including summarized and detailed financial, program, budget, cost, and economic reports and analyses for all entities. Because they are able to get information on their specific issues of interest, they might benefit from the CFR but are not its primary audience. Internal users include Congress, Federal executives, and program managers. Of these three internal users, some have considered Congress as the ultimate intermediary between the public and its Government. That notwithstanding, Congress, as would the other internal users, has access to more specific internal information and reports for conducting its work. Thus they are not the main audience of the CFR. However, these users may rely on the CFR with its broad indicators and summarized information as "a reference document to lead to more detailed or disaggregated information in specific areas."[16] Each internal user has access to detailed, disaggregated information, but relies on summarized data in a more limited capacity as indicators for general Governmental financial position and condition. Internal users would use the CFR to provide "an overall picture of the financial health of the Government that is not available elsewhere…[and provide it with] a general framework to situate [its] own activities."[17]

[15] Ibid. pp. iv-v.

[16] Ibid. p.8.

[17] ibid. p.9.

Summary

22. Based on the above analysis, the Board concluded that the CFR would be of general interest to five user groups. However, the Board believes that the external user groups representing the general public, that is, Citizens and Citizen Intermediaries, are the primary audiences for the CFR.

23. The Board also considered comments from respondents to its exposure draft (see paragraph 11). Some respondents requested that specific individuals be added to the examples of persons included in the Citizen Intermediary group. Since the Board intended that the individuals listed in the group description were typical examples rather than an exhaustive list, it decided not to expand the list of examples. Rather it decided to slightly modify the wording of the description of the Citizen Intermediary group to clarify that the individuals and groups listed are typical examples and not an exhaustive list.

Qualitative Characteristics

24. To be useful, FASAB's SFFAC 1 provides that information should be reliable, relevant, consistent, comparable, understandable and timely. The FASAB considers these characteristics as it deliberates standards applicable to all Federal reporting entities, both agency level and the government as a whole. In the Federal environment, satisfaction of these characteristics occurs when FASAB develops standards for Federal reporting. At the CFR level, where the audited agency level data are aggregated, the manner in which the data are presented to the general audience for which the CFR is intended is a fundamental consideration. Because Federal financial statements differ from commercial financial statements in concept, form, volume, and complexity and the intended audience for Federal financial statements is so all encompassing, the FASAB is emphasizing the need for the CFR to be understandable. The Board concurs with a study by the Association of Government Accountants on Government accountability reporting that concluded that, "the problem of reporting to the citizens is not primarily one of inability to develop meaningful information or lack of it. Rather, the principal problem is the manner in which this information is communicated to the American citizens."[18] The study suggested that the abundance of detailed financial data

published by the Government does not give citizens a succinct and comprehensive picture of the Government's activities.

25. To support supplying citizens with a full picture of Government activities in an understandable manner, the Board concluded that each user group should be able to easily locate the types of information in which it might be interested. For example, if an item is reported, all information related to that item should be reported in one primary location, if feasible.[19] If not feasible, the report should provide clear linking language, notes, or other information that would guide the reader to the information on the item or topic that is split among different sections of the report. Ultimately, the CFR's content and structure should be clear and complete to users.

26. In addition to the characteristic of understandability to citizens who may not have detailed knowledge of accounting principles (discussed above), this concepts statement emphasizes the qualitative characteristic of timeliness as being important for the CFR. As noted in SFFAC 1 (par. 162), "if financial reports are to be useful, they must be issued soon enough to affect decisions." No matter how relevant, reliable, consistent, or comparable information might be, if the intended audience does not understand the information or if the information is not available in a timely manner, the information will not be useful to or used by that audience.

27. The Board also considered comments from some respondents who did not believe that the qualitative characteristics of understandability and timeliness should be emphasized at the expense of the other 4 characteristics (relevance, reliability, consistence and comparability). The Board affirmed that its intent as stated in paragraph 9 of the exposure draft was to acknowledge that all 6 characteristics were important for all reports and users. Its focus on the characteristics of understandability and timeliness related to the aggregated nature of

[18] *Toward a Report to Citizens on the State of Their Nation and the Performance of Their Government: Proceedings of the AGA Task Force on a Report to Citizens on the State of the Nation*, November 1994, p.25.

[19] If items to be reported have mixed levels of audit coverage, the level of audit coverage for each item should be clearly identified. The audit standards in AU 558 will govern the labeling of the items.

the report and the intended audiences. It decided to delete the last two sentences of paragraph 22 of the exposure draft:

> Thus, these two qualitative characteristics (understandability and timeliness) serve as a foundation for constructing accounting standards for a useful CFR. The Board will consider the other qualitative characteristics as standards are developed, considered, and adopted.

28. The Board believes that these two sentences caused some respondents to conclude the other 4 characteristics were not important to the Board.

General Purpose Financial Reporting

29. Since the Board considers the CFR a general purpose financial report, it reiterates its discussion from SFFAC 1, where it described the limitations of financial reporting. It said that "general purpose financial reporting is not the only source of financial information … In many cases, users of general purpose financial reports need to consult other sources to satisfy their information needs…While certain information is provided by general purpose financial reports, other information is better provided by, or can be provided only by, financial reporting outside such reports. Still other information is provided by nonfinancial reports or by financial reports about segments of the national society other than the Federal Government and its component entities (e.g., economic reporting)." [20]

Board Approval

30. The Board unanimously approved issuing this concepts statement.

[20] SFFAC 1, *Objectives of Federal Financial Reporting*, par. 30-31.

Appendix A: Objectives of Federal Financial Reporting[21]

31. **Budgetary Integrity**. Federal financial reporting should assist in fulfilling the Government's duty to be publicly accountable for monies raised through taxes and other means and for their expenditure in accordance with the appropriations laws that establish the Government's budget for a particular fiscal year and related laws and regulations. Federal financial reporting should provide information that helps the reader to determine

    - how budgetary resources have been obtained and used and whether their acquisition and use were in accordance with the legal authorization,
    - the status of budgetary resources, and
    - how information on the use of budgetary resources relates to information on the cost of programs [and] operations and whether information on the status of budgetary resources is consistent with other accounting information on assets and liabilities.

32. **Operating Performance**. Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities. Federal financial reporting should provide information that helps the reader to determine

    - the costs of providing specific programs and activities and the compositions of, and changes in, these costs;
    - the efforts and accomplishments associated with Federal programs and the changes over time and in relation to costs; and
    - the efficiency and effectiveness of the Government's management of its assets and liabilities.

33. **Stewardship**. Federal financial reporting should assist report users in assessing the impact on the country of the Government's operations and investments for the period and how, as a result, the Government's and the Nation's financial conditions have changed and may change in the future.

[21] From Statement of Federal Financial Accounting Concepts 1, SFFAC 1, *Objectives of Federal Financial Reporting*, par. 13-17.

34. Federal financial reporting should provide information that helps the reader to determine whether

- the Government's financial position improved or deteriorated over the period,
- future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due, and
- Government operations have contributed to the Nation's current and future well-being.

35. **Systems and Controls**. Federal financial reporting should assist report users in understanding whether financial management systems and internal accounting and administrative controls are adequate to ensure that

- transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the purpose authorized, and are recorded in accordance with Federal accounting standards;
- assets are properly safeguarded to deter fraud, waste, and abuse, and
- performance measurement information is adequately supported.

Appendix B: Acronyms

AICPA – American Institute of Certified Public Accountants

CFR – Consolidated Financial Statement of the US Government

FASAB – Federal Accounting Standards Advisory Board

GAAP – generally accepted accounting principles

SFFAC – Statement of Federal Financial Accounting Concepts

SFFAS – Statement of Federal Financial Accounting Standards

Statement of Federal Financial Accounting Standards No. 1: Accounting for Selected Assets and Liabilities

Status

Issued	March 30, 1993
Effective Date	For fiscal years ending September 30, 1994 and thereafter.
Volume I References	SFFAS No. 5, *Accounting for Liabilities of the Federal Government* (provides definition of a liability) SFFAS No. 7, *Accounting for Revenue and Other Financing Sources* (provides for recognition of receivables from nonexchange)
Volume II References	Accounts Payable (A10), Advances and Prepayments (A30), Cash (C20), Entity and Nonentity Assets (E30), Fund Balance with Treasury (F50), Governmental and Intragovernmental Assets and Liabilities (G60), Interest Payable (I50), Interest Receivable (I80), Investments in Treasury Securities (I80), Liabilities (L40), Other Current Liabilities (O40), Receivables (R10)
Interpretations and Technical Releases	
Affects	No other statements.
Affected by	Paragraph 53, SFFAS No. 7, affects paragraph 41, by providing additional guidance regarding accruing accounts receivable.

Summary

This statement defines and illustrates the distinction between Entity Assets and Non-entity Assets, as well as Intragovernmental and Governmental Assets and Liabilities.

Assets available to an entity to use in its operations are entity assets while those assets not available to an entity but held by the entity are non-entity assets. While both entity and non-entity assets are to be reported in entity statements, the standards require the segregation of entity and non-entity assets. In addition, a liability (due to Treasury or other entities) must be recognized in an amount equal to non-entity assets.

Intragovernmental assets and liabilities arise from transactions among federal entities. Governmental assets and liabilities arise from transactions of the federal government or an entity of the federal government with nonfederal entities. The standards require that all selected assets and liabilities addressed in SFFAS No. 1 be reported separately as intragovernmental or governmental assets and liabilities.

The statement also establishes specific standards for six assets: Cash, Fund Balance with Treasury, Accounts Receivable, Interest Receivable, Advances and Prepayments, and Investments in Treasury Securities; and three liabilities: Accounts Payable, Interest Payable, and Other Current Liabilities. The standards provide definitions of each asset and liability as well as recognition, measurement, and disclosure requirements.

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Introduction

Objective

1. In this Statement, the Board recommends accounting standards for selected assets and liabilities of the federal government and its entities. The standards apply to both governmental and commercial-type functions of the federal government.

2. The selected assets and liabilities are among the fundamental elements of federal accounting and financial reporting. By recommending these standards in the Board's first Statement, the Board's objective is to provide definitive accounting and reporting guidance to federal agencies in these fundamental areas at the earliest stage of the Board's consideration and development of federal accounting standards.

3. In a separate project, the Board is identifying users' needs and federal accounting and reporting objectives. Although the Board's deliberation on objectives has not been finalized, there is a general consensus that one overall objective for accounting and financial reporting is to assure accountability of federal governmental entities. The Board believes that issuing these selected standards will help in fostering that overall objectives.

4. Specifically, the recommended standards would assist users of financial statements in:

   - assessing the efficiency and effectiveness of the government's management of its assets and liabilities, and
   - determining whether the government's financial position improved or deteriorated over the reporting period.

Approach

5. The Board's initial approach to developing accounting standards was to review the existing accounting standards prescribed by the General Accounting Office (GAO) in its *Policy and Procedures Manual for the Guidance of Federal Agencies*, *Title 2 Accounting*, *(Title 2)*. The purpose of the review was to determine whether some of the *Title 2* standards, with any necessary modifications, could be recommended by the Board to the principals of the Joint Financial Management Improvement Program (JFMIP).

6. Although the *Title 2* standards had not been fully implemented by federal agencies, they represented a starting point for further analysis. The *Title 2* standards were reviewed in light of the accounting and reporting requirements established in the Chief Financial Officers (CFOs) Act of 1990. At the time, the Board considered current accounting practices of federal agencies. It also considered the findings from its project on user needs and objectives of federal financial reporting. As a result of the review, the Board decided that with certain modifications, accounting standards for selected assets and liabilities could be recommended to the JFMIP principals.

7. These selected assets and liabilities involve less complex issues than other assets and liabilities to be considered by the Board in the future. The Board also believes that the selected assets and liabilities are so basic to financial reporting that they will not conflict with any conceptual framework that the Board may develop.[1]

8. The standards on the selected assets and liabilities were proposed in the Board's first Exposure Draft issued in September 1991, entitled *Financial Resources*, *Funded Liabilities*, *and Net Financial Resources and Federal Entities*. A total of 69 respondents submitted their comments to the Board on the Exposure Draft. A public hearing on the Exposure Draft was held on February 28, 1992.

9. In preparing this Statement of recommended standards, the Board considered the respondents' comments. Based on the comments the Board received and its reevaluation in relation to the Board's current thinking on user needs and objectives of federal financial reporting, the Board made changes to the proposals contained in the Exposure Draft. The specific changes are discussed in Appendix A, "Basis of the Board's Conclusions."

Scope

10. The selected assets addressed in this Statement are:

    - Cash

[1]The Board is also addressing other assets and liabilities. It has issued a proposed standard for direct loans and loan guarantees (see Exposure Draft entitled *Accounting for Direct Loans and Loan Guarantees*, September 15, 1992, and *Accounting for Inventory and Related Property*, December 1992).

- Fund Balance with Treasury
- Accounts Receivable
- Interest Receivable
- Advances and Prepayments
- Investments in Treasury Securities

11. The selected liabilities addressed in this Statement are:

- Accounts Payable
- Interest Payable
- Other Current Liabilities

Materiality

12. Except as otherwise noted, the accounting and reporting provisions of the accounting standards recommended in this Statement need not be applied to items that are qualitatively and quantitatively immaterial.

13. The determination of whether an item is material depends on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement.

Applicability

14. The accounting standards recommended in this Statement are applicable to the federal government and its departments and agencies in the executive branch that fall within the definition of "executive agency" as defined in 31 U.S.C. 102 and 3501.

Effective Date

15. The accounting standards recommended in this Statement will be effective for financial statements prepared for fiscal years ending September 30, 1994, and thereafter. Earlier adoption is encouraged.

Explanation

16. The Board's focus in this Statement is on setting accounting standards for the individual federal entity level of reporting. In this Statement, the standards are also applicable to financial reporting by the U.S. government as a whole, except for those standards related to intragovernmental assets and liabilities, which are defined in the general standards and noted in specific standards.

17. The word "entity" refers to a unit within the federal government, such as a department, agency, bureau, or program, for which a set of financial statements will be prepared. The word entity also encompasses a group of related or unrelated commercial functions, revolving funds, trust funds, and/or other accounts for which financial statements are prepared in accordance with OMB guidance on the form and content of financial statements.

General Standards

Intragovernmental vs. Governmental Assets and Liabilities

18. ***Intragovernmental assets and liabilities*** arise from transactions among federal entities. Intragovernmental assets are claims of a federal entity against other federal entities. Intragovernmental liabilities are claims against the entity by other federal entities.

19. Among the assets covered by this Statement, intragovernmental assets include an entity's fund balance with Treasury, investments in Treasury securities, accounts and interest receivable from federal entities, and advances and prepayments to federal entities.

20. Intragovernmental liabilities include accounts and interest payable to federal entities and other current liabilities due to federal entities, such as receipt of federal advances and prepayments.

21. ***Governmental assets and liabilities*** arise from transactions of the federal government or an entity of the federal government with nonfederal entities. Governmental assets are claims of the federal government or an entity within the federal government against nonfederal entities. Governmental liabilities are amounts that the federal government or an entity within the federal government owes to nonfederal entities. The term nonfederal entities encompasses domestic and foreign persons and organizations outside the U.S. government. The term public is also used in this Statement to represent nonfederal entities.

22. Among the assets covered by this Statement, governmental assets that would be reported by a federal entity include cash, accounts and interest receivable from nonfederal entities, and advances and prepayments made to nonfederal entities.

23. Governmental liabilities include accounts and interest payable to nonfederal entities, other liabilities due to nonfederal entities, and advances and prepayments received from nonfederal entities.

24. Intragovernmental assets and liabilities should be reported separately from governmental assets and liabilities. This requirement applies to all of the selected assets and liabilities addressed in this document.

Entity Assets vs. Non-entity Assets

25. ***Entity assets*** are those assets which the reporting entity has authority to use in its operations. ***Non-entity assets*** are those assets that are held by an entity but are not available to the entity. An example of non-entity assets are customs duty receivables that the Customs Service collects for the U.S. government but has no authority to spend. A similar example is federal income tax receivable that the Internal Revenue Service collects for the U.S. government.

26. Both entity assets and non-entity assets under an entity's custody or management should be reported in the entity's financial statements. Non-entity assets reported in an entity's financial statements should be segregated from entity assets. An amount equal to non-entity assets should be recognized as a liability (due to Treasury or other entities) in the entity's financial statements.

Specific Standards

Cash

27. *Cash*, including imprest funds, should be recognized as an asset. Cash consists of:

    a. coins, paper currency and readily negotiable instruments, such as money orders, checks, and bank drafts on hand or in transit for deposit;

    b. amounts on demand deposit with banks or other financial institutions; and

    c. foreign currencies, which, for accounting purposes, should be translated into U.S. dollars at the exchange rate on the financial statement date.

28. ***Entity cash.*** Entity cash is the amount of cash that the reporting entity holds and is authorized by law to spend.

29. ***Non-entity cash.*** Non-entity cash is cash that a federal entity collects and holds on behalf of the U.S. government or other entities. In some circumstances, the entity deposits cash in its accounts in a fiduciary capacity for the U.S. Treasury or other entities. Non-entity cash should be reported separately from entity cash.

30. ***Restricted cash.*** Cash may be restricted. Restrictions are usually imposed on cash deposits by law, regulation, or agreement. Non-entity cash is always restricted cash. Entity cash may be restricted for specific purposes. Such cash may be in escrow or other special accounts. Financial reports should disclose the reasons and nature of restrictions.

Fund Balance with Treasury

31. A federal entity's fund *balance with the Treasury* is the aggregate amount of funds in the entity's accounts with Treasury for which the entity is authorized to make expenditures and pay liabilities. Fund balance with Treasury is an intragovernmental item. From the reporting entity's perspective, a fund balance with Treasury is an asset because it represents the entity's claim to the federal government's resources. However, from the perspective of the federal government as a whole, it is not an asset; and while it represents a commitment to make resources available to federal departments, agencies, programs and other entities, it is not a liability.

32. A federal entity's fund balance with Treasury includes clearing account balances and the dollar equivalent of foreign currency account balances. Foreign currency account balances should be translated into U.S. dollars at exchange rates determined by the Treasury and effective at the financial reporting date. A federal entity's fund balance with Treasury also includes balances for direct loan and loan guarantee activities held in the credit reform program, financing, and liquidating accounts.

33. An entity's fund balance with Treasury is increased by (a) receiving appropriations, reappropriations, continuing resolutions, appropriation restorations, and allocations, and (b) receiving transfers and reimbursements from other agencies. An entity's fund balance with Treasury is also increased by amounts borrowed from Treasury,

Federal Financing Bank, or other entities, and amounts collected and credited to appropriation or fund accounts that the entity is authorized to spend or use to offset its expenditures.

34. An entity's fund balance with Treasury does not include contract authority or unused authority to borrow. *Contract authority* is a statutory authority under which contracts or other obligations may be entered into prior to receiving an appropriation for the payment of obligations. The later enacted appropriation provides cash to liquidate obligations.[2] Thus, contract authority merely permits a federal entity to incur certain obligations but does not, in itself, add funds to the agency's accounts with Treasury.

35. *Authority to borrow* is a statutory authority that permits a federal agency to incur obligations and make payments for specific purposes out of borrowed funds. Authority to borrow adds funds to an agency's accounts with Treasury only after the agency actually uses the authority to borrow a specific amount of funds. Thus, authority to borrow is included in an entity's fund balance with Treasury only to the extent that funds are actually borrowed under the authority.

36. An entity's fund balance with Treasury is reduced by (a) disbursements made to pay liabilities or to purchase assets, goods, and services, (b) investments in U.S. securities (securities issued by Treasury or other federal government agencies), (c) cancellation of expired appropriations; (d) transfers and reimbursements to other entities or to the Treasury, and (e) sequestration or rescission of appropriations.

37. Disclosure should be made to distinguish two categories of funds within the entity's fund balance with Treasury: the obligated balance not yet disbursed and the unobligated balance. The obligated balance not yet disbursed is the amount of funds against which budgetary obligations have been incurred, but disbursements have not been made.

38. The *unobligated balance* is the amount of funds available to an entity against which no claims have been recorded. Unobligated balances are generally available to a federal entity for specific purposes stipulated

[2]Source of definition: OMB Circular A-34.

by law. Unobligated balances may also include balances in expired/canceled accounts that are available only for approved adjustments to prior obligations. Certain unobligated balances may be restricted to future use and are not apportioned for current use. Disclosure should be provided on such restrictions.

39. Federal entities should explain any discrepancies between fund balance with Treasury in their general ledger accounts and the balance in the Treasury's accounts and explain the causes of the discrepancies in footnotes to financial statements. (Discrepancies due to time lag should be reconciled and discrepancies due to error should be corrected when financial reports are prepared.) Agencies also should provide information on unused funds in expired appropriations that are returned to Treasury at the end of a fiscal year.

Accounts Receivable

40. Accounts receivable arise from claims to cash or other assets. The accounting standard for accounts receivable is set forth below.

41. ***Recognition of receivables.***[3] A receivable should be recognized when a federal entity establishes a claim to cash or other assets against other entities, either based on legal provisions, such as a payment due date, (e.g., taxes not received by the date they are due), or goods or services provided. If the exact amount is unknown, a reasonable estimate should be made. [See SFFAS 7, paragraph 53 for more.]

42. ***Separate reporting.*** Receivables from federal entities are intragovernmental receivables, and should be reported separately from receivables from nonfederal entities.

43. ***Entity vs. Non-entity receivables.*** Receivables should be distinguished between entity receivables and non-entity receivables.

[3]The word recognition used in this document bears the same meaning as used by the Financial Accounting Standards Board (FASB) in its conceptual statements. It means the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like. A recognized item is depicted in both words and numbers, with the amount included in the statement totals. Recognition comprehends both initial recognition of an item and recognition of subsequent changes in or removal of a previously recognized item. FASB Statement of Financial Accounting Concepts No. 5, par. 6.

Entity receivables are amounts that a federal entity claims for payment from other federal or nonfederal entities and that the federal entity is authorized by law to include in its obligational authority or to offset its expenditures and liabilities upon collection.[4] ***Non-entity receivables*** are amounts that the entity collects on behalf of the U.S. government or other entities, and the entity is not authorized to spend.[5] Receivables not available to an entity are non-entity assets and should be reported separately from receivables available to the entity.

44. ***Recognition of losses due to uncollectible amounts.*** Losses on receivables should be recognized when it is more likely than not that the receivables will not be totally collected. The phrase *more likely than not* means more than a 50 percent chance of loss occurrence.

45. An allowance for estimated uncollectible amounts should be recognized to reduce the gross amount of receivables to its net realizable value.[6] The allowance for uncollectible amounts should be reestimated on each annual financial reporting date and when information indicates that the latest estimate is no longer correct.

46. ***Measurement of losses.*** Losses due to uncollectible amounts should be measured through a systematic methodology. The systematic methodology should be based on analysis of both individual accounts and a group of accounts as a whole.

47. ***Individual account analysis.*** Accounts that represent significant amounts should be individually analyzed to determine the loss allowance. Loss estimation for individual accounts should be based on (a) the debtor's ability to pay, (b) the debtor's payment record and

[4]An entity may have receivables that, once collected, can be used as offsets to the entity's budget authority and outlays only when authorized by Congress. Before receiving the authorization, however, those receivables are non-entity receivables.

[5]Governmental receipts include collections arising from the sovereign and regulatory powers unique to the federal government, e.g., income tax receipts, customs duties, court fines, certain license fees, etc. A federal entity may be responsible for collecting these receipts on behalf of the U.S. government, but is not authorized to use the monies collected to offset its expenditures.

[6]In the Board's Exposure Draft, *Accounting for Direct Loans And Loan Guarantees*, September 15, 1992, receivables are accounted for on a net present value basis. [See SFFAS No. 2]

willingness to pay, and (c) the probable recovery of amounts from secondary sources, including liens, garnishments, cross collections and other applicable collection tools.

48. The allowance for losses generally cannot be based solely on the results of individual account analysis. In many cases, information may not be available to make a reliable assessment of losses on an individual account basis or the nature of the receivables may not lend itself to individual account analysis. In these cases, potential losses should be assessed on a group basis.

49. ***Group analysis.*** To determine the loss allowance on a group basis, receivables should be separated into groups of homogeneous accounts with similar risk characteristics.

50. The groups should reflect the operating environment. For example, accounts receivable can be grouped by: (a) debtor category (business firms, state and local governments, and individuals), (b) reasons that gave rise to the receivables (tax delinquencies, erroneous benefit payments, trade accounts based on goods and services sold, and transfers of defaulted loans to accounts receivable), or (c) geographic regions (foreign countries, and domestic regions). Within a group, receivables are further stratified by risk characteristics. Examples of risk factors are economic stability, payment history, alternative repayment sources, and aging of the receivables.

51. Statistical estimation by modeling or sampling is one appropriate method for estimating losses on groups of receivables. Statistical estimation should take into consideration factors that are essential for estimating the level of losses, including historical loss experience, recent economic events, current and forecast economic conditions, and inherent risks.

52. ***Disclosure.*** Agencies should disclose the major categories of receivables by amount and type, the methodology used to estimate the allowance for uncollectible amounts, and the total allowance.

Interest Receivable

53. Interest receivable should be recognized for the amount of interest income earned but not received for an accounting period. Interest receivable should be recognized as it is earned on investments in interest-bearing securities. Interest also should be recognized on

outstanding accounts receivable and other U.S. government claims against persons and entities in accordance with provisions in 31 U.S.C. 3717, Interest and Penalty Claims. (See also Federal Claims Collection Standards, 4 CFR Part 103, paragraph 102.13.)[7]

54. No interest should be recognized on accounts receivable or investments that are determined to be uncollectible unless the interest is actually collected. Payments received from the debtor are required to be applied first to penalty and administrative cost charged, second to interest receivable, and third to outstanding debt principal, per Federal Claims Collection Standards, 4 C.F.R. 102.13(f).

55. However, until the interest payment requirement is officially waived by the government entity or the related debt is written off, interest accrued on uncollectible accounts receivable should be disclosed.

56. Interest receivable from federal entities should be accounted for and reported separately from interest receivable from the public.

Advances and Prepayments

57. *Advances* are cash outlays made by a federal entity to its employees, contractors, grantees, or others to cover a part or all of the recipients' anticipated expenses or as advance payments for the cost of goods and services the entity acquires. Examples include travel advances disbursed to employees prior to business trips, and cash or other assets disbursed under a contract, grant, or cooperative agreement before services or goods are provided by the contractor or grantee.

58. *Prepayments* are payments made by a federal entity to cover certain periodic expenses before those expenses are incurred. Typical prepaid expenses are rents paid to a lessor at the beginning of a rental period. Progress payments made to a contractor based on a percentage of completion of the contract are not advances or prepayments.

59. Advances and prepayments should be recorded as assets. Advances and prepayments are reduced when goods or services are received, contract terms are met, progress is made under a contract, or prepaid

[7]Accounting for imputed interest, interest on long-term leases, interest on loans, and interest on amounts deposited in credit reform accounts will be addressed when the Board considers accounting standards in these areas.

expenses expire. A travel advance, for example, should be initially recorded as an asset and should be subsequently reduced when travel expenses are actually incurred. Amounts of advances and prepayments that are subject to refund (for example, a settled travel claim indicating the traveler owes part of the advance to the government) should be transferred to accounts receivable.

60. Advances and prepayments paid out by an entity are assets of the entity. On the other hand, advances and prepayments received by an entity are liabilities of the entity (see the recommended standard for other current liabilities). In financial reports of an entity, advances and prepayments the entity paid out (assets) should not be netted against advances and prepayments that the entity received (liabilities).

61. Advances and prepayments made to federal entities are intragovernmental items and should be accounted for and reported separately from those made to nonfederal entities.

Investments in Treasury Securities

62. ***Scope.*** This standard applies to investment by federal entities in Treasury securities, including (a) nonmarketable par value Treasury securities, (b) market-based Treasury securities expected to be held to maturity, and (c) marketable Treasury securities expected to be held to maturity. This standard does not apply to investments by federal entities in securities (debt and equity) and other financial instruments issued by other than the U.S. Treasury.

63. *Nonmarketable par value Treasury securities* are special series debt securities that the U.S. Treasury issues to federal entities at face value (par value). The securities are redeemed at face value on demand; thus investing entities recover the full amounts invested.

64. *Market-based Treasury securities* are debt securities that the U.S. Treasury issues to federal entities without statutorily determined interest rates. Although the securities are not marketable, their terms (prices and interest rates) mirror the terms of marketable Treasury securities.

65. *Marketable Treasury securities*, including Treasury bills, notes, and bonds, are initially offered by Treasury to the marketplace and can then be bought and sold on securities exchange markets. Their bid and ask prices are publicly quoted by the marketplace.

66. ***Treasury securities expected to be held to maturity.*** Aside from nonmarketable par value Treasury securities, this standard applies to market-based and marketable Treasury securities that are expected to be held to maturity. An investment in securities is *expected to be held to maturity* only if the investing entity has the intent and ability to hold those securities to maturity. An investment in Treasury securities should not be considered as expected to be held to maturity if the investing entity is likely to sell the securities in response to short-term cash needs, changes in market interest rates, or for other reasons.

67. ***Separate accounting and reporting for federal and nonfederal securities.*** Investments of a federal entity in U.S. securities (securities issued by Treasury and federal agencies) are intragovernmental investments. These U.S. securities also represent intragovernmental liabilities of the Treasury Department or other federal entities that issue the securities. Investments in securities issued by the U.S. Treasury or other federal entities should be accounted for and reported separately from investments in securities issued by nonfederal entities.

68. ***Initial recording.*** The three types of Treasury securities covered by this standard (nonmarketable par value Treasury securities, market-based Treasury securities expected to be held to maturity, and marketable Treasury securities expected to be held to maturity) should be recognized at their acquisition cost. If the acquisition is made in exchange for nonmonetary assets, the acquired securities should be recognized at the fair market value of either the securities acquired or the assets given up, whichever is more definitively determinable.

69. If the acquisition cost differs from the face (par) value, the security should be recorded at the acquisition cost, which equals the security's face value plus or minus the premium or discount on the investment. A discount is the excess of the security's face amount over its purchase price. A premium is the excess of the purchase price over the security's face value. The balance in the valuation account is treated as a contra account to the debt security.

70. ***Valuation subsequent to acquisition.*** Subsequent to their acquisition, investments in Treasury securities should be carried at their acquisition cost, adjusted for amortization, if appropriate, as explained below.

71. If an amount of premium or discount exists, the carrying amount of the investments should be adjusted in each reporting period to reflect the amortization of the premium or the discount. Premiums and discounts should be amortized over the life of the Treasury security using the interest method. Under the interest method, the effective interest rate (the actual interest yield on amounts invested) multiplied by the carrying amount of the Treasury security at the start of the accounting period equals the interest income recognized during the period (the carrying amount changes each period by the amount of the amortized discount or premium). The amount of amortization of discount or premium is the difference between the effective interest recognized for the period and the nominal interest for the period as stipulated in the Treasury security. (See Appendix B for an illustration of the interest method of amortization.)

72. ***Disclosure of market value.*** For investments in market-based and marketable Treasury securities, the market value of the investments should be disclosed. For purposes of determining a market value, investments should be grouped by type of security, such as marketable or market-based Treasury securities. The market value of investments in a group is calculated by the market price of securities of that group at the financial reporting date multiplied by the number of notes or bonds held at the financial reporting date.

73. ***Investment reclassification.*** In rare instances, significant unforeseeable circumstances may cause a change in an entity's intent or ability to hold to maturity certain securities that are initially classified as expected to be held to maturity. In these circumstances, the affected securities should be reclassified as securities available for sale or early redemption (redemption before the security's maturity). Once a security is reclassified it is no longer subject to this standard.

Accounts Payable

74. Accounts payable are amounts owed by a federal entity for goods and services received from, progress in contract performance made by, and rents due to other entities.

75. Accounts payable are not intended to include liabilities related to on-going continuous expenses such as employees' salary and benefits, which are covered by other current liabilities. (See recommended standard for Other Current Liabilities.)

76. Amounts owed for goods or services received from federal entities represent intragovernmental transactions and should be reported separately from amounts owed to the public.

77. When an entity accepts title to goods, whether the goods are delivered or in transit, the entity should recognize a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated.

78. When a contractor provides the government with goods that are also suitable for sale to others, the liability usually arises when the contractor physically delivers the goods and the government receives them and takes formal title. However, when a contractor builds or manufactures facilities or equipment to the government's specifications, formal acceptance of the products by the government is not the determining factor for accounting recognition. Constructive or de facto receipt occurs in each accounting period, in accordance with the following paragraph.

79. For facilities or equipment constructed or manufactured by contractors or grantees according to agreements or contract specifications, amounts recorded as payable should be based on an estimate of work completed under the contract or the agreement. The estimate of such amounts should be based primarily on the federal entity's engineering and management evaluation of actual performance progress and incurred costs.

80. The reporting entity should disclose accounts payable not covered by budgetary resources.

Interest Payable

81. Interest payable should be recorded for the amount of interest expense incurred and unpaid. Interest incurred results from borrowing funds from Treasury, Federal Financing Bank, other federal entities, or the public. Interest also should be recorded on late payment of bills by the federal entity (see provisions in 31 U.S.C. 3901 through 3907, Prompt Payment) and on refunds (see provisions in 26 U.S.C. 6611). Interest payable of an entity on borrowed funds and unpaid bills should be recognized at the end of each period.

82. Interest payable to federal entities is an intragovernmental liability and should be accounted for separately from interest payable to the public.

Other Current Liabilities

83. The term *other current liabilities* is used to report current liabilities that are not recognized in specific categories such as accounts payable; interest payable; debt owed to the public, Treasury, or other entities; and liabilities for loan guarantee losses. Other current liabilities may include unpaid expenses that are accrued for the fiscal year for which the financial statements are prepared and are expected to be paid within the fiscal year following the reporting date.

84. Typical examples of other current liabilities to be recognized are: (a) accrued employees' wages, bonuses, and salaries for services rendered in the current fiscal year for which paychecks will be issued in the following year; (b) accrued entitlement benefits payable, such as Old Age Survivors Insurance (OASI) and Veterans Compensation and Pension benefits applicable to the current period but not yet paid, and (c) annuities for the current fiscal year administered by trust, pension, or insurance programs for which payment would be made in the following fiscal year. Such liabilities may be presented on the face of the financial reports as *Other Current Liabilities* or as one or more separate categories depending on the materiality of the amounts.

85. Federal entities may receive advances and prepayments from other entities for goods to be delivered or services to be performed. Before revenues are earned, the current portion of the advances and prepayments should be recorded as other current liabilities. After the revenue is earned (goods or services are delivered, or performance progress is made according to engineering evaluations), the entity should record the appropriate amount as a revenue or financing source and should reduce the liability accordingly. Other current liabilities due to federal entities are intragovernmental liabilities that should be reported separately from those due to employees and the public.

86. The reporting entity should disclose the amount of current liabilities not covered by budgetary resources.

Appendix A: Basis Of The Board's Conclusions

87. This Appendix provides a discussion on the substantive comments that the Board received from respondents to Exposure Draft No. 1, "Financial Resources, Funded Liabilities, and Net Financial Resources of Federal Entities" (November 18, 1991) and from testimony at a public hearing on the Exposure Draft held February 28, 1992. The Appendix explains the basis of the Board's conclusions on issues raised by the respondents.

Basic Concepts

88. ***Net financial resources.*** In the Exposure Draft, the Board proposed the concept of net financial resources . The term net financial resources was referred to as an entity's total financial resources less its total funded liabilities (Exposure Draft, page 11). The Exposure Draft stated that the amount of net financial resources provides a general measure of an entity's financial sufficiency before new appropriations are provided. The Exposure Draft further stated that information on the components of an entity's net financial resources (obligated and unobligated balances of budget authority and other items) can provide additional insight into an entity's financial situation.

89. Many respondents do not see convincing evidence that the concept of net financial resources is useful. They point out that there are no concrete examples to illustrate how the information can be used. Some respondents also do not believe that the measure of net financial resources is well defined. They point out that one of the elements missing from the concept is the amount of unfunded liabilities. They state that without measuring unfunded liabilities, the measure of net financial resources is incomplete and can be misleading.

90. The Board has decided to postpone consideration of the net financial resources concept. The Board believes that the usefulness of the concept can be further explored after it completes its project on users' needs and objectives for financial accounting and reporting.

91. ***Entity financial resources.*** In the Exposure Draft, the Board discussed the concept of entity financial resources. The concept was defined as assets of a federal entity that consist of (a) the entity's cash and funds authorized and available for disbursement (excluding contract authority and unused authority to borrow), (b) resources of the entity that are expected to be converted into cash to satisfy

liabilities, and (c) conversion of cash into another form (for example prepayments) that would be consumed. Under this definition, the Exposure Draft identified as financial resources: cash, funds with Treasury, claims to cash (for example accounts receivable and loans receivable), claims to goods and services (for example advances and prepayments), inventories held for sale, and investments.

92. As indicated in the Exposure Draft, financial resources are a subset of assets that provide liquidity (cash and assets that can be converted to cash) to meet a federal entity's operational needs. The concept was considered useful because federal entities obtain resources from the budget to finance their operations and are held accountable for the use of the financial resources.

93. The Board has decided not to use the term financial resources in this document. However, a definition of the term financial resources and its usefulness will be further considered by the Board in its conceptual framework project. In the absence of the term, the items that would provide future economic benefits to the government and its entities are referred to as assets. The term asset as used in this document means an item that embodies a probable future economic benefit that can be obtained or controlled by the federal government or a reporting entity as a result of past transactions or events. (The definition of assets will be considered by the Board in the future.)

94. ***Funded liabilities.*** The Exposure Draft proposed the definition of "funded liabilities" as "liabilities for which the federal entity has received budget authority to cover the related expenditure or expense."

95. The term "funded liabilities" would limit the recognition of liabilities to the extent that they are funded. The Board believes that the liabilities addressed in this document should be recognized when they are incurred, regardless of whether they are funded. The Board therefore decided not to use the term "funded liabilities" in this document. However, the Board recommends that disclosure be made for liabilities that are not covered by budgetary resources.

96. The word "liability" used in this document means a probable and measurable future outflow of resources arising from past transactions

or events.[8] A comprehensive definition of liabilities is being considered by the Board in its project concerning liabilities in general. However, this document addresses only those selected liabilities that routinely recur in normal operations and that are due within a fiscal year. These liabilities are accounts payable, interest payable, and other current liabilities. The category of other current liabilities includes salary and entitlement benefit expenses that are accrued and would be paid within a fiscal year.

General Standards

97. The recommended standards apply to reporting by the federal government and its entities for both governmental assets and liabilities and intragovernmental assets and liabilities reported at the entity level.

98. An entity may have two categories of assets and liabilities intragovernmental and governmental assets and liabilities. The difference between intragovernmental and governmental assets and liabilities is explained below:

(1) ***Intragovernmental assets and liabilities.*** These assets and liabilities arise from intragovernmental transactions. For example, investments held by a federal entity in Treasury securities are reported by the entity as an asset. However, the Treasury securities also are liabilities of the Department of the Treasury. Thus, the securities represent intragovernmental assets and liabilities. Another example is fund balance with Treasury. An entity's fund balance with Treasury of an entity will be reported as an asset by the entity. However, it is not an asset of the federal government; rather, it is a commitment of the U.S. government to provide funds to a federal entity. (See discussion, which follows, on Fund balance with Treasury.)

(2) ***Governmental assets and liabilities.*** These are assets and liabilities that arise from transactions of the federal government with nonfederal entities (persons and organizations outside the U.S. government, either foreign or domestic). For example, income taxes to be collected from the public are reported on IRS

[8] A comprehensive definition of "liabilities" is being considered by the Board in its project concerning liabilities in general. [See SFFASs 5 and 12 for more on liabilities.]

financial statements as receivables. These receivables are assets of the federal government.

99. The recommended standards require that intragovernmental assets and liabilities be reported separately from governmental assets and liabilities.

100. Assets reported by an entity also are distinguished between entity and non-entity assets.

(1) ***Entity assets.*** Entity assets are assets that are available to an entity for its use. Entity assets include both intragovernmental and governmental assets. Supplies inventory held by an entity for consumption in its operations is an entity asset as well as a governmental asset. A receivable of a federal entity from another federal entity is an entity asset if the receiving entity has authority to use the amount collected.

(2) ***Non-entity assets.*** An entity may have assets under its custody and management that the entity is not authorized to use. In this Statement, these assets are called non-entity assets, as distinguished from entity assets that the entity is authorized to use in its operations. For example, customs duty receivables to be collected by the Customs Service is a non-entity asset that would be reported by the Customs Service.

101. The Board recommends that both entity assets and non-entity assets under an entity's custody or management be recognized in the entity's financial statements. Non-entity assets should be separately reported in an entity's financial statements.

102. The following exhibit, using receivables as an example, illustrates the relationship between entity and non-entity assets on one hand and intragovernmental and governmental assets on the other hand.

Accounts Receivable

	Entity Assets	Non-Entity Assets
Intra-governmental Assets	Amounts receivable from a federal entity for goods or services delivered that will be available to the receiving entity to spend.	Amounts to be collected from a federal entity that will not be available to the receiving entity to spend.
Governmental Assets	Amounts receivable from a nonfederal entity for goods or services that will be available to the receiving entity to spend.	Amounts (such as taxes) to be collected from a nonfederal entity that will not be available to the receiving entity to spend.

Specific Standards

Cash

103. The Board has retained from the Exposure Draft the requirement for separate reporting of restricted and unrestricted cash. However, after considering comments on the Exposure Draft, the Board has modified the definition of restricted cash.

104. The Exposure Draft proposed that unrestricted cash include amounts in demand deposits. However, whether an amount of cash is restricted does not depend on where the cash is kept. For example, federal entities may hold cash in demand deposit accounts on behalf of Treasury. Since the entities have no authority to spend the cash, from the entities' perspective, these amounts of cash are restricted.

105. The recommended standard in this document redefines restricted cash as (1) amounts of cash that an entity holds on behalf of Treasury or other entities and does not have authority to spend, and (2) amounts of cash that are legally restricted to specific purposes.

Fund Balance with Treasury

106. The recommended standard provides guidance on the composition of fund balance with Treasury. Events that cause an entity's fund balance to increase include receiving appropriations, allocations, transfers, receipts that the entity is authorized to spend (or to use to offset its expenditures) and borrowing from Treasury. An entity's fund balance is reduced by amounts disbursed to pay liabilities and expenditures, amounts invested in securities, amounts of appropriations canceled or

rescinded, and amounts transferred to other agencies or to the Treasury.

107. With respect to fund balance with Treasury, the Board has considered the following issues:

(1) Is fund balance with Treasury an asset?

108. The Board believes that from the perspective of a federal entity (such as a bureau, a program, or a fund), fund balance with Treasury is an asset. In fact, it is the most important source against which an entity can make expenditures and incur liabilities.

109. However, the Board recognizes that a fund balance with Treasury is an intragovernmental item. It represents a entity's authorized claim to the federal government's resources on one hand, and the government's commitment to supply resources to the entity on the other hand. The claims and commitments would not be reported when financial reports of individual entities are consolidated on a government-wide level. Thus, from the perspective of the federal government as a whole, fund balances with Treasury are not assets of the federal government.

(2) How does fund balance with Treasury relate to budgetary resources?

110. A fund balance is created by budget authority. An appropriation is the major form of budget authority that creates a fund balance with Treasury for an entity. Thus, the relationship between fund balance with Treasury and budget authority cannot be ignored.

111. However, an entity's fund balance with Treasury does not necessarily equal its budgetary resources. The difference between these two concepts may be clarified by examining their definitions. A fund balance represents the sum of amounts that is actually available in an entity's accounts with Treasury. Budgetary resources on the other hand encompass all authorities for an entity to incur obligations. Some of the authorities do not in themselves provide funds to the entity. Contract authority, for example, allows an entity to incur obligations under a contract. However, it does not, in itself, provide funds to the entity's accounts with Treasury. An appropriation is necessary for the entity to have funds to liquidate obligations incurred under contract authority.

112. Authority to borrow does not in itself place funds into an entity's accounts with Treasury. In order to increase its fund balance with Treasury, an entity must actually borrow under its borrowing authority.

113. For these reasons, the recommended standard states that fund balance with Treasury does not include contract authority and unused authority to borrow.

(3) Should the fund balance exclude funds designated for special purposes?

114. Some respondents to the Exposure Draft believe that the standard should identify funds held with Treasury that are not available to the entity's operations. For example, the Department of Energy collects fines levied under the Emergency Petroleum Allocation Act of 1973, deposits those funds in an escrow account with Treasury, and ultimately disburses those funds to injured parties or for other uses as directed by court decisions.

115. It is not unusual that funds in certain accounts are held and restricted to specific purposes. Amounts of trust funds, for example, are held for the specific purpose of making benefit payments to eligible recipients. The restriction on funds held for the Department of Energy to pay persons injured by oil pricing and allocation violations is another example. The Board believes that the fund balance of a reporting entity should include funds held in all accounts of the entity regardless of whether they are designated for specific purposes.

Accounts Receivable

116. Respondents raised issues related to the recognition and measurement of losses due to uncollectible amounts. Before addressing the Board's actions in relation to respondents' comments, however, the terms recognition and measurement as used in this Statement are explained below:

117. **Recognition** means formally recording or incorporating an item into the records and financial statements as an asset, liability, expense, revenue, or similar element. For assets or liabilities, recognition encompasses subsequent changes to the amounts of assets and liabilities.

118. **Measurement** is the process of expressing an asset or liability in monetary units. Measuring an item requires selecting an appropriate measurement attribute such as historical cost, current market value, net realizable value, or present value of future cash flows.

119. In the proposed standard and the discussion of accounts receivable, the term recognition concerns the timing of recording an asset or the impairment of an asset in the financial records. The term measurement concerns the valuation basis and the dollar amount of the asset that should be reported.

120. Detailed discussions of respondents' comments and the Board's actions are provided in the following paragraphs.

121. ***Timing of receivable recognition.*** The Exposure Draft states that a receivable should be recorded when events (e.g., payment due dates) or transactions occur that entitle an entity to accrue revenue or receive a reimbursement or fund transfer. Some respondents questioned the use of payment due dates as a criterion for recognizing receivables. These respondents stated a receivable should be recognized when an entity is owed an amount or earns a revenue, and that due dates are irrelevant.

122. Some receivables result from exchange transactions. For example, receivables may result from goods and services provided to other entities. However, claims to cash or other assets also result from the federal government's legal authority to levy taxes and impose duties, fees and fines. These receivables are not related to revenue-earning functions or exchange transactions, but are based on the federal government's authority to collect the payments and a party's liability to pay cash or provide other assets to cover the claims. For the accrual of taxes, the tax due date represents the date that the government demands payment. The payment due date is a definitive criterion for accruing taxes.

123. The Board, therefore, recommends that a receivable be recognized when a claim to cash or other assets is established based either on goods or services provided or the government's legal authority to levy and collect. The Board is not recommending a revenue recognition standard at this time.

124. ***Loss recognition.*** In the Exposure Draft, it was proposed that a loss be recognized when it is more likely than not that a receivable has been impaired. The phrase more likely than not means a greater than 50 percent probability of occurrence.

125. Several respondents questioned why the Board used the more likely than not criterion for loss recognition instead of the probable criterion used in the private sector under generally accepted accounting principles (GAAP).[9]

126. The Board may refer to the pronouncements and statements issued by other standard setting bodies in deliberating accounting standards for the federal government. However, the Board is not bound by these pronouncements and statements, especially when accounting standards promulgated for other sectors are not relevant to the federal government.

127. In the case of loss recognition on receivables, the Board believes that there should be a definitive guideline for recognizing government credit losses. The word probable is subject to broad interpretation (often being interpreted as meaning a virtual certainty of occurrence) and could allow for belated recognition of losses.

128. The Board proposed the more stringent criterion of more likely than not, which requires the recognition of losses when there is more than a 50 percent chance that some receivables will not be collected. In recommending the more likely than not criterion, the Board's intent is to achieve unbiased, consistent, and reliable loss recognition in federal government accounting.

129. The more likely than not criterion can be applied to both individual accounts and groups of accounts. Both significant individual accounts receivable (e.g., unusually large refunds due from contractors, medicaid reimbursements from third parties, substantial tax delinquencies, or other large claims) and groups of small accounts should be analyzed and losses recognized if it is more likely than not that some or all of the amounts owed will not be collected.

[9]FASB Statement of Standards No. 5, *Accounting for Contingencies*.

130. When applying the loss recognition criterion, the Board believes it is appropriate to recognize the nature of federal receivables. Many of the federal government's receivables, unlike trade accounts of private firms or loans made by banks, are not created through credit screening procedures. These receivables arise because of activities such as fines from regulatory violations, refunds from erroneous benefit payments, reimbursements, and overdue taxes and duties. In these circumstances, historical experience and economic factors indicate that the receivables frequently are not fully collectible. These receivables meet the loss recognition test because of their inherent risk. Therefore, an appropriate amount of allowance for losses should be recognized at their inception.

131. ***Loss measurement.*** Because of the large volume of federal transactions, accounts receivable generally exist in large groups. Some groups may consist of several hundred thousand accounts. In such cases, losses on uncollectible amounts should be assessed on a group basis using statistical sampling techniques. Statistical sampling should be supplemented by historical trend experience, adjusted for current conditions.

132. On the other hand, some government receivables arise from transactions of significant amounts. These receivables should be individually analyzed to assess losses due to risks specifically attributable to the individual accounts. The assessment of impairment of individual accounts may not always provide a valid basis to estimate the impairment of the entire group. Often, losses may exist for the group that are not currently identifiable on an individual basis. The Board believes that the federal government's receivables are generally subject to losses due to inherent risks. Therefore, allowances for receivables should be viewed in the context of the overall risk of the receivables being assessed.

133. Based on the above considerations, the recommended standard provides that, for reporting purposes, losses on accounts receivable should be determined by evaluating accounts on both a group and an individual basis.

Interest Receivable

134. In the Exposure Draft, the proposed standard requires that interest be recognized on a receivable until the receivable is repaid or written off. At the same time, the proposed standard requires that an allowance

for uncollectible interest be provided. The intent of the proposed standard is to establish the debtor's liability for the accrued interest.

135. Some respondents expressed concern that there is usually a lengthy period from the time a receivable is determined to be uncollectible until it is written off. It would be burdensome to recognize interest on the uncollectible receivable and, at the same time, offset the amount of interest recognized by an allowance for uncollectible interest.

136. The initial intent of this procedure was to maintain a correct amount of the debtor's liability. This purpose can be achieved by record-keeping procedures rather than financial reporting. Therefore, for financial reporting, the Board has concurred that (a) interest receivable should be recognized only on collectible accounts, and (b) interest receivable on uncollectible accounts should be recognized only when it is actually received.

Advances and Prepayments

137. There were no comments on the substance of the recommended accounting standard for advances and prepayments since the standard does not contain significant changes from the current accounting practice within federal government agencies. Some respondents requested that the Board clarify that prepayments do not include progress payments made on long-term contracts. Since progress payments are made based upon percentage of completion of a contract, the Board concluded that progress payments are not advances or prepayments.

138. Comments were also received questioning whether advances and prepayments should be included within the definition of financial resources (as proposed in the Exposure Draft) since advances and prepayments are not usually converted to cash or budget authority available for use by the entity.

139. The Board recognizes that, as in the case of inventories held for consumption, advances and prepayments convert into goods and services, but do not convert into cash. However, since the term financial resources is not used in this Statement, the issue is now moot. Advances and prepayments normally benefit current operations and, therefore, are normally considered current assets.

Investments in Treasury Securities

140. The recommended standard applies to investments in Treasury securities, including (1) nonmarketable par value Treasury securities, (2) market-based Treasury securities held to maturity, and (3) marketable Treasury securities held to maturity.

141. In the future, the Board will address investments that are not covered by this standard. In the interim, federal entities should continue their current accounting practices for those investments not covered by this standard.

142. Federal entities, particularly the Social Security and the retirement trust funds, invest available funds in excess of their current needs in special Treasury securities issued in the government account series. The terms of the Treasury securities are usually designed to meet the cash needs of government accounts. The vast majority of the investments are in nonmarketable Treasury securities issued exclusively to federal agencies. Most of them are par value securities, and some are market-based securities whose prices and interest rates reflect market terms. Thus, although the scope of the recommended standard is limited, it covers more than 90 percent of federal entities' investments.

143. A few federal entities are permitted to buy and sell marketable Treasury securities on the open market. Some federal entities which conduct business with the public or provide insurance to the private sector may acquire marketable Treasury securities as a part of a rescue and takeover transaction. This standard applies to marketable Treasury securities only to the extent that they are expected to be held to maturity.

144. In the Exposure Draft, the Board proposed that investments in par value nonmarketable Treasury securities be reported at cost. The Board also proposed that marketable securities and market-based Treasury securities be reported at market value as of the reporting date.

145. A number of respondents, however, expressed concern with the recognition of increases and decreases in assets based on market value, and the recognition of associated gains or losses. These respondents believe these are unrealized gains and losses which do not represent actual increases or decreases in assets. Some respondents also indicated that market value fluctuations generally do

not affect an entity's investments in securities intended to be held to their maturity.

146. In this Statement, the Board continues to use the cost based valuation for nonmarketable par value Treasury securities. The cost basis is appropriate for this type of security because the invested amounts will be fully recovered at redemption.

147. The Board also recommends the cost or amortized cost basis for the valuation of market-based Treasury securities and marketable Treasury securities that are to be held to maturity. The Board believes that the cost basis is appropriate because the invested amounts can be fully recovered when the Treasury securities mature. During the time periods when the securities are outstanding, the market prices of the securities may fluctuate due to interest rate changes or other temporary causes. However, so long as the securities are not to be sold to the market, the investing entity would not be affected by such market price fluctuations. For this reason, the Board decided to recommend the cost based approach rather than market value approach for marketable Treasury securities expected to be held to maturity.

148. The Board considered the valuation issues related to securities not covered by this standard. The Board has concluded that the use of a fair value approach pertains to a broad conceptual issue that needs to be addressed in its conceptual framework. Until the Board reaches decisions on the conceptual framework, it is premature to recommend a valuation basis for securities beyond those covered by this standard.

149. The Board believes that the criteria for classifying an investment as expected to be held to maturity should be based on the intent and ability of the investing entity to hold the security to its maturity. Intent and ability differ from a mere absence of an intent to sell the security. An evaluation of whether an entity has the intent and ability to hold its investments should be based on the entity's current and projected financial condition and its recent pattern in buying, selling, and managing Treasury securities. A security should not be classified as expected to be held to maturity if for cash needs or other investment management reasons the investing entity is not able to hold the security to its maturity.

150. At each financial reporting date, the appropriateness of this classification should be reassessed. In rare instances, an entity's originally stated intent or ability to hold a security to maturity may change due to significant unforeseen changes in the entity's cash needs or in other circumstances. When this occurs, securities initially classified as expected to be held to maturity should be reclassified to securities available for sale or early redemption.

Accounts Payable

151. Accounts payable are set up to record an entity's liability for goods and services received or work progress made by a contractor for which payment has not been made.

152. Some respondents questioned the timing of recognizing a liability in accounts payable. A federal entity, under budgetary accounting, records an obligation when the entity places a purchase order or signs a contract. An obligation, once incurred, reduces an entity's resources available for obligation. Budgetary accounting entries are required to record the amounts obligated and to reduce the available budget authority. For financial reporting purposes, liabilities are recognized when goods and services are received or are recognized based on an estimate of work completed under a contract or agreement.

153. Some federal entities believe it is appropriate to recognize a liability in accounts payable when a purchase order is placed. The theory of this practice is that the purchase order represents a use of the entity's budgetary resources and that recognizing the liability would correctly reduce the entity's available budgetary resources.

154. Proponents for this practice also argue that, in many cases, goods produced under government contracts bear unique specifications for government needs and, as a result, cannot be sold to other customers. Thus, they argue that it is virtually certain that the government has incurred a liability toward the contractor.

155. The Board recognizes that there is a need to reconcile budget execution results and financial effects. In budgetary accounting, when a purchase order is placed, an obligation is recorded to ensure budgetary control. However, recognition of the claim from a financial accounting standpoint does not occur until goods are delivered, work progress is actually made by a contractor, or services are performed since these events generally trigger a cash outlay that liquidates the

obligation. The Board does not believe that recognizing a liability prior to a actual receipt or constructive receipt of goods or services should be adopted as a financial accounting standard. It also does not believe that it is appropriate to erase the distinction between recording obligations for budget purposes and recognizing a liability for financial accounting purposes.

156. Some respondents question whether a liability should be recognized for multi-year contracts that are to be financed through appropriations over a number of years. As has been discussed earlier, when a contract is entered, an obligation is recognized in budgetary accounting. However, until goods or services are received or work progress is made, the Board does not believe that an obligation should be recognized as a liability. When goods or services are received or work progress is made under either a short or long-term contract, a liability for unpaid amounts should be recognized.

Interest Payable

157. There were no substantial comments on the recommended accounting standard for interest payable. The recommended standard does not differ from the current accounting practice within federal government agencies.

Other Current Liabilities

158. The recommended standard covers the current liabilities that are not specifically defined in other standards. Current liabilities specifically defined in this Statement are accounts payable and interest payable. Accounts payable and interest payable represent liabilities arising from discrete transactions. The Board also plans to issue statements to define other specific liabilities such as liabilities incurred under a loan guarantee contract and borrowings from other entities.

159. Other current liabilities generally are related to on-going and continuous expenses, which are typically recognized throughout each accounting period rather than on an individual transaction basis. A typical example is the liability for employees salary that is accrued at the end of a fiscal year but is not paid.

160. The Exposure Draft indicated that a liability was considered funded if the related expense was incurred under budget authority. Some respondents suggested that the term budget authority be changed to budgetary resources . They argued that budgetary resources

encompass not only new budget authority, but also other resources available to incur liabilities for specified purposes in a given year.

161. The Board agrees that a liability (or a portion of the liability) should be considered funded from the reporting entity's perspective if it is covered by available budgetary resources. However, the recommended standard takes the position that a liability should be recognized when it is incurred, regardless of whether it is covered by available budgetary resources. The recommended standard also requires that disclosure should be made for liabilities that are not covered by available budgetary resources.

Appendix B: Illustration Of The Interest Method For Investment Discount And Premium

This Appendix provides an illustration of the interest method for amortizing a discount or premium of an investment in a marketable or a market-based Treasury security, such as a Treasury bond. The interest method is required in the recommended standard for investments. Before explaining the interest method itself, the concept of discount and premium will be explained.

Bond Discount And Premium

The price of a bond equals the present value of the bond's net future cash flows, including principal and interest payments, discounted to the time of its issuance. The discount rate is referred to as the effective interest rate. Since the effective interest rate usually equals the market interest rate, it may differ from the stated interest rate (the coupon rate) of the bond. The difference between the effective interest rate of a bond and its stated interest rate causes the bond price to be different from its face amount.

A Treasury bond may be purchased at a price higher or lower than the bond's face amount (par amount). The difference between the purchase price and the face amount is a discount if the price is lower than the face amount; or a premium if the price is higher than the face amount. The investor initially records the bond at its face amount and records the discount or the premium in a valuation allowance account. Thus, the carrying amount of the bond equals its face amount minus or plus the discount or the premium. The discount or the premium is amortized over the life of the bond, so that the bond would be redeemed at its face amount at its maturity.

The Interest Method

Under the interest method of amortization,[10] an amount of interest equal to the carrying amount of the investment times the effective interest rate, is calculated for each accounting period. This calculated interest is the effective interest of the investment (referred to as effective yield in some literature). The amount of effective interest is compared with the stated

[10]The interest method of amortization is described in several FASB statements and APB Opinions. For example, see paragraph 18, FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, and paragraph 16 of APB Opinion No. 12, *Omnibus Opinion*.

interest of the investment. (The stated interest is the interest that is payable to the investor according to the stated interest rate.) The difference between the effective interest and the stated interest is the amount by which the discount or the premium should be amortized (i.e., reduced) for the accounting period.

Examples

In the first example,[11] which shows the amortization of a discount, Treasury bonds with the face amount of $100,000 were purchased by a federal entity on the bonds' issuance date, January 1, 1992. The bonds' stated interest rate is 7 percent, and interest is payable at the end of each year. The bonds will mature in 5 years, on December 31, 1996. The cost of the investment is $96,007, with a discount of $3,993, which reflects an effective interest rate of 8 percent.

In Table 1 below, the annual discount amortization is in column 4, which equals column 3 minus column 2.

Table 1: Discount Amortization

Date	Stated Interest 7%	Effective Interest 8%	Discount Amortization	Unamortized Balance	Bonds Carrying Amount
1/1/92				$3,993	$ 96,007
12/31/92	7,000	$7,681	$681	3,312	96,688
12/31/93	7,000	7,735	735	2,577	97,423
12/31/94	7,000	7,794	794	1,783	98,217
12/31/95	7,000	7,857	857	926	99,074
12/31/96	7,000	7,926	926	0	100,000

In the second example, which is the amortization of a premium, Treasury bonds with the face amount of $100,000 were purchased by a federal entity on the bonds' issuance date January 1, 1992. The bonds' stated interest rate is 7 percent, and interest is payable at the end of each year. The bonds will mature in 5 years, on December 31, 1996. The cost of the investment is

[11]The examples are adapted from Glenn A. Welsch and Charles T. Zlatkovich, Intermediate Accounting, 8th ed. (Boston: Richard D. Irwin, Inc., 1989), p. 656.

$104,212, with a premium of $4,212, which reflects an effective interest rate of 6 percent.

In Table 2 below, the annual premium amortization is in column 4, which equals column 2 minus column 3.

Table 2: Premium Amortization

Date	Stated Interest 7%	Effective Interest 6%	Premium Amortization	Unamortized Balance	Bonds Carrying Amount
1/1/92				$4,212	$104,212
12/31/92	7,000	$6,253	$747	3,465	103,465
12/31/93	7,000	6,208	792	2,673	102,673
12/31/94	7,000	6,160	840	1,833	101,833
12/31/95	7,000	6,110	890	943	100,943
12/31/96	7,000	6,057	943	0	100,000

Appendix C: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273.

Statement of Federal Financial Accounting Standards No. 2: Accounting for Direct Loans and Loan Guarantees

Status

Issued	August 23, 1993
Effective Date	For fiscal years ending September 30, 1994 and thereafter.
Volume I References	SFFAS No. 3, *Accounting for Inventory and Related Property* (see foreclosed property)
Volume II References	Loans and Loan Guarantees (L60)
Interpretations and Technical Releases	TR 3, *Preparing and Auditing Estimates for Direct Loans and Loan Guarantees*
Affects	No other statements.
Affected by	SFFAS No. 18 SFFAS No. 19

Summary

The Statement provides accounting standards for federal direct loans and loan guarantees. The standards require that direct loans obligated and loan guarantees committed after September 30, 1991, be accounted for on a present value basis. The use of the present value accounting method is consistent with the intent of the Federal Credit Reform Act of 1990.

The standards contain the following essential requirements:

- **Direct loans** disbursed and outstanding are recognized as assets at the present value of their estimated net cash inflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance.
- For **guaranteed loans** outstanding, the present value of estimated net cash outflows of the loan guarantees is recognized as a liability. Disclosure is made of the face value of guaranteed loans outstanding and the amount guaranteed.
- For direct or guaranteed loans disbursed during a fiscal year, a **subsidy expense** is recognized. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows.
- The subsidy cost allowance for direct loans and the liability for loan guarantees are **reestimated** each year, taking into account all factors that may have affected the estimated cash flows. Any adjustment resulting from the reestimates is recognized as a subsidy expense (or a reduction in subsidy expense).
- When direct loans or loan guarantees are **modified**, the cost of modification is recognized at an amount equal to the decrease in the present value of the direct loans or the increase in the present value of the loan guarantee liabilities measured at the time of modification.
- Upon **foreclosure** of direct or guaranteed loans, the acquired property is recognized as an asset at the present value of its estimated future net cash inflows.

The standards permit but do not require restating pre-credit reform direct loans and loan guarantees at present value.

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Executive Summary

1. The Statement provides accounting standards for federal direct loans and loan guarantees. The standards require that direct loans obligated and loan guarantees committed after September 30, 1991, be accounted for on a present value basis. The use of the present value accounting method is consistent with the intent of the Federal Credit Reform Act of 1990.

2. The standards contain the following essential requirements:

   - Direct loans disbursed and outstanding are recognized as assets at the present value of their estimated net cash inflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance.
   - For guaranteed loans outstanding, the present value of estimated net cash outflows of the loan guarantees is recognized as a liability. Disclosure is made of the face value of guaranteed loans outstanding and the amount guaranteed.
   - For direct or guaranteed loans disbursed during a fiscal year, a subsidy expense is recognized. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows.
   - The subsidy cost allowance for direct loans and the liability for loan guarantees are reestimated each year, taking into account all factors that may have affected the estimated cash flows. Any adjustment resulting from the reestimates is recognized as a subsidy expense (or a reduction in subsidy expense).
   - When direct loans or loan guarantees are modified, the cost of modifications is recognized at an amount equal to the decrease in the present value of the direct loans or the increase in the present value of the loan guarantee liabilities measured at the time of modification.
   - Upon foreclosure of direct or guaranteed loans, the acquired property is recognized as an asset at the present value of its estimated future net cash inflows.

3. The standards permit but do not require restating pre-credit reform direct loans and loan guarantees at present value.

Introduction

Background

4. The federal government, in discharging its responsibility to promote the nation's general welfare, makes DIRECT LOANS[1] and guarantees loans to segments of the population not adequately served by nonfederal financial institutions. Examples of federal CREDIT PROGRAMS include farmers' home loans, small business loans, veterans' mortgage loans, and student loans. For those unable to afford credit at the market rate, federal credit programs provide subsidies in the form of direct loans offered at an interest rate lower than the market rate. For those to whom nonfederal financial institutions would be reluctant to grant credit because of the high risk involved, federal credit programs guarantee the payment of these nonfederal loans, absorbing the costs of defaults.

5. Because federal credit programs provide interest subsidies and sustain losses caused by defaults, the costs of these programs are significant. It is crucial, therefore, that the actual and expected costs of federal credit programs be fully recognized in both budget and financial reporting.

The Federal Credit Reform Act Of 1990

6. The primary intent of the Federal Credit Reform Act of 1990 is to ensure that the SUBSIDY COSTS of direct loans and LOAN GUARANTEES are taken into account in making budgetary decisions. To achieve this general result, the Act has the following specific purposes: (a) ensure a timely and accurate measure and presentation in the President's budget of the costs of direct loan and loan guarantee programs, (b) place the cost of credit programs on a budgetary basis equivalent to other federal spending, (c) encourage the delivery of benefits in the form most appropriate to the needs of beneficiaries, and (d) improve the allocation of resources among credit programs and between credit and other spending programs.

[1]Terms included in Appendix C: Glossary are printed in CAPITAL LETTERS when they appear for the first time. (Note: See "Appendix E: Consolidated Glossary" on page 1273.)

7. The major provisions of the Act, which is effective for fiscal year 1992 and thereafter, are to:

- Require that, for each fiscal year in which the direct loans or the loan guarantees are to be obligated, committed, or disbursed, the President's budget reflect the long-term cost to the government of the subsidies associated with the direct loans and loan guarantees. The subsidy cost estimate for the President's budget is to be based on the PRESENT VALUE of specified cash flows discounted at the average rate of marketable Treasury securities of similar maturity.
- Require that, before direct loans are obligated or loan guarantees are committed, annual appropriations generally be enacted to cover these costs. (However, mandatory programs have permanent indefinite appropriations.)
- Provide for borrowing authority from Treasury to cover the non-subsidy portion of direct loans.
- Establish budgetary and financing control for each credit program through the use of three types of accounts: the PROGRAM ACCOUNT (budgetary), the FINANCING ACCOUNT (non-budgetary), and the LIQUIDATING ACCOUNT (budgetary).

The Need For Accounting Information

8. Accounting information on credit programs provides the basis for evaluating program performance by comparing actual accounting data with estimated budget data. Budget analysts and decision-makers can use accounting information to compare actual cash flows with projected cash flows and actual costs of direct loans and loan guarantees with their estimated costs.

9. For credit program managers, information on estimated default losses and related liabilities, when recognized in a timely manner, can be an important tool in evaluating credit program performance. The information can help determine a credit program's overall financial condition and identify its financing needs.

10. Furthermore, cost and performance information on loans and loan guarantees maintained by COHORT and RISK CATEGORY can highlight those groups that are not expected to meet budget estimates because of increased risk. Based on such information, program managers can take timely action to reduce costs, control risks where possible, and improve credit program performance.

Present Value Accounting

11. The Federal Credit Reform Act of 1990 requires that effective October 1, 1991, the cost of direct loans and loan guarantees be estimated at present value for the budget. The objectives of using the present value measurement in federal credit reform are to measure, recognize, and control subsidy costs of direct loans and loan guarantees.[2]

12. For direct loans, the effect of using the present value measurement is to estimate the extent of the disbursed amounts that would be recovered, and the extent of the disbursed amounts that is a subsidy cost. The portion that can be recovered is the present value of projected net cash inflows discounted at the Treasury rate of similar maturity. This portion is not considered a cost to the government because it is expected to be returned to the government in future amounts. The remaining portion of the cash disbursement represents a cost to the government, resulting either from lending at a rate lower than the Treasury interest rate, or from default losses, or both.

13. Under credit reform, the subsidy portion of direct loans is financed by appropriations, and the unsubsidized portion of the loans, which equals the present value of the government collections from the borrowers, is financed with funds borrowed from Treasury. The subsidy cost of loans must be REESTIMATED and updated annually.

14. The present value measurement basis is also applied to loan guarantees. Before credit reform, as in the case of direct loans, loan guarantees were measured for the budget on a cash basis. Thus, loan guarantees could appear to be virtually cost free, since cash payments by the government were not required unless and until the guaranteed loans defaulted at a future date. Under credit reform, the future cash outflows required by LOAN GUARANTEE COMMITMENTS must be projected and discounted at an appropriate Treasury interest rate. The present value of the cash outflows is the cost of the loan guarantees. Before loan guarantees are committed, annual appropriations generally must be enacted to cover the cost of the loan guarantees.

[2]Congressional Budget Office, "Credit Reform: Comparable Budget Costs for Cash and Credit" (Dec. 1989), p.33.

Financial Reporting

15. The Board believes that present value measurement should be adopted for financial accounting and reporting on direct loans and loan guarantees that have been or will be obligated or committed after September 30, 1991. Since the Act requires that the costs of these POST-1991 DIRECT LOANS AND LOAN GUARANTEES be estimated at present value for budget purposes, financial reports on actual results measured at present value can be used as feedback to compare with budget estimates. Such comparisons can be used as a basis to improve future estimates and REESTIMATES.

16. The Board recognizes that effective use of the present value accounting method depends on accurate projections of future cash flows over the life of direct or guaranteed loans. The efforts to make accurate projections should begin with establishing and using reliable records of historical credit performance data, and should take into consideration current and forecasted economic conditions.

17. The Board recognizes the value of having financial accounting support the budget. It endorses the logic underlying credit reform, and it recommends that accounting standards for credit be consistent with budgeting under credit reform. The Board is aware that as more experience is gained, some modifications may be made in budgetary requirements. It is the intention of the Board that so long as the modifications are made on a credit reform basis and do not materially affect the basic recognition and measurement principles embodied in the accounting standards, accounting practices for direct loans and loan guarantees should change as needed in order to be consistent with the budget.

18. The Board considered the expected costs and efforts that would be required in restating PRE-1992 DIRECT LOANS AND LOAN GUARANTEES at present value. Based on this consideration, the standards permit but do not require restating those loans and loan guarantees on a present value basis.

19. The standards were proposed in an Exposure Draft issued in September 1992. Comments were received from 36 organizations and individuals. Oral comments were also presented at a meeting by representatives of federal agencies with major credit programs. The Board considered all the comments received and incorporated changes, as appropriate. Issues raised by those who responded to the

Exposure Draft and the Board's conclusions are presented in Appendix A, "Basis of the Board's Conclusions."

Effective Date

20. The FASAB recommends that the accounting standards recommended in this Statement become effective for fiscal years ending September 30, 1994, and thereafter. An earlier implementation is encouraged.

The Accounting Standards

Explanation

21. These standards concern the recognition and measurement of direct loans, the liability associated with loan guarantees, and the cost of direct loans and loan guarantees. The standards apply to direct loans and loan guarantees on a group basis, such as a cohort or a risk category of loans and loan guarantees. Present value accounting does not apply to direct loans or loan guarantees on an individual basis, except for a direct loan or loan guarantee that constitutes a cohort or a risk category.

Accounting Standards

Post-1991 Direct Loans

22. Direct loans disbursed and outstanding are recognized as assets at the present value of their estimated net cash inflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance.

Post-1991 Loan Guarantees

23. For guaranteed loans outstanding, the present value of estimated net cash outflows of the loan guarantees is recognized as a liability. Disclosure is made of the face value of guaranteed loans outstanding and the amount guaranteed.

Subsidy Costs of Post-1991 Direct Loans and Loan Guarantees

24. For direct or guaranteed loans disbursed during a fiscal year, a subsidy expense is recognized. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows, discounted at the

interest rate of marketable Treasury securities with a similar maturity term, applicable to the period during which the loans are disbursed (hereinafter referred to as the applicable Treasury interest rate).

25. For the fiscal year during which new direct or guaranteed loans are disbursed, the components of the subsidy expense of those new direct loans and loan guarantees are recognized separately among interest subsidy costs, default costs, fees and other collections, and other subsidy costs.

26. The interest subsidy cost of direct loans is the excess of the amount of the loans disbursed over the present value of the interest and principal payments required by the loan contracts, discounted at the applicable Treasury rate. The interest subsidy cost of loan guarantees is the present value of estimated interest supplement payments.

27. The default cost of direct loans or loan guarantees results from any anticipated deviation, other than prepayments, by the borrowers from the payments schedule in the loan contracts. The deviations include delinquencies and omissions in interest and principal payments. The default cost is measured at the present value of the projected payment delinquencies and omissions minus net recoveries. Projected net recoveries include the amounts that would be collected from the borrowers at a later date or the proceeds from the sale of acquired assets minus the costs of foreclosing, managing, and selling those assets.

28. The present value of fees and other collections is recognized as a deduction from subsidy costs.

29. Other subsidy costs consist of cash flows that are not included in calculating the interest or default subsidy costs, or in fees and other collections. They include the effect of prepayments within contract terms.

Subsidy Amortization and Reestimation

30. The subsidy cost allowance for direct loans is amortized by the INTEREST METHOD using the interest rate that was originally used to calculate the present value of the direct loans when the direct loans were disbursed. The amortized amount is recognized as an increase or decrease in interest income.

31. Interest is accrued and compounded on the liability of loan guarantees at the interest rate that was originally used to calculate the present value of the loan guarantee liabilities when the guaranteed loans were disbursed. The accrued interest is recognized as interest expense.

32. The subsidy cost allowance for direct loans and the liability for loan guarantees are reestimated each year as of the date of the financial statements. Since the allowance or the liability represents the present value of the net cash outflows of the underlying direct loans or loan guarantees, the reestimation takes into account all factors that may have affected the estimate of each component of the cash flows, including prepayments, defaults, delinquencies, and recoveries. Any increase or decrease in the subsidy cost allowance or the loan guarantee liability resulting from the reestimates is recognized as a subsidy expense (or a reduction in subsidy expense). Reporting the subsidy cost allowance of direct loans (or the liability of loan guarantees) and reestimates by component is not required. [See SFFAS No. 18]

Criteria for Default Cost Estimates

33. The criteria for default cost estimates provided in this and the following paragraphs apply to both initial estimates and subsequent reestimates. Default costs are estimated and reestimated for each program on the basis of separate cohorts and risk categories. The reestimates take into account the differences in past cash flows between the projected and realized amounts and changes in other factors that can be used to predict the future cash flows of each risk category.

34. In estimating default costs, the following risk factors are considered: (1) loan performance experience; (2) current and forecasted international, national, or regional economic conditions that may affect the performance of the loans; (3) financial and other relevant characteristics of borrowers; (4) the value of collateral to loan balance; (5) changes in recoverable value of collateral; and (6) newly developed events that would affect the loans' performance. Improvements in methods to reestimate defaults are also considered.

35. Each credit program should use a systematic methodology, such as an econometric model, to project default costs of each risk category. If individual accounts with significant amounts carry a high weight in risk exposure, an analysis of the individual accounts is warranted in making the default cost estimate for that category.

36. Actual historical experience of the performance of a risk category is a primary factor upon which an estimation of default cost is based. To document actual experience, a data base should be maintained to provide historical information on actual payments, prepayments, late payments, defaults, recoveries, and amounts written off.

Revenues and Expenses

37. Interest accrued on direct loans, including amortized interest, is recognized as interest income. Interest accrued on the liability of loan guarantees is recognized as interest expense. Interest due from Treasury on uninvested funds is recognized as interest income. Interest accrued on debt to Treasury is recognized as interest expense.

38. Costs for administering credit activities, such as salaries, legal fees, and office costs, that are incurred for credit policy evaluation, loan and loan guarantee origination, closing, servicing, monitoring, maintaining accounting and computer systems, and other credit administrative purposes, are recognized as administrative expense. Administrative expenses are not included in calculating the subsidy costs of direct loans and loan guarantees.

Pre-1992 Direct Loans and Loan Guarantees

39. The losses and liabilities of direct loans obligated and loan guarantees committed before October 1, 1992, are recognized when it is more likely than not that the direct loans will not be totally collected or that the loan guarantees will require a future cash outflow to pay default claims. The allowance of the uncollectible amounts and the liability of loan guarantees should be reestimated each year as of the date of the financial statements. In estimating losses and liabilities, the risk factors discussed in the previous section should be considered. Disclosure is made of the face value of guaranteed loans outstanding and the amount guaranteed.

40. Restatement of pre-1992 direct loans and loan guarantees on a present value basis is permitted but not required.

Modification of Direct Loans and Loan Guarantees

41. The term “modification” means a federal government action, including new legislation or administrative action, that directly or indirectly alters the estimated subsidy cost and the present value of outstanding direct loans, or the liability of loan guarantees.

42. Direct modifications are actions that change the subsidy cost by altering the terms of existing contracts or by selling loan assets.

Existing contracts may be altered through such means as forbearance, forgiveness, reductions in interest rates, extensions of maturity, and prepayments without penalty. Such actions are modifications unless they are considered reestimates, or workouts as defined below, or are permitted under the terms of existing contracts.

43. Indirect modifications are actions that change the subsidy cost by legislation that alters the way in which an outstanding portfolio of direct loans or loan guarantees is administered. Examples include a new method of debt collection prescribed by law or a statutory restriction on debt collection.

44. The term "modification" does not include subsidy cost reestimates, the routine administrative workouts of troubled loans, and actions that are permitted within the existing contract terms. Workouts are actions taken to maximize repayments of existing direct loans or minimize claims under existing loan guarantees. The expected effects of work-outs on cash flows are included in the original estimate of subsidy costs and subsequent reestimates.

A. MODIFICATION OF DIRECT LOANS

45. With respect to a direct or indirect modification of pre-1992 or post-1991 direct loans, the cost of modification is the excess of the PRE-MODIFICATION VALUE[3] of the loans over their POST-MODIFICATION VALUE[4] The amount of the modification cost is recognized as a modification expense when the loans are modified.

46. When post-1991 direct loans are modified, their existing BOOK VALUE is changed to an amount equal to the present value of the loans' net

[3]The term "pre-modification value" is the present value of the net cash inflows of direct loans estimated at the time of modification under pre-modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to the remaining maturity of the direct loans under pre-modification terms (simply stated, the pre-modification terms at the current rate).

[4]The term "post-modification value" is the present value of the net cash inflows of direct loans estimated at the time of modification under post-modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to the remaining maturity of the direct loans under post-modification terms (simply stated, the post-modification terms at the current rate).

cash inflows projected under the modified terms from the time of modification to the loans' maturity and discounted at the ORIGINAL DISCOUNT RATE (the rate that is originally used to calculate the present value of the direct loans, when the direct loans were disbursed).

47. When pre-1992 direct loans are directly modified, they are transferred to a financing account and their book value is changed to an amount equal to their post-modification value. Any subsequent modification is treated as a modification of post-1991 loans. When pre-1992 direct loans are indirectly modified, they are kept in a liquidating account. Their bad debt allowance is reassessed and adjusted to reflect amounts that would not be collected due to the modification.

48. The change in book value of both pre-1992 and post-1991 direct loans resulting from a direct or indirect modification and the cost of modification will normally differ, due to the use of different discount rates or the use of different measurement methods. Any difference between the change in book value and the cost of modification is recognized as a gain or loss. For post-1991 direct loans, the MODIFICATION ADJUSTMENT TRANSFER[5] paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

B. MODIFICATION OF LOAN GUARANTEES

49. With respect to a direct or indirect modification of pre-1992 or post-1991 loan guarantees, the cost of modification is the excess of the POST-MODIFICATION LIABILITY[6] of the loan guarantees over their

[5]OMB instructions provide that if the decrease in book value exceeds the cost of modification, the reporting entity receives from the Treasury an amount of modification adjustment transfer equal to the excess; and that if the cost of modification exceeds the decrease in book value, the reporting entity pays to the Treasury an amount of modification adjustment transfer to offset the excess. (See OMB Circular A-11.)

[6]The term "post-modification liability" is the present value of the net cash outflows of the loan guarantees estimated at the time of modification under the post-modification terms, and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to the remaining maturity of the guaranteed loans under post-modification terms (simply stated, the post-modification terms at the current rate).

PRE-MODIFICATION LIABILITY.[7] The modification cost is recognized as modification expense when the loan guarantees are modified.

50. The existing book value of the liability of modified post-1991 loan guarantees is changed to an amount equal to the present value of net cash outflows projected under the modified terms from the time of modification to the loans' maturity, and discounted at the original discount rate (the rate that is originally used to calculate the present value of the liability when the guaranteed loans were disbursed).

51. When pre-1992 loan guarantees are directly modified, they are transferred to a financing account and the existing book value of the liability of the modified loan guarantees is changed to an amount equal to their post-modification liability. Any subsequent modification is treated as a modification of post-1991 loan guarantees. When pre-1992 direct loan guarantees are indirectly modified, they are kept in a liquidating account. The liability of those loan guarantees is reassessed and adjusted to reflect any change in the liability resulting from the modification.

52. The change in the amount of liability of both pre-1992 and post-1991 loan guarantees resulting from a direct or indirect modification and the cost of modification will normally differ, due to the use of different discount rates or the use of different measurement methods. Any difference between the change in liability and the cost of modification is recognized as a gain or loss. For post-1991 loan guarantees, the modification adjustment transfer[8] paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

[7]The term "pre-modification liability" is the present value of the net cash outflows of loan guarantees estimated at the time of modification under the pre- modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to the remaining maturity of the guaranteed loans under pre-modification terms (simply stated, the pre- modification terms at the current rate.)

[8]OMB instructions provide that if the increase in liability exceeds the cost of modification, the reporting entity receives from the Treasury an amount of modification adjustment transfer equal to the excess; and that if the cost of modification exceeds the increase in liability, the reporting entity pays to the Treasury an amount of modification adjustment transfer to offset the excess. (See OMB Circular A-11.)

C. SALE OF LOANS

53. The sale of post-1991 and pre-1992 direct loans is a direct modification. The cost of modification is determined on the basis of the pre-modification value of the loans sold. If the pre-modification value of the loans sold exceeds the net proceeds from the sale, the excess is the cost of modification, which is recognized as modification expense.

54. For a loan sale with RECOURSE, potential losses under the recourse or guarantee obligations are estimated, and the present value of the estimated losses from the recourse is recognized as subsidy expense when the sale is made and as a loan guarantee liability.

55. The book value loss (or gain) on a sale of direct loans equals the existing book value of the loans sold minus the net proceeds from the sale. Since the book value loss (or gain) and the cost of modification are calculated on different bases, they will normally differ. Any difference between the book value loss (or gain) and the cost of modification is recognized as a gain or loss.[9] For sales of post-1991 direct loans, the modification adjustment transfer[10] paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

D. DISCLOSURE

56. Disclosure is made in notes to financial statements to explain the nature of the modification of direct loans or loan guarantees, the discount rate used in calculating the modification expense, and the basis for recognizing a gain or loss related to the modification.

Foreclosure of Post-1991 Direct Loans and Guaranteed Loans

57. When property is transferred from borrowers to a federal credit program, through FORECLOSURE or other means, in partial or full settlement of post-1991 direct loans or as a compensation for losses that the government sustained under post-1991 loan guarantees, the foreclosed property is recognized as an asset at the present value of its

[9]If there is a book value gain, the gain to be recognized equals the book value gain plus the cost of modification.

[10]See footnote No. 5 for an explanation of "modification adjustment transfer."

estimated future net cash inflows discounted at the original discount rate.

58. If a legitimate claim exists by a third party or by the borrower to a part of the recognized value of the foreclosed assets, the present value of the estimated claim is recognized as a special contra valuation allowance.

59. At a foreclosure of guaranteed loans, a federal guarantor may acquire the loans involved. The acquired loans are recognized at the present value of their estimated net cash inflows from selling the loans or from collecting payments from the borrowers, discounted at the original discount rate.

60. When assets are acquired in full or partial settlement of post-1991 direct loans or guaranteed loans, the present value of the government's claim against the borrowers is reduced by the amount settled as a result of the foreclosure.

Write-off of Direct Loans

61. When post-1991 direct loans are written off, the unpaid principal of the loans is removed from the gross amount of loans receivable. Concurrently, the same amount is charged to the allowance for subsidy costs. Prior to the WRITE-OFF, the uncollectible amounts should have been fully provided for in the subsidy cost allowance through the subsidy cost estimate or reestimates. Therefore, the write-off would have no effect on expenses.

Appendix A: Basis Of The Board's Conclusions

This appendix discusses the substantive comments that the Board received from respondents to the Exposure Draft, Accounting for Direct Loans and Loan Guarantees, issued in September 1992. The Appendix explains the Board's conclusions on issues raised by the respondents.

Present Value Accounting

62. Several respondents were opposed to using present value accounting for direct loans and loan guarantees. They pointed out that although the Federal Credit Reform Act of 1990 requires the use of present value to measure the subsidy costs of direct loans and loan guarantees for the budget, the law does not require using present value for financial reporting. They believed that since there are no legal requirements, the adoption of present value accounting should be based on cost-benefit considerations.

63. These respondents emphasized the complexity and cost of implementing and maintaining present value accounting. Because of the need to separately account for the direct loans or loan guarantees obligated or committed by each credit program in a fiscal year by cohort, as years go by, the number of cohorts would multiply. An agency with a number of loan and loan guarantee programs estimated that within 5 years, there would be more than 200 cohorts, one for each year and each program. Since most of its loans are long-term, maturing in 30 or more years, the number of cohorts would be staggering.

64. The respondents who were opposed to present value accounting doubted whether there would be any significant improvement in financial information on loans and loan guarantees reported on a present value basis compared with information traditionally reported on a nominal value basis. They contended that both present value accounting and nominal value accounting rely on historical experience and management judgment to evaluate risk as the primary variable in determining a default allowance. They further argued that since present value calculations involve cash flow estimates over future years, information based on the estimates is not necessarily more reliable than information reported under the nominal value accounting method.

65. A number of respondents expressed support of the Board's proposal to use present value accounting for direct loans and loan guarantees.

They believed that it is a positive step to bring budgeting and financial reporting together. They also believed that implementation of the proposed standards would present useful information for monitoring programs with direct loans and loan guarantees.

66. In proposing present value accounting, the Board's primary considerations were to carry out the intent of the Federal Credit Reform Act of 1990 and to make financial reporting compatible with the budget. (See Exposure Draft, Vol. 1, par. 15.) The Board believes that one of the objectives of financial reporting is to enable the reader to determine the status of budgetary resources, and whether those resources were acquired and used in accordance with the enacted budget.[11]

67. The Federal Credit Reform Act of 1990 requires using present value for the budget. The Board does not believe that this requirement should be ignored for financial reporting. Since budgetary resources for direct loan and loan guarantee subsidies are provided on a present value basis, financial reporting on the acquisition, use, and status of the resources should be on the same basis. Only by using the same basis can financial information be used to compare the actual results with the budget.

68. Indeed, distortion in information would result if present value were not used to report direct loans or loan guarantees that are budgeted on a present value basis. This can be illustrated by the following example.

69. Suppose a group of 5-year term loans in the aggregate amount of $100,000 were disbursed by a federal credit program at the end of fiscal year 1992. The loans require paying an annual interest of 5 percent and repaying the principal in fiscal year 1997. It was estimated that the interest would be collected each year, but only $80,000 of the principal would be repaid when the loans mature. During the year the loans were disbursed, the average interest rate of Treasury securities of the same maturity was 9 percent.

70. Based on the cash flow projection shown in Table 1 below, at the end of the 1992 fiscal year, the present value of the direct loans was $71,440 and the loans' subsidy cost was $28,560. It is assumed in this

[11]FASAB Exposure Draft, Objectives of Federal Financial Reporting, Vol. 1, par. 13.

example, that as required by credit reform, the subsidy cost ($28,560) was funded with appropriations, and the remaining amount ($71,440) was financed with borrowing from Treasury at 9 percent.

Table 1: The Present Value Of Direct Loans

Fiscal Years	Expected Payments
1993	$5,000
1994	5,000
1995	5,000
1996	5,000
1997	$85,000
Present value at 9%	**$71,400**

71. If the nominal value accounting method were used in financial reporting, the $20,000 of the principal that was estimated to be uncollectible would have been reported as a bad debt expense. The estimated uncollectible amount of $20,000 would have been recognized as the cost of the loans in financial statements. In reality, however, the agency spent $28,560 of budgetary resources to fund the cost of the loans.

72. Also, if the nominal value accounting method were used, the loans as assets would have been reported at $80,000 at the end of the 1992 fiscal year, which equals the $100,000 principal of the loans minus an allowance of $20,000 for the uncollectible amount. On the other hand, debt to Treasury would have been reported at $71,440, which was the amount actually borrowed to finance the loans. The financial information would have shown an excess of the assets over the liability by $8,560. In reality, however, even if the default estimate was correct, the entire collection of interest and principal would be used to pay interest and principal to Treasury. The credit program in fact would have no excess in assets. The following is a comparison of the loans reported on a present value basis and on a nominal value basis.[12]

[12]Tables are provided only for illustration. They do not represent a reporting format.

Table 2: Reporting On The Direct Loans At Present Value On September 30, 1992

Assets		Liabilities	
Loans receivable	$100,000	Debt to Treasury	$71,440
Subsidy cost allowance (28,560)	(28,560)		
Loans receivable, net	$ 71,440		
		Net Position	**$ 0**

Table 3: Reporting On The Direct Loans At Nominal Value On September 30, 1992

Assets		Liabilities	
Loans receivable	$100,000	Debt to Treasury	$71,440
Subsidy cost allowance (28,560)	(20,000)		
Loans receivable, net	$ 80,000		
		Net Position	**$ 8,560**

73. A similar distortion would result in reporting loan guarantees. The distortion would be caused by reporting loan guarantee liabilities on a nominal value basis, whereas the budgetary resources received to finance the liabilities are measured at a present value basis.

74. In evaluating efforts and costs of implementing present value accounting for post-1991 direct loans and loan guarantees, one should keep in mind that the federal direct loan and loan guarantee programs have modified or will have to modify their accounting systems in order to implement the budgeting requirements of the Federal Credit Reform Act of 1990. They will have to maintain data by cohort and risk category, compute interest on borrowing from Treasury and on uninvested funds, and make subsidy estimates and reestimates. The accounting standards provided in this statement do not require more than the budget process requires in these respects, and thus they would not result in a substantial amount of additional effort or cost.

75. Some respondents indicated that it would be burdensome if present value accounting were to be implemented on a loan-by-loan (or transaction) basis. The Board does not propose that the accounting standards be implemented on a loan-by-loan basis. The standards should apply to a cohort (or risk category) of direct loans or loan guarantees in the aggregate.

76. In addition to making financial reporting consonant with the budget, the Board also believes that the standards proposed in the Exposure Draft will produce better financial information for the following reasons:

77. First, the proposed standards would require measuring and recognizing the subsidy costs of direct loans and loan guarantees at their inception rather than at a later date. The current accounting practice does not require this. In the absence of this requirement, the cost of direct loans is not recognized when the loans are disbursed, and the liability to pay claims under loan guarantees is not usually recognized when guaranteed loans are disbursed.

78. Second, the proposed standards would require a comprehensive evaluation of future cash flows over the life of direct loans and guaranteed loans, including payments of interest, principal, fees, prepayments, defaults, delinquencies, and recoveries. The current accounting practice typically provides an allowance for the portion of the principal that would not be collected. It does not take into account the impact of other cash flow elements.

79. Third, the proposed standards would require discounting the net cash flows at the government's borrowing rate on marketable Treasury securities. Discounting is a basic feature of present value accounting that measures and recognizes the interest subsidy cost of direct loans and loan guarantees, and the time value of all cash flows. The time value of such cash flows is not accounted for under the nominal value accounting method, and the interest subsidy cost is not accounted for when the loans are disbursed.

80. Finally, the proposed standards would require an annual systematic review of the projected cash flows. The projections would be revised and updated to reflect newly developed events, changes in economic conditions, and better understanding of the factors that cause defaults. The subsidy costs would be reestimated accordingly. The reestimation

requirement assures that credit programs maintain an up-to-date data base by cohort and risk category of actual collections, defaults, and amounts written off on federal loans and loan guarantees. Such a complete data base was not available prior to credit reform.

81. In summary, the recognition of cost at inception, the comprehensive evaluation of all future cash flows, and the discounting of future cash flows to present value are complementary elements at the core of present value accounting. When taken together, they place an economic value on the cost the federal government incurs in making direct loans and loan guarantees. Likewise, they place an economic value rather than a nominal value on loan assets and loan guarantee liabilities.

82. Based on the view that financial accounting should be compatible with the budget, and based on the other advantages of using the present value accounting, the Board has concluded that the present value accounting method should be used in the accounting standards for post-1991 direct loans and loan guarantees.

Subsidy Cost Component

83. The Exposure Draft proposed that when direct or guaranteed loans are disbursed, their subsidy expense be recognized separately among interest subsidy costs, default costs, fees (as a deduction from the costs), and other subsidy costs.

84. The Exposure Draft also proposed the following requirement: The interest subsidy allowance shall be amortized using the interest method. Compound interest shall be accumulated on the allowances for default losses, fees, and other cost components.

85. The Exposure Draft posed a question: Should the subsidy cost components, if material, be recognized separately in financial reporting? Some respondents agreed that the subsidy cost components should be separately recognized. They believed that separate recognition would provide the level of detail needed to understand the program better and improve their component estimates for budget formulation.

86. Some respondents were opposed to reporting subsidy costs by component on the grounds that (1) only the aggregate amount of subsidy costs is needed for budget execution purposes,

(2) information on cost components may not be used by management, and (3) the cost of complex record-keeping and calculations outweigh the benefit.

87. After considering the benefits and efforts required in accounting for subsidy cost components, the Board has concluded that when direct or guaranteed loans are disbursed, the subsidy expense of the direct loans or loan guarantees should be recognized in separate components. The Board believes that by reporting the subsidy expense components of direct or guaranteed loans disbursed during the reporting year, the cost components of newly disbursed direct loans and loan guarantees can be compared with those of prior years. The cost component information would be valuable for making credit policy decisions, monitoring portfolio quality, and improving credit performance. Information on interest subsidies and fees would help in making decisions on setting interest rates and fee levels. Information on default costs would help in evaluating credit performance.

88. In calculating the present value of the subsidy costs for the budget, agencies must first develop data on cash flow components. OMB requires agencies to use the OMB credit subsidy model, which takes these cash flows as inputs and automatically calculates the components of the subsidy cost. Since the information on subsidy cost components of new direct loans and loan guarantees is available, reporting the information would not require significant additional efforts.

89. However, the Board realizes that it would require considerable efforts to maintain records for the present value of cost components for each existing cohort of loans and loan guarantees, amortize or accumulate interest on each component each year, adjust each component each year for reestimates, and, if applicable, adjust each component for modifications when they occur. After considering the efforts that would be required and the benefits that could be derived, the Board decided not to recommend the requirement to amortize or accumulate interest on each subsidy cost component. Without this requirement, credit programs may amortize the subsidy allowance of each cohort in aggregate, using the interest method. They would not have to maintain records for the present value of each cost component and adjust them annually. This would greatly ease the record-keeping and calculation burden.

90. By eliminating the requirement to amortize and accumulate interest on each component of the subsidy cost allowance, the Board realizes that information would not be available to track changes in the present values of the components. However, data would still be available to track changes in the total amount of a cohort's subsidy allowance affected by annual reestimates. The primary factor that causes changes in the subsidy allowance would be default reestimates. Furthermore, the Board believes that it is of a critical importance that each credit program maintain a data base for actual collections, defaults, delinquencies, and recoveries. For purposes of monitoring program performance and estimating future losses, the actual default and collection data base is more important than tracking changes in the allowance for the present value of subsidy costs by component. The actual default and collection data base is also necessary for estimating and reestimating subsidy costs.

Accounting For Fees

91. In the Exposure Draft, the Board proposed that the present value of estimated fee receipts be recognized as a deduction from the subsidy expense. The Board posed a question: How should fees be recognized on an entity's financial reports? Should they be recognized as a deduction of subsidy expense, or as a revenue?

92. Many respondents agreed with the proposal that the present value of estimated fee collections be recognized as a deduction of subsidy expense. Some respondents contended that fees should be recognized as a revenue rather than as an expense component. They stated that offsetting revenues against expenses would not provide clear revenue/expense information concerning the operating results of a credit program. Some of the respondents also said that to the extent some of the fees are used to defray administrative costs, they should not offset subsidy expenses because the Federal Credit Reform Act of 1990 excludes administrative costs from subsidy expenses.

93. The Board is not persuaded by the arguments that fees should be reported as a revenue. The subsidy expense of direct loans and loan guarantees is the focal point of credit reform, and it is measured as the present value of the net cash flows of the direct loans and loan guarantees. Since the estimated fees are a component of the cash flows, the Board believes that the present value of fees should be reported as a component of the subsidy expense. Since the Board has concluded that all of the subsidy expense components, including the

present value of fees, are to be reported separately, reporting the present value of fees as an expense component would not reduce information on the collection of fees. Furthermore, the administrative expenses that are excluded from subsidy costs are often covered by appropriations, rather than paid by fee collections. Thus, it is not necessary to allocate a portion of the fee collections to pay the administrative costs that are not a part of the subsidy costs.

Pre-1992 Direct Loans And Loan Guarantees

94. The phrase pre-1992 direct loans and loan guarantees refers to direct loans obligated and loan guarantees committed before October 1, 1991, the effective date of the Federal Credit Reform Act of 1990. In the Exposure Draft, the Board did not recommend restating pre-1992 direct loans and loan guarantees at present value. The Board's position was that the costs of restating those direct loans and loan guarantees would outweigh the benefits.

95. Most respondents who commented on this issue agreed with the Board's position. They emphasized that the restatement of pre-1992 direct loans and loan guarantees would be a complex process and would require substantial resources. They pointed out that a major difficulty is caused by the lack of complete and accurate historical data that a restatement needs to be based upon. Because of the lack of accurate data, even if the agencies incurred a great deal of cost, the restated loans and loan guarantees could not be accurately compared with post-1991 loans and loan guarantees on the same basis. The respondents pointed out that since the pre-1992 direct loans and loan guarantees were obligated or committed in the past, restated information would be of limited usefulness to current budget decisions. They also pointed out that the amount of pre-1992 direct loans and loan guarantees outstanding would diminish over time as loans matured, defaulted, or were modified.

96. In addition to considering the comments on the Exposure Draft, the Board also considered the findings of a GAO report presented to the Board.[13] The GAO report suggested that by not requiring a restatement of pre-1992 direct loans and loan guarantees at present value, poor

[13] *GAO Report to the Chairman, Senate Budget Committee, Federal Credit Programs: Agencies Had Serious Problems Meeting Credit Reform Accounting Requirements* (GAO/AFMD-93-17, Jan. 1993).

information would be perpetuated, which could affect the ability to (1) forecast the future budgetary impact of pre-credit reform credit activity, (2) minimize losses, and (3) judge the reasonable accuracy of subsidy estimates for post-1991 credit. The GAO report recommended using simplified methods, such as sampling techniques, to restate pre-1992 direct loans and loan guarantees at present value.

97. However, there was a strong indication in the comments the Board received and in the findings of the GAO report that agencies have been experiencing serious difficulties in implementing the credit reform requirements related to post-1991 direct loans and loan guarantees. A restatement of pre-1992 direct loans and loan guarantees, even on a sampling basis, would require additional use of the agencies' limited accounting resources. The Board also agrees with the view that as the pre-1992 direct and guaranteed loans are approaching their maturity and are paid off, liquidated, or written off, the difference between their present value and nominal value becomes less significant. Thus, the Board concludes that it is appropriate not to require restating pre-1992 direct loans and loan guarantees at present value.

98. The Department of Veterans Affairs stated in its comments that it had accounted for pre-1992 loan guarantees on a present value basis. The Department of Education indicated in its comments that it planned to report pre-1992 loans on a present value basis. Their efforts to account for pre-1992 loans and loan guarantees at present value, although not at the same level of detail as required by credit reform, could very well result in improved information for credit management. Other agencies may follow their examples. The Board believes that reporting those pre-1992 direct loans and loan guarantees on a present value basis should be permitted.

99. Although a restatement of pre-1992 direct loans and loan guarantees at present value is not required, the Board continues to believe that it is of fundamental importance to estimate and recognize losses and liabilities for those direct loans and loan guarantees. Loss estimation and recognition are necessary to support federal government financial planning and management. The information on both current and potential liabilities related to federal credit programs alerts Congress and federal officials to the long-term costs and future financing needs.

100. The recommended standards would require that losses of pre-1992 direct loans and liabilities related to pre-1992 loan guarantees be

recognized when it is more likely than not that the loans will not be totally collected or the loan guarantees will require a future cash outflow to pay default claims. This is the same standard that the Board recommended for the recognition of losses on receivables in FASAB Statement of Recommended Accounting Standards No. 1, Accounting for Selected Assets and Liabilities.

101. The Board believes that each loan guarantee program should disclose the aggregate amount of outstanding guaranteed loans. In addition, it should also disclose its risk exposure, which is the guaranteed portion of the total outstanding guaranteed loans.

Modifications

102. A modification is a government action that alters the estimated subsidy cost of outstanding direct loans or loan guarantees. Both a government action and an alteration in subsidy cost are necessary conditions for a modification. A subsidy reestimate is not a modification.

103. Direct modifications change the subsidy cost by legislation or administrative actions that alter the terms of existing contracts or by selling loan assets. Existing contracts may be altered by such means as forgiveness, forbearance, reductions in interest rates, extensions of maturity, and prepayments without penalty. Such actions are modifications unless they are considered workouts as explained below or are permitted by the existing contract terms.

104. Indirect modifications change the subsidy cost by legislation that alters the way in which an outstanding portfolio of direct loans or loan guarantees is administered. Examples include a new method of debt collection prescribed by law or a statutory restriction on debt collection. Such new legislation would produce a one-time effect on the subsidy cost of outstanding direct loans and loan guarantees only. After the enactment of the legislation, the effects of the legislation are included in the original subsidy cost estimates of newly obligated direct loans and newly committed loan guarantees. Thus, the legislation is not a modification with respect to direct loans obligated and loan guarantees committed subsequent to its enactment.

105. The term “modification” does not include the routine administrative work-outs of troubled loans or loans in imminent default. Work-outs are actions undertaken to maximize the repayments to the government

under existing direct loans or to minimize claim payments that the government would make under loan guarantees. The expected effects of work-outs on cash flows are included in the original estimate and the reestimates of the subsidy cost. Therefore, a workout effort is not a government action that alters the estimated subsidy cost of direct loans or loan guarantees.

106. The term "modification" also does not include actions that are permitted within the existing contract terms, such as prepayments without penalty permitted by existing loan contracts. The expected effects of such actions on cash flows are included in the original estimate and the reestimates of the subsidy cost.

107. Neither the term "modification" nor the term "workout" includes additional disbursements to borrowers that increase the amount of direct loans outstanding. These disbursements are considered to be new loans in the amount of the increment.

108. When direct loans and loan guarantees are modified, the subsidy cost of the modification must be calculated. The book value of the modified loans and the liabilities of the modified loan guarantees must be restated. The Exposure Draft used two types of discount rates to calculate the present values of post-1991 direct loans and loan guarantees that are modified: CURRENT DISCOUNT RATES and original discount rates.

109. The term "current discount rate" refers to the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to the remaining maturity of the direct or guaranteed loans, under either pre-modification terms, or post-modification terms, whichever is appropriate. The cost of modification is measured as the excess of the present value of pre-modification net cash flows over the present value of post-modification cash flows, both discounted at a current discount rate. This is consistent with the measurement method described in OMB instructions.

110. The term "original discount rate" refers to the discount rate that is originally used to calculate the present value of the direct loans or the present value of loan guarantee liabilities, when the direct or guaranteed loans were disbursed. The value of modified loans or the liability of modified loan guarantees equals the present value of

modified cash flows discounted at the original discount rate. The original discount rate is used to determine the value of modified loans because this is the interest rate that the Treasury charges on funds that it lends to the credit program to finance the loans. The original discount rate is also used to determine the liability of modified loan guarantees because this is the interest rate that the Treasury pays on funds that it holds for the credit program to pay future claims.

111. Because of using the two different rates, a difference will normally occur between the change in the book value of modified direct loans and the cost of the modification. In the case of loan guarantees, there will normally also be a difference between the change in the liability of modified loan guarantees and the cost of modification.

112. The Exposure Draft used an example to illustrate the difference.[14] The example used the original discount rate of 6 percent to calculate the book value of a modified loan, and it used the current discount rate of 8 percent to calculate the cost of modification. The calculations resulted in a difference between the change in book value and the cost of modification.

113. OMB instructions require that an amount equal to the difference between the change in book value and the cost of modification either be returned to, or received from, the Treasury to offset the difference. The amount transferred to offset the difference is referred to in OMB instructions as the modification adjustment transfer. This transfer does not constitute a part of the cost of modification and is not a budget outlay or collection.

114. Several respondents objected to use of the current rate for measuring the modification cost. They believed that both the modification cost and the value of the modified loans (or the liability of modified loan guarantees) should be measured on the same basis, using the original discount rate. They said that by using the original discount rate for measuring both the cost and the book value or the liability, there would be no difference between the modification cost and change in book value (or change in loan guarantee liability). They argued that the additional computations at current discount rate do not result in any additional meaningful information for use by management. They

[14]See Exposure Draft, Vol. 2, pars. 221 through 231, and Appendix 2, pages 139 through 143.

contended that the complexity of the computation, the effect of changing discount rates, and the resulting difference between the change in book value and the cost of modification would only detract from management's ability to analyze the results of modification.

115. The Board realizes that it is undesirable to calculate the cost of modification and change in book value on different bases. Because the cost of modification and the book value are calculated on different bases, the modification expense recognized would not equal the decrease in the book value of direct loans (or the increase in the liability of loan guarantees) resulting from the modification.

116. However, it is also undesirable to recognize a modification expense at a measurement basis that differs from the budget and appropriation basis. The OMB instructions concerning the definition and the cost of modification have carried a great weight on the Board's consideration of the subject. The OMB instructions require that the cost of modification be measured at the current rate, and appropriations approved for a modification will equal the cost of modification. The Board believes that financial reporting should reflect the modification cost recognized in the budget and the modification appropriations received.

117. The Board also appreciates the rationale in OMB instructions. The Federal Credit Reform Act of 1990 requires that the calculation of modification cost be based on the estimated present value of the direct loans or loan guarantees at the time of modification. This requirement has been interpreted as calculating the present value of modification cost at the discount rate applicable at the time of modification. The Board also agrees with the substantive rationale for using the current rate. By using the current rate, the calculation of the modification cost will reflect the economic cost of the modification at the time when the modification decision is made.

118. The Board found that some of the opposition to the use of the current rate for modifications arose because of a misunderstanding about the difference between modifications and work-outs. Once the distinction was clarified between work-outs (which are included in the initial subsidy estimates and are quantified using the original rates) and modifications (which require separate action as described, but are less frequent in occurrence), much of the opposition to using current rates for modifications disappeared.

119. In considering a solution for the measurement difference between the modification cost and the book value of the loan (or the loan guarantee liability), the Board has considered as an alternative whether the current rate could also be used to calculate the value of modified direct loans (or the liability of modified loan guarantees) so that the change in direct loan book value or loan guarantee liability could equal the cost of modification. The Board has decided against this for the two reasons explained below.

120. First, under credit reform, the un-subsidized portion of direct loans is financed by funds borrowed from Treasury, while the subsidy cost of the direct loans is financed by appropriations. Thus, the carrying amount of direct loans at any point should equal the balance of debt to Treasury. Proceeds from collecting direct loan principal and interest will be used to repay debt to Treasury. This exact match between loan assets and liabilities (debt to Treasury) is a unique feature that makes credit reform loans and loan guarantees different from private sector lending.

121. When a modification occurs, the book value of the direct loans is affected. An amount of modification appropriation, plus or minus the modification adjustment transfer, would be used to reduce the debt to Treasury. By doing so, the book value of the modified loans and the balance of the debt to Treasury would continue to be equal. It is important to note that the interest rate on the debt to Treasury does not change as a result of the modification; it remains the original rate. Thus, the debt balance to Treasury in fact equals the present value of future payments to Treasury discounted at the original rate. Since the debt to Treasury is based on the original rate, that rate should also be used to calculate the book value of modified loans, so that the book value of the loans and the balance of debt to Treasury would be kept equal.

122. A parallel situation exists with loan guarantees. The financing account of each loan guarantee program maintains a fund balance with the Treasury equal to the liability of the loan guarantees. The fund balance and the liability grow at the same compound interest rate. The fund balance will accrue interest at the original rate applicable at the time the guaranteed loans were disbursed. The interest rate will not change because of a modification of the loan guarantees. Thus, only by measuring the liability of the modified loan guarantees at the original rate could the liability be kept equal to the fund balance.

123. Second, even if the current rate were used to calculate the book value of modified loans, the difference between the change in book value (or the change in liability balance) and the modification cost would not disappear. In measuring the change in book value (or the change in liability balance), the starting point is the pre-modification book value (or the pre-modification liability balance), which is based on the original discount rate. If the current rate is used to calculate the post-modification book value of modified direct loans, the change in book value would equal the difference between the pre-modification book value (based on the original rate) and the post-modification book value (based on the current rate). Similarly, if the current rate is used to calculate the post-modification balance of modified loan guarantee liabilities, the change in liability balance would equal the difference between the pre-modification balance (based on the original rate) and the post-modification balance (based on the current rate).

124. The cost of modification, on the other hand, is calculated differently. The starting point of the calculation is not the existing pre-modification book value of the modified loans (or the existing pre-modification book value of the liability of the modified loan guarantees). For both direct loans and loan guarantees, the calculation uses the present value of pre-modification net cash flows discounted at the current discount rate as the starting point. This pre-modification value differs from the existing pre-modification book value because the latter is based on the original discount rate. The cost of modification equals the difference between the present value of pre-modification net cash flows (discounted at the current rate) and the present value of post-modification net cash flows (also discounted at the current rate). Since the calculations take a different starting point, the cost of modification would not equal the change in book value.

125. Because of the two reasons above, the Board believes that the best solution available is to measure the cost of modification at the current discount rate, and to calculate the carrying amount of modified loans and loan guarantee liabilities at the original discount rate.

126. However, while it makes sense to determine the cost of modification based on the current discount rate, financial reporting cannot discard the pre-modification balance of direct loans or loan guarantee liabilities that are carried in the accounting records. Because of the use of different discount rates, the change in book value will be

different from the cost of modification. The Board believes that the effect of a modification on assets or liabilities should be reflected in the operating statement. The Board believes that in addition to recognizing the cost of modification as a modification expense, any difference between the change in book value and the modification expense should be recognized as a gain or loss. Thus, the net effect of the modification on the operating statement equals the decrease in loan assets or the increase in the liability of loan guarantees resulting from the modification.

127. Based on this view, the Board has concluded that, with respect to a modification of direct loans, any difference between the change in the book value of the direct loans resulting from the modification and the cost of modification should be recognized as a gain or loss in the operating statement. Similarly, any difference between the change in the amount of liability of loan guarantees resulting from the modification and the cost of modification should be recognized as a gain or loss in the operating statement. The gain or loss is to be recognized in a category distinguished from the modification expense. The modification adjustment transfer paid or received to offset the gain or loss is to be reported as a financing source or a reduction in financing source.

128. The Board further believes that agency financial statements should include a footnote to explain the calculation of the cost of modifications and nature of gain or loss on modifications.

Appendix B: Technical Explanations And Illustrations

This Appendix explains and illustrates the accounting standards for direct loans and loan guarantees. The explanations and illustrations are presented to show how the standards may be applied but are not standards themselves. They also take into account OMB and Treasury regulations on credit reform.

This Appendix has 4 parts:

- Part I: Post-1991 Direct Loans
- Part II: Pre-1992 Direct Loans
- Part III: Post-1991 Loan Guarantees
- Part IV: Pre-1992 Loan Guarantees

Topics covered include:

- the measurement and recognition of direct loans, subsidy costs, and the liability of loan guarantees;
- the reestimation and the amortization of the subsidy cost allowance;
- the reestimation of loan guarantee liabilities and the accumulation of interest on the liabilities;
- the recognition of revenues and expenses;
- modifications of direct loans and loan guarantees (including the sale of direct loans);
- the write-off of direct loans; and
- the foreclosure of assets upon default.

The Appendix does not illustrate financial statements, journal entries, or accounting procedures. Readers should consult OMB, GAO, and Treasury for guidance.

Part I: Post-1991 Direct Loans

Post-1991 direct loans are direct loans obligated after September 30, 1991. The accounting for post-1991 direct loans is explained and illustrated in this part of the Appendix through an example described below:

At the end of fiscal year 1994, a federal credit program disburses a number of direct loans with a total principal of $10 million. Those loans constitute a cohort for that year. The maturity term of that cohort is 5 years and the stated annual interest rate is 4 percent.

All of the amounts used in the text below are in thousands of dollars.

The loan contracts require an annual payment of $2,246 per year for 5 years, paid at the end of each year. In Table 1 below, the required annual payments are shown in column (a).[15] The amounts in column (b) equal the beginning loan balance of each period multiplied by the stated interest rate of 4 percent. The amounts in column (c) are principal repayments, which equal the amounts in column (a) minus the amounts in column (b). The amounts in column (d) are the ending principal balance of each period, which equal the beginning balance minus the principal repayment of that period, shown in column (c).

Table 1: Payment Schedule (in thousands of dollars)

FY	Payment (a)	Interest (b)	Principal (c)	Year-End Loan Balance (d)
1994				$10,000
1995	$2,246	$400	$1,846	8,154
1996	2,246	326	1,920	6,234
1997	2,246	249	1,997	4,237
1998	2,246	169	2,077	2,160
1999	2,246	86	2,160	0

It is also assumed that:

- The average interest rate of Treasury marketable securities of a similar maturity for the period during which the loans are disbursed is 6 percent.
- Fees totaling $500 are received when the loans are disbursed. The fees are used to reduce the need to borrow from Treasury.

A. Reporting Post-1991 Direct Loans And Their Subsidy Costs

The accounting standard for post-1991 direct loans requires that direct loans disbursed and outstanding be recognized as assets at the present value of their estimated net cash inflows. The difference between the

[15]The annual payment is derived by dividing the present value factor of 4.45182 into the principal of $10,000. The present value factor can be found in any ordinary annuity table, and it equals the present value of $1 paid over 5 periods discounted at 4 percent. Alternatively, knowing the loan principal, the number of pay back periods, and the interest rate, one can use computer software or a financial calculator to find the required payment per period.

outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance.[16]

To implement the standard in the example, a cash flow projection and present value calculations are prepared. Based upon the risk factors and other criteria for default cost estimates that are enumerated in the accounting standards, it is estimated that losses in cash flows due to the defaults would equal 30 percent of the scheduled payments for fiscal year 1997 and each year thereafter.[17] Table 2 below displays the cash flow projections and present value calculations.

Table 2: Projected Cash Flows Discounted To The End Of FY 1994 (in thousands of dollars)

FY	Fee Collections	P & I Payments[a]	Default Losses	Net Cash Inflows
1994	$500			$500
1995		$2,246		2,246
1996		2,246		2,246
1997		2,246	$(674)	1,572
1998		2,246	(674)	1,572
1999		2,246	(674)	1,572
PV at 6%	$500	$9,461	$(1,603)	$8,358

[a]The term "P & I Payments" used in this table as well as other tables throughout this Appendix denotes scheduled principal and interest payments required in loan contracts.

The present value of the loans' estimated net cash inflows is $8,358. The direct loans are recognized as assets at that amount. Since the loans' outstanding principal is $10,000, the difference between the loans' outstanding principal and their present value is $1,642, which is recognized as the subsidy cost allowance.

[16]In this Appendix, the requirements of the accounting standards are summarized to address specific situations. However, the standards are not quoted verbatim. Readers should refer to the text of the standards for their exact wording.

[17]The standard defines losses in cash flows due to default as being due to defaults net of recoveries. However, to simplify computations, recoveries are assumed to be zero throughout Parts I and II of this Appendix. References to defaults throughout Parts I and II should be understood to mean defaults net of recoveries for all cases where recoveries are expected. The accounting standard for recoveries is illustrated in Part III of this Appendix.

The accounting standard for post-1991 direct loans requires that for direct loans disbursed during a fiscal year, a subsidy expense be recognized. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows, discounted at the interest rate of marketable Treasury securities with a similar maturity term, applicable to the period during which the loans are disbursed (hereinafter referred to as the applicable Treasury interest rate).

In the example, the present value of the loans' cash outflows is the disbursed amount of $10,000. The present value of the loans' estimated net cash inflows is $8,358. The difference between those two amounts is $1,642, which is recognized as subsidy expense.

The accounting standard for post-1991 direct loans requires that for the fiscal year during which new direct loans are disbursed, the components of the subsidy expense of those new direct loans be recognized separately among interest subsidy costs, default costs, fees and other collections, and other subsidy costs.

The interest subsidy cost of direct loans is the excess of the amount of the loans disbursed over the present value of the interest and principal payments required by the loan contracts, discounted at the applicable Treasury interest rate (6 percent in this example). In this example, the amount of the loans disbursed is $10,000. The present value of the scheduled interest and principal payments is $9,461. The difference between those two amounts is $539, which is recognized as the interest subsidy cost.

The default cost of direct loans results from any anticipated deviation, other than prepayments, by the borrowers from the payment schedules in the loan contracts. The deviations include delinquencies and omissions in interest and principal payments. The default cost is measured at the present value of the projected payment delinquencies and omissions minus net recoveries. (See footnote 3.) In this example, the present value of the projected payment omissions minus net recoveries is $1,603, which is recognized as the default cost.

The present value of fee collections is $500, which is recognized as a deduction from subsidy costs.

There are no other subsidy costs[18] in this example.

The subsidy expense of the loans is the sum of the above cost components, which is $1,642, calculated as follows:

Interest subsidy cost	$ 539
Fee collections	(500)
Loan default cost	1,603
Total subsidy cost	**$1,642**

The loan disbursements are financed by three sources: subsidy payments, borrowing from Treasury, and fee collections. The subsidy cost of $1,642 is provided by appropriated funds; and the present value of loans, equal to $8,358, is provided by fee collections and funds borrowed from Treasury at the Treasury interest rate of 6 percent.

The fees are collected when the loans are disbursed. Because all cash flows, including fee collections, are used to calculate the subsidy cost allowance, the amount of the fee collections is credited to the subsidy cost allowance. The collected amount reduces the amount that has to be borrowed from the Treasury. As a result, the subsidy cost allowance is $2,142, which is the sum of the interest subsidy cost of $539 and the default subsidy cost of $1,603. This is $500 more than the total subsidy cost of $1,642. The debt to Treasury is $7,858, which is $500 less than the present value of the loans of $8,358.

Table 3 displays the asset and liability balances at the end of fiscal year 1994.

Table 3: Assets And Liabilities As Of The End Of FY 1994 (in thousands of dollars)

Assets		Liabilities	
Loans receivable	$10,000	Debt to Treasury	$7,858
Less:			
Allowance for subsidy costs	(2,142)		
Loans receivable, Net	$ 7,858		

[18]The term “other subsidy costs” is explained in the standard for subsidy costs of post-1991 direct loans and loan guarantees.

B. Subsidy Reestimation And Amortization

(1) Subsidy Reestimation

The accounting standard for post-1991 direct loans requires that the subsidy cost allowance for direct loans be reestimated each year as of the date of the financial statements. Since the allowance represents the present value of the net cash outflows of the underlying direct loans, the reestimation takes into account all factors that may have affected the estimate of each component of the cash flows, including prepayments, defaults, delinquencies, and recoveries. Any increase or decrease in the subsidy cost allowance resulting from the reestimates is recognized as a subsidy expense (or a reduction in subsidy expense).

The standard further states that reporting the subsidy cost allowance of direct loans and reestimates by component is not required.

In Appendix A, the Basis of the Board's Conclusions, it is pointed out that the primary factor that causes changes in the subsidy cost allowance would be default reestimates. The accounting standard provides a number of risk factors and other default cost criteria to be considered in making the default cost estimates and reestimates.

In this illustration, it is originally estimated that 30 percent of the loan payments would be lost due to defaults for fiscal year 1997 and thereafter. The first reestimate is made early in fiscal year 1995. Because so little time has passed since the subsidy was initially estimated, the estimated cash flows are unchanged and the reestimate is zero. (This illustration assumes that the interest rates at the time of loan obligation and disbursement are the same, so no reestimate is needed for the difference in interest rates.)

The second reestimation is performed early in fiscal year 1996, in preparing financial statements for fiscal year 1995. It reestimates the subsidy cost allowance as of the end of fiscal year 1994. After evaluating all of the risk factors, it is concluded that defaults would occur in fiscal year 1996, instead of 1997, and that 60 percent, instead of 30 percent, of the cash flows would be lost due to the defaults in fiscal year 1996 and thereafter. Table 4 below displays the present values of the reestimated cash flows discounted to the end of fiscal year 1994.

Table 4: Subsidy Cost Reestimation: Projected Cash Flows Discounted To The End Of FY 1994 (in thousands of dollars)

FY	P & I Payments	Default Losses	Net Cash Flows
1995	$2,246	$0	$2,246
1996	2,246	(1,348)	898
1997	2,246	(1,348)	898
1998	2,246	(1,348)	898
1999	2,246	(1,348)	898
PV at 6%	$9,461	$(4,405)	$5,056

The present value of the reestimated net cash inflows discounted to the end of fiscal year 1994 is $5,056, compared to the loans' book value of $7,858, a decrease of $2,802. Thus, the subsidy cost allowance is increased by $2,802, from $2,142 to $4,944. The amount of the increase in the subsidy cost allowance (which is the decrease in the present value of the loans), resulting from the reestimate, is recognized as subsidy expense reestimates.

A subsidy payment of $2,802, equal to the subsidy expense resulting from the reestimate, is received under permanent indefinite authority. The amount is used to repay borrowing from Treasury. Thus, the outstanding balance of the debt to Treasury is reduced by $2,802 to $5,056.

Furthermore, the direct loan program also receives a payment under permanent indefinite authority to cover the interest accrued on the reestimate subsidy payment of $2,802 for the period from the end of fiscal year 1994 to the end of fiscal year 1995. The payment is $168, which equals $2,802 times the applicable Treasury interest rate of 6 percent. This amount is recognized as interest income reestimates, and the money is used to pay the interest on the $2,802 borrowed from Treasury but repaid with the reestimate subsidy.

Table 5 displays the asset and liability balances as of the end of fiscal year 1994, adjusted for the reestimate that was calculated early in fiscal year 1996.

Table 5: Assets And Liabilities As Of The End Of FY 1994: Amounts Adjusted For Reestimate Calculated In Early FY 1996 (in thousands of dollars)

Assets		Liabilities	
Loans receivable	$10,000	Debt to Treasury	$5,056
Less:			
Allowance for subsidy cost	(4,944)		
Loans Receivable, Net	$ 5,056		

(2) Subsidy Amortization

The accounting standard for post-1991 direct loans requires that the subsidy cost allowance for direct loans be amortized by the interest method using the interest rate that was originally used to calculate the present value of the direct loans when the direct loans were disbursed. The amortized amount is recognized as an increase or decrease in interest income.

The subsidy cost allowance is amortized as a whole, not by components. Under the interest method of amortization, the amortization of each period equals the effective interest of the outstanding direct loans minus the nominal interest. For any period for which interest is to be paid (a fiscal year in this example), the effective interest equals the book value (which is also the present value) of the direct loans at the beginning of the period times the applicable Treasury rate. The nominal interest equals the outstanding nominal balance of the loans at the beginning of the period times the interest rate stated in the loan contracts.

In the example, the book value of the direct loans, as reestimated, is $5,056. The effective interest for fiscal year 1995 is $303, which equals the book value of $5,056 times the applicable Treasury rate of 6 percent. The nominal interest for that year is $400, which equals the nominal principal of the direct loans $(10,000) times the stated rate of 4 percent. The amortized amount is a negative amount of $97 for fiscal year 1995, which equals the effective interest minus the nominal interest. The subsidy cost allowance is increased by $97, from $4,944 to $5,041. The amortized amount is

recognized as a reduction in interest income. (Interest income for fiscal year 1995 is calculated in section C: Revenues and Expenses.)[19]

The same procedure of amortization is applied for each of the subsequent years so long as the direct loans are outstanding. The collection of interest and principal payments must be properly accounted for together with the amortization, so that the asset and liability balances can be updated.

At the end of fiscal year 1995, payments of $2,246 are received from the borrowers as scheduled. Of this amount, $400 is interest payments, and the remaining amount of $1,846 is principal repayments. Thus, the outstanding nominal balance of the loans is reduced by $1,846 to $8,154.

The $2,246 received from the borrowers was paid to Treasury. Although the debt to Treasury outstanding at the end of fiscal year 1994 was $7,858, the amount of $2,802 has been paid off by the subsidy payment for the reestimate. This left $5,056 of debt to Treasury. The interest that accrued on this remaining debt to Treasury is $303; the interest that accrued on the amount of debt paid off by the subsidy reestimate is $168, but it is covered by the interest on the reestimate. Therefore, of the $2,246 collected from the borrowers, $303 is interest paid to Treasury. The remaining $1,943 is principal repayment to Treasury. After the principal repayment, the outstanding debt to Treasury becomes $3,113.

Table 6 below displays the asset and liability balances after the amortization and the collection of interest and principal payments at the end of fiscal year 1995.

Table 6: Assets And Liabilities After Amortization At The End Of FY 1995 (in thousands of dollars)

Assets		Liabilities	
Loans receivable	$8,154	Debt to Treasury	$3,113
Less:			
Allowance for subsidy costs	(5,041)		
Loans Receivable, Net	$3,113		

[19]Amortization can alternatively be computed as interest expense other than reestimates $(471) minus the sum of interest income from borrowers $(400), interest income from reestimates $(168), and interest income on fund balance with Treasury $(0). These figures are derived in section C below.

C. Revenues And Expenses

The accounting standard for post-1991 direct loans requires that interest accrued on direct loans, including amortized interest, be recognized as interest income. Interest accrued on debt to Treasury is recognized as interest expense.

In this example, interest income for fiscal year 1995 is $471, which consists of the following items:

Nominal interest	$ 400
Amortized interest	(97)
Interest reestimates	168
Total interest income	**$ 471**

Interest expense on the debt to Treasury for the fiscal year is also $471, which equals the debt to Treasury of $7,859 at the beginning of the year times 6 percent. It is financed with the following sources:

Collections from borrowers	$ 303
Interest on reestimated subsidy payments	168
Total interest expense	**$ 471**

Costs of administering credit activities, such as salaries, legal fees, and office costs, that are incurred for credit policy evaluation, loan origination, closing, servicing, monitoring, maintaining accounting and computer systems, and other credit administrative purposes, are recognized separately as administrative expenses. Administrative expenses are not included in calculating the subsidy costs of direct loans.

D. Modification Of Post-1991 Direct Loans

The accounting standard on modifications states that the term "modification" means a federal government action, including new legislation or administrative action, that directly or indirectly alters the estimated subsidy cost and the present value of outstanding direct loans.

Readers should refer to the text of the standard and to Appendix A, Basis of the Board's Conclusions, for a more detailed definition of modifications.

Assume that in October 1995, shortly after the close of fiscal year 1995, Congress passed legislation to aid the borrowers. The legislation forgave some of the outstanding loans, and extended the maturity of the remaining

loans for one additional year (to the end of fiscal year 2000). It is estimated that 70 percent of the outstanding amounts, or $5,708, is forgiven.

The legislative action is within the definition of direct modification because it is a federal government action that directly changes the estimated subsidy cost and the present value of outstanding direct loans by altering the terms of existing contracts.

The accounting standard on modifications states that with respect to a direct or indirect modification of pre-1992 or post-1991 direct loans, the cost of modification is the excess of the pre-modification value of the loans over their post-modification value. The amount of the modification cost is recognized as a modification expense when the loans are modified.

The accounting is implemented in the steps described below.

(1) Calculate The Pre-Modification Value

The pre-modification value is the present value of the net cash inflows of the direct loans estimated at the time of modification under pre-modification terms and discounted at the current discount rate.

As used in this part and Part II of this Appendix, the current discount rate is the interest rate applicable at the time of modification on marketable Treasury securities with a similar maturity to the remaining maturity of the direct loans under pre-modification terms or post-modification terms, whichever is appropriate.[20]

The cash flows of the loans under pre-modification terms during 1996-99 are assumed to be the same as the cash flows that were reestimated early in fiscal year 1996 for these years and that are shown in Table 4. Those cash flows are used to calculate the loans' pre-modification value. It is assumed that the Treasury rate for a comparable maturity (4 years) and applicable to the time of modification is 4.5 percent. As Table 7 below shows, the present value of the pre-modification cash flows discounted at 4.5 percent is $3,223.

[20]The definition of the current discount rate is provided in Appendix C, Glossary. [See Appendix E of this Volume.]

Table 7: Pre-Modification Value (in thousands of dollars, calculated at the current discount rate)

FY	P & I Payments	Default Losses	Net Cash Flows
1996	$2,246	$(1,348)	$ 898
1997	2,246	(1,348)	898
1998	2,246	(1,348)	898
1999	2,246	(1,348)	898
PV AT 4.5%	$8,058	$(4,835)	$3,223

(2) Calculate The Post-Modification Value

The loans' post-modification value is the present value of the loans' net cash inflows estimated at the time of modification under post-modification terms and discounted at the current discount rate (for a 5-year maturity).

The modification forgives 70 percent of the outstanding principal amounts, and requires the remaining 30 percent, or $2,446, be paid back in 5 years (instead of 4 years) starting with year 1996. The stated interest rate remains at 4 percent. As shown in Table 8 below, under the modified terms, the required annual principal and interest payment is $549.

Table 8: Payment Schedule Of The Modified Loans (in thousands of dollars)

FY	Payment	Interest	Principal	Year-end Loan Balance
1995				$2,446
1996	$549	$97	$452	1,994
1997	549	79	470	1,524
1998	549	61	488	1,036
1999	549	41	508	528
2000	549	21	528	0

It is estimated that 20 percent of the scheduled cash inflows of the modified loans would be lost due to defaults. The current discount rate for a maturity of 5 years is 5 percent. As Table 9 shows, the present value of the post-modification cash inflows discounted at 5 percent is $1,902.

Table 9: Post-Modification Value (in thousands of dollars, calculated at the current discount rate)

FY	P & I Payments	Default Losses	Net Cash Flows
1996	$549	$(110)	$439
1997	549	(110)	439
1998	549	(110)	439
1999	549	(110)	439
2000	549	(110)	439
PV AT 5%	$2,377	$(475)	$1,902

(3) Calculate And Recognize The Cost Of Modification

The cost of modification is the excess of the pre-modification value over the post-modification value. Since the pre-modification value is $3,223, and the post-modification value is $1,902, the cost of modification is $1,321, which is recognized as a subsidy expense for modifications.

(4) Calculate The Change In The Loans' Book Value

The accounting standard on direct loan modifications requires that when post-1991 direct loans are modified, their existing book value be changed to an amount equal to the present value of the loans' net cash inflows projected under the modified terms from the time of modification to the loans' maturity and discounted at the original discount rate (the rate that is originally used to calculated the present value of the direct loans, when the direct loans were disbursed).

In this example, the original discount rate is 6 percent. As Table 10 below shows, the present value of the net cash inflows estimated under the modified terms and discounted at 6 percent is $1,849.

Table 10: Post-Modification Book Value (in thousands of dollars, calculated at the original discount rate)

FY	P & I Payments	Default Losses	Net Cash Flow
1996	$ 549	$(110)	$ 439
1997	549	(110)	439
1998	549	(110)	439
1999	549	(110)	439
2000	549	(110)	439
PV AT 6%	$2,312	$(463)	$1,849

At the time the modification action is taken, the existing book value of the loans is $3,113. The book value is changed to $1,849. This represents a decrease in book value by $1,264.

Table 11 displays the effect of the modification on the book amounts. The table shows that, due to the forgiveness, (1) the outstanding balance of the loans receivable is reduced from $8,154 to $2,446, (2) the book value is reduced from $3,113 to $1,849, and (3) the subsidy cost allowance, which is the difference between the gross amount and the book value, is changed from $5,041 to $597.

Table 11: Change In The Value Of Modified Loans (in thousands of dollars)

	Gross Amount	Book Allowance	Value
Before Modification	$8,154	$(5,041)	$3,113
After Modification	$2,446	$(597)	$1,849

(5) Calculate The Gain Or Loss And The Debt To Treasury

The accounting standard on direct loan modifications states that the change in book value of both pre-1992 and post-1991 direct loans resulting from a direct or indirect modification and the cost of modification will normally differ, due to the use of different discount rates or the use of different measurement methods. Any difference between the change in book value and the cost of modification is recognized as a gain or loss.

For post-1991 direct loans, the modification adjustment transfer[21] paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

The change in book value in this case is $1,264, compared to the cost of modification of $1,321. The amount of the modification cost exceeds the change in book value by $57. This excess is recognized as a gain.

The credit program receives a subsidy appropriation equal to the cost of modification. Since the cost of modification exceeds the decrease in book value by $57, the credit program pays to the Treasury a modification adjustment transfer of $57 to offset the excess. This is reported as a reduction in financing source.

The $1,321 subsidy appropriation received minus the $57 modification adjustment transfer paid is used to repay debt to Treasury. As a result, the debt to Treasury is reduced by $1,264 from $3,113 to $1,849.

Table 12 displays the asset and liability balances after the modification in October 1995.

Table 12: Assets And Liabilities After Modification In October 1995 (in thousands of dollars)

Assets		Liabilities	
Loans Receivable	$2,446	Debt to Treasury	$1,849
Less:			
Allowance for subsidy cost	(597)		
Loans Receivable, Net	$1,849		

[21]OMB instructions provide that if the decrease in book value exceeds the cost of modification, the reporting entity receives from the Treasury an amount of modification adjustment transfer equal to the excess; and if the cost of modification exceeds the decrease in book value, the reporting entity pays to Treasury an amount of modification adjustment transfer to offset the excess. (See OMB Circular A-11.)

(6) Provide Disclosures

The accounting standard requires that disclosure be made in notes to financial statements to explain the nature of the modification of direct loans, the discount rate used in calculating the modification expense, and the basis for recognizing a gain or loss related to the modification.

With respect to the modification described above, a footnote disclosure should be made in the financial statements for fiscal year 1996. The disclosure would explain the following:[22]

(a) The direct loans in the cohort of fiscal year 1994 were modified in October 1995. The modification was to forgive 70 percent of the outstanding loans and to extend the maturity of the remaining loans to the end of fiscal year 2000.

(b) The modification expense is $1,321, which is the decrease in the present value of the cash flows from that estimated under pre-modification terms to that estimated under post-modification terms, discounted at the current interest rate of marketable Treasury securities of similar maturity. The pre-modification cash flows were discounted at the current discount rate of 4.5 percent, which was applicable to a maturity of 4 years, and the post-modification cash flows were discounted at the current discount rate of 5 percent, which was applicable to a maturity of 5 years.

(c) As a result of the modification, the book value of the loans receivable decreased by $1,264, from $3,113, as reported at the end of fiscal year 1995, to $1,849. The difference between this decrease in book value and the modification expense, which amounts to $57, is recognized as a gain in the operating statement.

E. Write-off Of Direct Loans

The accounting standard on write-off of direct loans requires that when post-1991 direct loans are written off, the unpaid principal of the loans be removed from the gross amount of loans receivable. Concurrently, the same amount is charged to the allowance for

[22]The disclosure will not be illustrated for other modifications explained in this Appendix.

subsidy costs. Prior to the write-off, the uncollectible amounts should have been fully provided for in the subsidy cost allowance through the subsidy cost estimate or reestimates. Therefore, the write-off would have no effect on expenses.

Direct loans in this example that are determined to be uncollectible are written off as of the end of fiscal year 1996. However, before the write-off, accounting is performed for the year-end reestimation, the amortization of the allowance for subsidy costs, and the recording of collections and payments. This takes the following steps:

(1) The Reestimation Of The Subsidy Cost Allowance

In early fiscal year 1997, before the write-off, the credit program makes a year-end reestimation for the subsidy cost allowance. This reestimation is for the balances calculated as of the end of fiscal year 1995 adjusted for the modification in October 1995 (Table 12). The result of the reestimation indicates that 20 percent of the outstanding loan payments due after the modification were lost because of defaults for fiscal year 1996, and the expected loss would be 30 percent in fiscal year 1997 and thereafter. The reestimated loss of 30 percent for fiscal year 1997 and the subsequent years is 10 percentage points more than the previous estimate made in October 1995, when the loans were modified. As Table 13 below shows, the net present value of the reestimated net cash inflows, discounted at the original rate of 6 percent to the end of fiscal year 1995, is $1,670.

Table 13: Subsidy Cost Reestimation: Projected Cash Flows Discounted To The End of FY 1995 (in thousands of dollars)

FY	P & I Payments	Default Losses	Net Cash Flows
1996	$ 549	$(110)	$ 439
1997	549	(165)	384
1998	549	(165)	384
1999	549	(165)	384
2000	549	(165)	384
PV AT 6%	$2,313	$(643)	$1,670

Based on the reestimate, the direct loans' book value is reduced by $179, from $1,849 to the reestimated present value of $1,670. This is accomplished by adjusting the subsidy cost allowance upward by $179,

from $597 to $776. The increase of $179 in the subsidy cost allowance is recognized as subsidy expense reestimates.

A subsidy payment of $179 equal to the subsidy cost increase resulting from the reestimate is received under permanent indefinite authority and is used to reduce debt to Treasury. As a result, the debt to Treasury is reduced from $1,849 to $1,670. Furthermore, the direct loan program also receives a payment under permanent indefinite authority to cover the interest accrued on the increased subsidy expense of $179. The payment is $11, which equals $179 times the applicable Treasury interest rate of 6 percent. This amount is recognized as interest income reestimates, and the money is used to pay interest accrued for fiscal year 1996 on the $179 borrowed from Treasury, that is repaid by the subsidy reestimate.

The following table displays the asset and liability balances as of the end of fiscal year 1995, adjusted for the modification in October 1995 and the results of the reestimate that is calculated in early fiscal year 1997.

Table 14: Assets And Liabilities As Of The End Of FY 1995: Amounts Adjusted For Modification In October 1995 and Reestimates Calculated In Early FY 1997 (in thousands of dollars)

Assets		Liabilities	
Loans Receivable	$2,446	Debt to Treasury	$1,670
Less: Allowance for subsidy cost	(776)		
Loans Receivable, Net	$1,670		

(2) The Amortization Of The Subsidy Cost Allowance

The subsidy cost allowance is amortized as of the end of fiscal year 1996. The amortized amount equals the loans' effective interest minus their nominal interest. The loans' effective interest for fiscal year 1996 is $100, which is the loan's book value of $1,670, as reestimated, times the original discount rate of 6 percent. The loans' nominal interest is $98, which is the loans' nominal outstanding balance of $2,446 times the stated interest rate of 4 percent. Thus, the amortized amount is $2, which is the effective interest minus the nominal interest. The amortized amount is recognized as

interest income, and the allowance for subsidy costs is reduced by $2, and becomes $774.

(3) Collections and Payments

Of the scheduled annual payment of $549 for fiscal year 1996, payments of $439 are received from the borrowers, which equal 80 percent of the scheduled payments. Of the amount received, $78 is interest payment (which equals 80 percent of the loans' balance of $2,446 times the stated interest rate of 4 percent), and the remaining $361 is principal repayment. The outstanding nominal principal of the loans is reduced by $361 to $2,085. There is unpaid accrued interest of $20 (which equals 20 percent of the loans' nominal balance as of the end of fiscal year 1995 times the stated interest rate of 4 percent). At this point of time, the loans' book value is $1,331, which equals the outstanding principal of $2,085, plus interest receivable of $20, minus the subsidy cost allowance of $774.

The debt to Treasury was $1,849 after the modification in October 1995. Of that amount, $179 has been paid off with the subsidy payment received as a result of the reestimate, which reduces the debt to $1,670; and the $11 of accrued interest on the $179 has been paid off with the interest on the reestimate. The interest accrued on the remaining debt is $100, which equals the debt balance of $1,670 times the Treasury interest rate of 6 percent. Of the $439 in payments received from the borrowers, $100 is used to pay interest due Treasury, and the remaining $339 is used to reduce debt to Treasury. As a result, the balance of debt to Treasury becomes $1,331.

Table 15 displays the asset and liability balances after the amortization and the recording of collections and payments at the end of fiscal year 1996.

Table 15: Assets And Liabilities After Amortization At The End Of FY 1996 (in thousands of dollars)

Assets		Liabilities	
Loans Receivable	$2,085	Debt to Treasury	$1,331
Interest Receivable	20		
Less: Allowance for subsidy costs	(776)		
Loans & Interest Receivable, Net	$1,331		

(4) Write-Off of Uncollectible Direct Loans

It is confirmed that non-performing loans with an outstanding balance of $489 (20 percent of the direct loan balance after modification in October 1995) are in default and will not be collected. The credit program is authorized to write off those loans, and the unpaid accrued interest of $20. The total amount of the write-off is $509. Thus, the principal is reduced by $489 to $1,596, and the interest receivable of $20 is written off. The subsidy cost allowance is reduced by $509, from $774 to $265.

The loans' book value is not changed by the write-off; it remains $1,331, which equals the remaining principal of $1,596, minus the subsidy allowance of $265. Table 16 below shows the asset and liability balances after the write-off.

Table 16: Assets And Liabilities After The Write-off As Of The End Of FY 1996 (in thousands of dollars)

Assets		Liabilities	
Loans Receivable	$1,596	Debt to Treasury	$1,331
Less: Allowance for subsidy costs	(265)		
Loans Receivable, Net	$1,331		

The book value of $1,331, as indicated in the above table, equals the present value of estimated net cash inflows of the remaining outstanding loans. The estimated cash flows and the present value calculations are shown in Table 17.

In Table 17 the amounts in column (a) are the scheduled annual principal and interest payments. Since the principal of the outstanding loans is $1,596 and the remaining life of the loans is 4 years, the required annual payment is $439. The amounts in column (b) equal the default amounts reestimated at the end of fiscal year 1996 minus the scheduled payments of the loans that have been written off (recoveries on those loans are assumed to be zero). The amounts in column (c) are the projected net cash inflows of the outstanding loans.

Table 17: Projected Cash Flows After Loan Write-off: Discounted To The End Of FY 1996 (in thousands of dollars)

FY	P & I Payments	Default Losses	Net Cash Flows
1996	$ 549	$(110)	$ 439
1997	549	(165)	384
1998	549	(165)	384
1999	549	(165)	384
2000	549	(165)	384
PV AT 6%	$2,313	$(643)	$1,670

It should be noted that to calculate the amortization correctly in subsequent periods, the unpaid principal and interest should be written out of the nominal principal balance. The amortization would be distorted if the unpaid amounts were kept in the nominal principal balance and continued to accrue interest. However, direct loan programs may need to keep the non-paying loans in their accounting records until collection efforts are exhausted and the loans are authorized to be written off. The non-paying loans and interest accrued on them should be accounted for separately, so that the amortization of the subsidy cost allowance of the performing loans can be calculated correctly. Readers should consult Treasury, OMB, or GAO, for guidance on accounting for non-paying loans.

F. Sale Of Direct Loans

The accounting standard on sale of loans states that the sale of post-1991 and pre-1992 direct loans is a direct modification.[23]

It is assumed that after the close of fiscal year 1996, the credit program is authorized to sell the loans. In October 1996, all of the loans are sold with recourse. The net proceeds from the sale amount to $1,100. Accounting for the sales takes the steps explained in the paragraphs that follow.

(1) Recognize The Cost of Modification

The accounting standard on sale of loans requires that the cost of modification be determined on the basis of the pre-modification value of the loans sold. If the pre-modification value of the loans

[23]This assumes that the sales proceeds were not included in the cash flow estimates for the initial subsidy calculation.

sold exceeds the net proceeds from the sale, the excess is the cost of modification, which is recognized as modification expense.

The pre-modification value of the loans sold is the present value of the loans' net cash inflows estimated under pre-modification terms and discounted at the current discount rate.

The net cash inflows of the direct loans estimated prior to the sale are assumed to be the same as those estimated after the loan write-off at the end of fiscal year 1996 (shown in Table 17). It is assumed that the current discount rate for a similar maturity (4 years) is 5 percent. To calculate the pre-modification value, the net cash flows are now discounted at the current discount rate of 5 percent. As Table 18 shows, the pre-modification value of the loans sold is $1,362.

Table 18: Pre-Modification Value Of The Loans Sold, As Of October 1996 (in thousands of dollars, calculated at the current discount rate)

FY	P & I Payments	Default Losses	Net Cash Flows
1997	$ 439	(55)	$384
1998	439	(55)	384
1999	439	(55)	384
2000	439	(55)	384
PV AT 6%	$1,557	$(195)	$1,362

The pre-modification value of the loans sold exceeds the net proceeds of $1,100 from the sale by $262, which is recognized as a modification expense. The credit program receives an appropriation equal to that amount to cover the modification cost. (The credit program must have an appropriation equal to the modification cost before it can sell the loans.)

(2) Recognize Book Value Gain Or Loss

The accounting standard on sale of direct loans states that the book value loss (or gain) on a sale of direct loans equals the existing book value of the loans sold minus the net proceeds from the sale. Since the book value loss (or gain) and the cost of modification are calculated on different bases, they will normally differ. Any difference between the book value loss (or gain) and the cost of

modification is recognized as a gain or loss.[24] For sales of post-1991 direct loans, the modification adjustment transfer paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

The existing book value of the loans sold is $1,331. Upon the sale, this amount is removed from the books. At the same time, the net proceeds of $1,100 from the sale are recorded. The book value loss is $231. The accounting standard requires that any difference between the book value loss and the cost of modification be recognized as a gain or loss. In this case, the cost of modification is $262 and the book value loss is $231. The difference of $31 is recognized as a gain. Under the OMB instructions, this amount will be paid to Treasury as a modification adjustment transfer, and is recorded as a reduction in financing sources.

(3) Recognize the Subsidy Expense on Recourse

The accounting standard on sale of loans requires that for a loan sale with recourse, potential losses under the recourse or guarantee obligations be estimated, and that the present value of the estimated losses from the recourse be recognized as subsidy expense when the sale is made and as a loan guarantee liability.

It is estimated that 10 percent of the loans sold with a principal of $160 would default at the end of fiscal year 1997. Upon their default, the federal credit program will pay the loan purchaser an amount equal to the defaulted principal plus accrued interest. The estimated future default payment is $166, which equals the principal of the loans that are expected to default plus the 4 percent nominal interest of $6 accrued on those loans for one year.

At the time the loans are sold, the interest rate of Treasury securities of a similar maturity is 5 percent. The present value of the estimated default payment discounted at 5 percent is $158. This amount is recognized as a subsidy expense and a loan guarantee liability. The credit program receives an appropriation of $158 to cover the guarantee expense, which is paid to the loan guarantee financing account and becomes part of the fund balance of that account. (An appropriation must be available to cover the subsidy

[24]If there is a book value gain, the gain to be recognized equals the book value gain plus the cost of modification.

expense before the loans can be sold, since the payment to the loan guarantee financing account must be made in order for the guarantee to take effect.)

At this point, the credit program has $1,489 in cash, which was derived from the following events:

Net proceeds from the loan sale	$1,100
Appropriation to cover the modification cost	262
Appropriation to cover estimated recourse liability	158
Less: modification adjustment transfer	(31)
Total in fund balance	**$1,489**

The credit program uses $1,331 to pay off the debt to Treasury, which was borrowed to finance the direct loans. The remaining balance of $158 has been paid to the loan guarantee financing account (as stated above). That amount, together with interest for one year at 5 percent, is to cover the recourse liability of the loan guarantee financing account.

Part II: Pre-1992 Direct Loans

Pre-1992 direct loans are direct loans obligated prior to October 1, 1991, and are recorded in liquidating accounts. **The accounting standard requires that the losses of pre-1992 direct loans be recognized when it is more likely than not that the direct loans will not be totally collected. The allowance of the uncollectible amounts should be reestimated each year as of the date of the financial statements. In estimating losses, the risk factors discussed in the standard for post-1991 direct loans should be considered.**

The standard further states that restatement of pre-1992 direct loans on a present value basis is permitted but not required.

All of the amounts used in the text that follows are in thousands of dollars.

A. Provision For Uncollectible Amounts

Assume that at the end of fiscal year 1994 a credit program has pre-1992 direct loans with outstanding principal of $5,000 at 7 percent interest rate, maturing in three years (at the end of fiscal year 1997). The program management evaluates the risk factors enumerated in the accounting standard, and estimates that the net loss of principal due to defaults would be $2,000. Thus, the program management provides an allowance of $2,000

for uncollectible amounts, and charges that amount to bad debt expense.[25] Thus, the book value of the loans is $3,000, as shown below:

Loans receivable	$5,000
Less uncollectible amounts	(2,000)
Loan receivable, net	**$3,000**

B. Modification Of Pre-1992 Direct Loans

Assume that in October 1994, shortly after the close of fiscal year 1994, a decision is made to take the following actions: (1) forgive 50 percent of the amounts due, (2) lower the interest rate to 4 percent, and (3) extend the due date to the end of fiscal year 2000.

These actions are within the definition of direct modification because they are federal government actions that would directly change estimated subsidy costs and the present value of outstanding direct loans by altering the terms of existing contracts.

The accounting standard on direct loan modifications states that with respect to a direct or indirect modification of pre-1992 direct loans, the cost of modification is the excess of the pre-modification value of the loans over their post-modification value. The amount of the modification cost is recognized as a modification expense when the loans are modified.

Accounting for the cost of modification takes the following steps:

(1) Calculate The Pre-Modification Value

The pre-modification value is the present value of the net cash inflows of the direct loans estimated at the time of modification under pre-modification terms and discounted at the current discount rate.

It is estimated that under the pre-modification terms, 40 percent of the cash flows would be lost due to defaults in fiscal year 1995 and each year thereafter. The current discount rate for a maturity of 3 years is 4 percent. As Table 19 below shows, the present value of the estimated net cash

[25]This assumes that no allowance for uncollectible amounts was provided prior to fiscal year 1994. If there is an allowance for uncollectible amounts, that allowance should be adjusted to the current estimate and the difference between the current estimate and the existing allowance should be charged to bad debt expense.

inflows discounted at 4 percent is $3,172. This is the pre-modification value of the loans.

Table 19: Pre-Modification Value (in thousands of dollars, calculated at the current discount rate)

FY	P & I Payments	Default Losses	Net Cash Flows
1995	$1,905	$(762)	$1,143
1996	1,905	(762)	1,143
1997	1,905	(762)	1,143
PV at 4%	$5,287	$(2,115)	$3,172

(2) Calculate The Post-Modification Value

The loans' post-modification value is the present value of the loans' net cash inflows estimated at the time of modification under post-modification terms and discounted at the current discount rate.

The modification reduces the outstanding principal by 50 percent to $2,500, lowers the nominal interest rate to 4 percent, and extends the maturity by 3 years to the end of fiscal year 2000. As shown in Table 20 below, under the post-modification terms, the required payments will be $477 per year for six years.

Table 20: Payment Schedule Of The Modified Loans (in thousands of dollars)

FY	Payment	Interest	Principal	Year-end Loan Balance
1994	$477			$2,500
1995	477	$100	$377	2,123
1996	477	85	392	1,731
1997	477	69	408	1,323
1998	477	53	424	899
1999	477	36	441	458
2000	477	19	458	0

Taking into consideration that the loans owed by borrowers with poor conditions have been forgiven, it is estimated that only 10 percent of the

cash flows would be lost due to defaults. The current discount rate for a maturity of 6 years is 5 percent. As shown in Table 21, the present value of the estimated net cash inflows discounted at 5 percent is $2,179. This is the loans' post-modification value.

Table 21: Post-modification Value (in thousands of dollars, calculated at the current discount rate)

FY	P & I Payments	Default Losses	Net Cash Flows
1995	$477	$(48)	$429
1996	477	(48)	429
1997	477	(48)	429
1998	477	(48)	429
1999	477	(48)	429
2000	477	(48)	429
PV at 5%	$2,421	$(242)	$2,179

(3) Calculate And Recognize The Cost Of Modification

The cost of modification is the excess of the loans' pre-modification value over the loans' post-modification value. Since the loans' pre-modification value is $3,172, and their post-modification value is $2,179, the cost of modification is $993, which is recognized as a subsidy expense for modifications.

The credit program receives an appropriation of $993 to cover the modification expense, which is paid to the financing account. The financing account, in turn, pays this amount to the liquidating account as part of its payment to acquire the loans. (A subsidy appropriation equal to the cost of modification must be available before the modification can take place.)

(4) Calculate The Change In Book Value And The Gain Or Loss

With respect to modifications of pre-1992 direct loans, the standard requires that when pre-1992 direct loans are directly modified, they be transferred to a financing account and their book value be changed to an amount equal to their post-modification value.

Any subsequent modification is treated as a modification of post-1991 loans.[26]

The change in book value of pre-1992 direct loans resulting from a direct or indirect modification and the cost of modification will normally differ, due to the use of different discount rates or the use of different measurement methods. Any difference between the cost of modification and the change in the loans' book value due to modification is recognized as a gain or loss.

Prior to the modification, the book value of the loans was recorded in the liquidating account at $3,000. Upon modification, the loans are transferred from the liquidating account to the financing account and recorded at their post-modification value of $2,179. The change in book value is a decrease of $821. Since the cost of modification is $993, and the change in book value is $821, the difference of $172 is recognized as a gain.

The financing account pays the liquidating account an amount equal to the loans' pre-modification value of $3,172. This comes from two sources. First, the financing account receives the $993 that is appropriated for the cost of modification. Second, the financing account borrows from Treasury the remainder, which is $2,179, the post-modification value of the loans. In exchange, the liquidating account transfers to the financing account the loan assets that had a book value of $3,000 before the modification was made. The gain to the liquidating account is $172, which, as shown above, equals the difference between the cost of modification and the change in book value of the loans.

Post-1991 loan guarantees are loan guarantees committed after September 30, 1991. The accounting standards for post-1991 loan guarantees are explained and illustrated through the use of an example described below:

A cohort of 5-year term loans that amounts to $10 million in face value is guaranteed by a federal loan guarantee program. The guarantee covers 60 percent of the principal and interest payments. The borrowers are required to pay interest annually at 7 percent, and to repay the principal

[26]The accounting standard provides that when pre-1992 direct loans are indirectly modified, they are kept in a liquidating account; and that their bad debt allowance is reassessed and adjusted to reflect amounts that would not be collected due to the modification. Indirect modifications of pre-1992 direct loans are not illustrated.

when the loans mature at the end of the the year. The government agrees to pay a 1 percent interest supplement to the lenders at the end of each year over the loans' life. The loans are disbursed on September 30, 1994. The federal loan guarantee program collects a fee of 5 percent, when the loans are disbursed. The average interest rate of marketable Treasury securities of a similar maturity for the period in which the guaranteed loans are disbursed is 6 percent.

All of the amounts used in the text that follows are in thousands of dollars.

Part III: Post-1991 Loan Guarantees

A. Reporting The Liability Of Post-1991 Loan Guarantees And Their Subsidy Costs

The accounting standard for post-1991 loan guarantees requires that for guaranteed loans outstanding, the present value of estimated net cash outflows of the loan guarantees be recognized as a liability. Disclosure is made of the face value of the guaranteed loans outstanding and the amount of the outstanding balance that is guaranteed.

To implement the standard in the example, cash flow estimates and present value calculations are prepared. It is projected that the borrowers would pay interest when due, but would default on 60 percent, or $6,000, of the principal repayments. Upon default, the federal credit program will pay 60 percent of the defaulted principal, equal to $3,600, to the lenders. It is projected that a net recovery of $2,000 will be realized a year later through the foreclosure and sale of pledged assets. The fees of $500 are received when the guaranteed loans are disbursed.

Table 22 below shows the estimated cash flows and the present values of the cash flows.

Table 22: Projected Cash Flows Discounted To The Time Of Disbursement (in thousands of dollars)

FY	Fee Receipts	Interest Supplements	Net Default Payments	Recoveries	Cash Flows
1994	$(500)				$(500)
1995		$100			100
1996		100			100
1997		100			100
1998		100			100
1999		100	$3,600		$3,700
2000				$(2,000)	(2,000)
PV at 6%	$(500)	$421	$2,690	$(1,410)	$1,201

The present value of the estimated net cash outflows of the loan guarantees is $1,201. This amount is recognized as a liability.

Disclosure is made in a footnote to the financial statements for fiscal year 1994 that guaranteed loans have an outstanding principal of $10,000, and the guaranteed amount is $6,000. (A similar disclosure is made in each year so long as the guaranteed loans are outstanding.)

The accounting standard for post-1991 loan guarantees requires that for guaranteed loans disbursed during a fiscal year, a subsidy expense be recognized. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the guaranteed loans minus the present value of estimated cash inflows, discounted at the interest rate of marketable Treasury securities with a similar maturity term, applicable to the period during which the loans are disbursed (hereinafter referred to as the applicable Treasury interest rate).

In the example, the present value of the cash outflows minus the present value of the cash inflows is $1,201, which is recognized as a subsidy expense.

The accounting standard for post-1991 loan guarantees requires that for the fiscal year during which new guaranteed loans are disbursed, the components of the subsidy expense of those new loan guarantees be recognized separately among interest subsidy costs, default costs, fees and other collections, and other subsidy costs.

The interest subsidy cost of the loan guarantees is the present value of the interest supplement payments to the lenders, which, in this example, is $421.

The default cost is the present value of the projected default payments minus the present value of net recoveries. The present value of the default payments is $2,690, and the present value of the net recoveries is $1,410. Thus, the default cost is $1,280.

The present value of fee collections, which is $500, is recognized as a deduction from subsidy costs.

There are no other subsidy costs in this example.

The subsidy expense of the loan guarantees is the sum of the above cost components, which is $1,201, calculated as follows:

Interest subsidy cost	$421
Fee collections	(500)
Loan default cost	1,280
Total subsidy cost	**$1,201**

The loan guarantee program receives an appropriation equal to the subsidy cost of $1,201. When the guaranteed loans are disbursed, the appropriated amount is paid to the loan guarantee financing account and is recorded in fund balance with Treasury. The $500 of fees are collected at the same time. The amount of the fees is debited to fund balance with Treasury and credited to the liability of the loan guarantees. Thus, the fund balance is raised to $1,701, on which Treasury pays 6 percent interest. The loan guarantee liability is also raised from $1,201 to $1,701.

Table 23 shows the projected cash flows and their present values after the receipt of fees.

Table 23: Projected Cash Flows Discounted To The End Of FY 1994, After The Receipt Of Fees (in thousands of dollars)

FY	Interest Supplements	Default Payments	Net Recoveries	Net Cash Flows
1994				
1995	$100			$100
1996	100			100
1997	100			100
1998	100			100
1999	100	$3,600		3,700
2000			$(2,000)	(2,000)
PV at 6%	$421	$2,690	$(1,410)	$1,701

Table 24 displays the asset and liability balances at the end of the 1994 fiscal year.

Table 24: Assets And Liabilities At The End Of FY 1994 (in thousands of dollars))

Assets		Liabilities	
Fund Balance with Treasury	$1,701	Loan Guarantee Liability	$1,701

B. Liability Reestimation And Interest Compounding

(1) The Reestimation Of The Liability Of Loan Guarantees

The accounting standard for post-1991 loan guarantees requires that the liability for loan guarantees be reestimated each year as of the date of the financial statements. Since the liability represents the present value of the net cash outflows of the underlying loan guarantees, the reestimation takes into account all factors that may have affected the estimate of each component of the cash flows, including prepayments, defaults, delinquencies, and recoveries. Any increase or decrease in the loan guarantee liability resulting from the reestimates is recognized as a subsidy expense (or a reduction in subsidy expense). Reporting the liability of loan guarantees and reestimates by component is not required.

In Appendix A, the Basis of the Board's Conclusions, it is pointed out that the primary factor that causes changes in the subsidies would be default reestimates. The accounting standard provides a number of risk factors and

other default cost criteria to be considered in making the default cost estimates and reestimates.

In the example, it is initially estimated that 60 percent of the loans will default on the principal repayments when the loans mature at the end of fiscal year 1999, and that $2,000 will be recovered from the sale of foreclosed assets. The first reestimate is made early in fiscal year 1995. Because so little time has passed since the subsidy was initially estimated, the estimated cash flows are unchanged and the reestimate is zero. (This illustration assumes that the interest rates at the time of commitment and disbursement are the same, so no reestimate is needed for the difference in interest rates.)

The second reestimation of the subsidy cost is made early in fiscal year 1996, in preparing financial statements for fiscal year 1995. It reestimates the loan guarantee liability as of the end of fiscal year 1994. It indicates that the initial default estimate is correct. However, it also indicates that the net recovery realized at the end of fiscal year 2000 would be $1,000, rather than $2,000. As shown in Table 25, because of the decrease in the amount of recovery, the present value of the net cash outflows discounted to the end of fiscal year 1994, is $2,406, rather than $1,701, as previously estimated for the end of fiscal year 1994 and shown in Table 23.

Table 25: Subsidy Cost Reestimation: Projected Cash Flows Discounted To The End Of FY 1994 (in thousands of dollars)

FY	Interest Supplements	Default Payments	Net Recoveries	Net Cash Flows
1995	$100			$00
1996	100			100
1997	100			100
1998	100			100
1999	100	$3,600		3,700
2000			$(1,000)	(1,000)
PV at 6%	$421	$2,690	$(705)	$2,406

The reestimated liability is $2,406, compared to the existing liability of $1,701, an increase of $705. The increase of $705 is added to the loan guarantee liability and is recognized as a subsidy expense reestimates.

The credit program receives a subsidy payment under permanent indefinite authority equal to $705 to cover the cost increase resulting from the reestimate. In addition, a payment of $42 is also received under permanent indefinite authority to cover the interest accrued on the $705 reestimate payment for the period from the end of fiscal year 1994 to the end of fiscal year 1995, and is reported as interest income. The total amount of $747 received is added to the fund balance.

(2) Interest Compounding

The accounting standard for post-1991 loan guarantees requires that interest be accrued and compounded on the liability of loan guarantees at the interest rate that was originally used to calculate the present value of the loan guarantee liabilities when the guaranteed loans were disbursed. The accrued interest is recognized as interest expense.

With the passage of time, the present value of the liability of the loan guarantees increases at a rate equal to the rate of interest used to discount the liability. The increase for fiscal year 1995 is $144, which equals the balance of the liability of $2,406, as reestimated, multiplied by the interest rate of 6 percent. The amount of the increase in the present value of the liability is added to the liability balance, and concurrently it is recognized as interest expense. As a result, the liability becomes $2,550.

Interest is also accrued on the credit program's fund balance of $1,701 at 6 percent. The amount of interest accrued is $102, which is added to the fund balance, and is recognized as interest income. As mentioned previously, the payments of $747 to cover the reestimated subsidy cost and the accrued interest are also added to the fund balance.

The interest supplement of $100 is paid for fiscal year 1995. Both the fund balance and the liability are reduced by $100.

As a result of the above transactions, the fund balance becomes $2,450, calculated as follows:

Fund balance at the end of FY 1994	$1,701
Interest on the fund balance	102
Subsidy payment reestimates	705
Interest on subsidy payment reestimates	42
Interest supplement paid	(100)
Fund balance at the end of FY 1995	**$2,450**

The loan guarantee liability is also $2,450 at the end of fiscal year 1995, calculated as follows:

Liability balance at the end of FY 1994, as reestimated	$2,406
Increase due to passage of time	144
Interest supplement paid	(100)
Liability balance at the end of FY 1995	**$2,450**

Table 26 displays the asset and liability balances at the end of the 1995 fiscal year.

Table 26: Assets And Liabilities After Interest Accumulations At The End Of FY 1995 (in thousands of dollars))

Assets		Liabilities	
Fund Balance with Treasury	$2,450	Loan Guarantee Liability	$1,701

C. Revenues And Expenses

The accounting standard for post-1991 loan guarantees requires that interest accrued on the liability of loan guarantees be recognized as interest expense, and that interest due from Treasury on uninvested funds be recognized as interest income. Interest accrued on debt to Treasury, if any, is recognized as interest expense.

In the example, interest accrued on the liability of loan guarantees is $144, which equals the reestimated liability of $2,406 times 6 percent. The amount is recognized as interest expense, and the same amount is added to the liability, as explained above.

Interest income recognized for fiscal year 1995 is also $144, consisting of (a) interest income of $102 on the fund balance, which equals the fund balance of $1,701 times 6 percent, and (b) interest income of $42 on the subsidy payment reestimates.

Costs of administering loan guarantee activities, such as salaries, legal fees, and office costs, that are incurred for credit policy evaluation, origination, closing, servicing, monitoring, maintaining accounting and computer systems, and other credit administrative purposes, are recognized separately as administrative expenses. Administrative expenses are not included in calculating the subsidy costs of loan guarantees.

D. Modification Of Post-1991 Loan Guarantees

Assume that in October 1995, shortly after the close of fiscal year 1995, the loan guarantee program takes action to expand its guarantee from 60 percent of the outstanding loan principal to 80 percent. This action is within the definition of direct modification because it is a government action that directly changes the estimated subsidy cost and the present value of the loan guarantee liability by altering the terms of the loan guarantee agreement.

The accounting standard on modifications of loan guarantees states that with respect to a direct or indirect modification of pre-1992 or post-1991 loan guarantees, the cost of modification is the excess of the post-modification liability of the loan guarantees over their pre-modification liability. The modification cost is recognized as modification expense when the loan guarantees are modified.

The accounting is implemented in the steps described below.

(1) Calculate the Pre-modification Liability

The pre-modification liability is the present value of the net cash outflows of loan guarantees estimated at the time of modification under the pre-modification terms and discounted at the current discount rate.

As used in this part and Part IV of this Appendix, the current discount rate is the interest rate applicable at the time of modification on marketable Treasury securities with a similar maturity to the remaining maturity of the guaranteed loans under pre-modification terms or post-modification terms, whichever is appropriate.[27]

The cash flows for the loan guarantees under pre-modification terms during 1996-2000 are assumed to be the same as the cash flows that were

[27]The definition of the current discount rate is provided in Appendix C, Glossary. [See Appendix E of this Volume.]

reestimated early in fiscal year 1996 for these years and that are shown in Table 25. Assume that the current discount rate for a comparable maturity (4 remaining years) is 4 percent. As Table 27 shows, the present value of the pre-modification net cash outflows discounted at 4 percent is $2,618.

Table 27: Pre-modification Liability (in thousands of dollars; calculated at the current discount rate)

FY	Interest Supplements	Default Payments	Net Recoveries	Net Cash Flows
1996	$100			$100
1997	100			100
1998	100			100
1999	100	$3,600		3,700
2000			$(1,000)	(1,000)
PV at 4%	$363	$3,077	$(822)	$2,618

(2) Calculate Post-modification Liability

The loan guarantees' post-modification liability is the present value of the loan guarantees' net cash outflows estimated at the time of modification under post-modification terms and discounted at the current discount rate.

The modification increases the guarantee percentage from 60 percent to 80 percent. It is estimated that 60 percent or $6,000 in principal repayments will default. This estimate is not affected by the modification. However, with the expansion of the guarantee percentage, the credit program will pay 80 percent of the defaulted amounts, equal to $4,800, to the lenders. The net cash outflows estimated under the post-modification terms are discounted at the current rate of 4 percent. As shown in Table 28 below, the present value of the estimated net cash outflows is $3,644. This is the post-modification liability of the loan guarantees.

TABLE 28: Post-modification Liability (in thousands of dollars; calculated at the current discount rate)

FY	Interest Supplements	Default Payments	Net Recoveries	Net Cash Flows
1996	$100			$100
1997	100			100
1998	100			100
1999	100	$4,800		4,900
2000			$(1,000)	(1,000)
PV at 4%	$363	$4,103	$(822)	$3,644

(3) Calculate And Recognize The Cost Of Modification

The cost of modification is the excess of the loan guarantee's post-modification liability over their pre-modification liability. Since the loan guarantees' post-modification liability is $3,644, and their pre-modification liability is $2,618, the cost of modification is $1,026, which is recognized as a subsidy expense for modifications.

(4) Calculate The Change In The Book Value Of The Liability

The accounting standard on loan guarantee modifications requires that the existing book value of the liability of modified post-1991 loan guarantees be changed to an amount equal to the present value of the net cash outflows projected under the modified terms from the time of modification to the loans' maturity, and discounted at the original discount rate (the rate that is originally used to calculate the present value of the liability, when the guaranteed loans were disbursed).

In this example, the original discount rate is 6 percent. The present value of the loan guarantees' net cash outflows estimated under the modified terms and discounted at 6 percent is $3,401. (See Table 29.)

Table 29: Post-modification Book Value Liability (in thousands of dollars; calculated at the original discount rate)

FY	Interest Supplements	Default Payments	Net Recoveries	Net Cash Flows
1996	$100			$100
1997	100			100
1998	100			100
1999	100	$4,800		4,900
2000			$(1,000)	(1,000)
PV at 6%	$346	$3,802	$(747)	$3,401

At the time the modification action was taken, the existing book value of the loan guarantee liability was $2,450 (See Table 26). The book value is changed to $3,401. This is an increase of $951 in the book value of the loan guarantee liability.

(5) Recognize A Gain Or Loss

The accounting standard on loan guarantee modifications states that the change in the amount of liability of both pre-1992 and post-1991 loan guarantees resulting from a direct or indirect modification and the cost of modification will normally differ, due to the use of different discount rates or the use of different measurement methods. Any difference between the change in liability and the cost of modification is recognized as a gain or loss. For post-1991 loan guarantees, the modification adjustment transfer[28] paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

The change in book value in this case is $951, compared to the cost of modification of $1,026. The difference between those two amounts is $75, which is recognized as a gain.

[28]OMB instructions provide that if the increase in liability exceeds the cost of modification, the reporting entity receives from the Treasury an amount of modification adjustment transfer equal to the excess; and if the cost of modification exceeds the increase in liability, the reporting entity pays to Treasury an amount of modification adjustment transfer to offset the excess. (See OMB Circular A-11.)

The credit program receives a subsidy appropriation equal to the cost of modification. Since the cost of modification exceeds the increase in book value by $75, the credit program pays to Treasury a modification adjustment transfer of $75 to offset the gain. This is reported as a reduction in financing source. The net effect of the modification is to increase the fund balance of the credit program by $951 to $3,401.

Table 30 displays the asset and liability balances after the modification in October 1995.

Table 30: Assets And Liabilities After The Modification In October 1995 (in thousands of dollars))

Assets		Liabilities	
Fund Balance with Treasury	$3,401	Loan Guarantee Liability	$3,401

E. Default And Foreclosure

Assume that for fiscal year 1996 and thereafter, annual reestimations do not result in any changes in cash flow estimates.[29] After accumulating interest at 6 percent and paying the $100 interest supplement annually, the credit program has $3,856 in its fund balance with Treasury at the end of fiscal year 1999, prior to paying any default claims. Table 31 shows annual changes in the fund balance.

Table 31: Fund Balance (in thousands of dollars)

At the End of FY	Interest Accrued	Interest Supplement Paid	Fund Balance
1995			$3,401
1996	$204	$(100)	3,505
1997	210	(100)	3,615
1998	217	(100)	3,732
1999	224	(100)	3,856

At the same time, the program's loan guarantee liability at the end of fiscal year 1999 is also $3,856, which equals the estimated default claim payment

[29]This assumption is made only to avoid repetitious illustrations.

of $4,800 minus $943, the present value of the estimated net recovery from foreclosing assets. It has been estimated that the net recovery would be $1,000 and would be realized at the end of fiscal year 2000. The present value of the net recovery discounted to the end of fiscal year 1999 at the original discount rate of 6 percent is $943.

As expected, when the guaranteed loans mature at the end of 1999, $6,000 of the principal is in default. To meet its guarantee obligation, the loan guarantee program must pay 80 percent of the default amount, or $4,800, to the lenders. When the defaults occur, the loan guarantee program in this example has the options to foreclose property pledged by the borrowers who defaulted, and/or to acquire the loans involved, as a compensation for the default payment.

The accounting standard on foreclosure requires that when property is transferred from borrowers to a federal credit program, through foreclosure or other means, as a compensation for losses that the government sustained under post-1991 loan guarantees,[30] the foreclosed property be recognized as an asset at the present value of its estimated future net cash inflows discounted at the original discount rate.

The accounting standard states that at a foreclosure of guaranteed loans, a federal guarantor may acquire the loans involved. The acquired loans are recognized at the present value of their estimated net cash inflows from selling the loans or from collecting payments from the borrowers, discounted at the original discount rate.

In this example, the default occurs at the loans' maturity and virtually no cash inflows can be realized either from selling the loans or collecting payments from the borrowers. The loan guarantee program therefore forecloses the assets. It continues to estimate that the net cash inflow from possessing and selling the foreclosed property will be $1,000 and will be received at the end of fiscal year 2000. The present value of the estimated net cash inflow discounted at the original rate of 6 percent to the end of fiscal year 1999 is $943.

[30]The accounting standard is the same for property transferred in partial or full settlement of post-1991 direct loans, and the application of the standard to direct loans is illustrated by the present example of loan guarantees.

The accounting standard requires that if a legitimate claim exists by a third party or by the borrower to a part of the recognized value of the foreclosed assets, the present value of the estimated claim be recognized as a special contra valuation allowance.

In this example, no such claim is assumed. Thus, the present value of the foreclosed property is recorded as an asset at $943. Concurrently, the amount of $943 is credited to the loan guarantee liability, so that the loan guarantee liability is increased from $3,856 to $4,800.

The default payment of $4,800 is more than the fund balance of $3,856, and the loan guarantee program does not receive cash from selling the foreclosed assets until one year later. The loan guarantee program borrows the difference of $943 from Treasury.[31] Thus, the fund balance is increased by $943 to $4,800, allowing the default payment to be made.

When the default payment is made, both the fund balance and the loan guarantee liability are reduced to zero. The credit program takes collection action against the borrowers. However, further recovery is not anticipated. At this time, the loan guarantee program has the following asset and liability balances as shown in Table 32.

Table 32: Assets And Liabilities At the End of FY 1999 (in thousands of dollars))

Assets		Liabilities	
Foreclosed property	$943	Debt to Treasury	$943

F. Disposition Of The Foreclosed Property

The foreclosed property is initially recorded at the present value of the estimated net cash inflows. Until the property is sold, the present value of the property must be updated to recognize changes in value due to the passage of time. The recognition is made through an accrual of interest at the original discount rate. The amount of interest accrued for fiscal year 2000 is $57, which equals the book value of the foreclosed property at the beginning of the fiscal year, which is $943, times the original discount rate

[31]Borrowing from Treasury is necessary in this example because all default payments occur at the same time. If they occurred in different years, the default payments in most cases might be covered by the fund balance and the proceeds from selling foreclosed assets. Borrowing would only be needed for defaults near the maturity date of the guaranteed loans

of 6 percent. This amount of interest is recognized as interest income, and is added to the book value of the foreclosed property. As a result, the book value of the foreclosed property becomes $1,000 at the end of fiscal year 2000.

Interest is also accrued on the debt to Treasury of $943 at the rate of 6 percent. The amount of interest for fiscal year 2000 is $57, and is recognized as interest expense. The amount is added to the debt to Treasury. As a result the debt to Treasury becomes $1,000 at the end of fiscal year 2000.

It is assumed that the property is sold at the end of fiscal year 2000 and the amount of net proceeds from the sale is $1,000. The amount of the net proceeds is used to pay off the debt to Treasury. As a result, the asset and liability balances for this cohort of loan guarantees are reduced to zero.

A reestimation should be performed for the net cash flow of the property after the end of fiscal year 2000. If the reestimation resulted in a reduction of the present value of the property, the amount of the reduction would be recognized as subsidy expense reestimates. As illustrated in preceding sections on reestimates, a payment from permanent indefinite authority would be available to cover the subsidy reestimate expense. In this case, because the property was sold at the estimated time for the estimated amount, there is no reestimate subsidy expense.

Part IV: Pre-1992 Loan Guarantees

Pre-1992 loan guarantees are loan guarantees committed prior to October 1, 1991, and the liabilities under pre-1992 loan guarantees are recorded in liquidating accounts. **The accounting standard requires that the liabilities of pre-1992 loan guarantees be recognized when it is more likely than not that the loan guarantees will require a future cash outflow to pay default claims. The liability of loan guarantees should be reestimated each year as of the date of the financial statements. In estimating liabilities, the risk factors discussed in the standard for post-1991 loan guarantees should be considered. Disclosure is made of the face value of guaranteed loans outstanding and the amount guaranteed.**

The standard states that restatement of pre-1992 loan guarantees on a present value basis is permitted but not required.

All of the amounts used in the text that follows are in thousands of dollars.

A. Recognition Of Liabilities

Assume that a federal credit program guarantees a group of loans and the guarantee was committed prior to October 1, 1991. At the end of fiscal year 1994, the loans have outstanding principal of $5,000 at 7 percent interest rate, maturing in three years. The borrowers are required to pay interest annually and to repay the principal at the end of 1997. The guarantee covers 60 percent of the principal.[32]

Disclosure is made in a footnote to the financial statements for fiscal year 1994 that guaranteed loans have an outstanding principal of $5,000, and the guaranteed amount is $3,000. (A similar disclosure is made in each year so long as the guaranteed loans are outstanding.)

The program management evaluates the risk factors enumerated in the accounting standard, and estimates that $2,500 of the loans' principal repayments would be defaulted when the loans mature. The program will pay 60 percent of the defaulted amount, equal to $1,500. It is also estimated that the credit program would realize a net recovery of $500 through acquiring and selling pledged assets. Thus, the program management recognizes a liability of $1,000, which equals the estimated default payment minus the net recovery. The $1,000 is charged to default expense.[33]

B. Modification Of Pre-1992 Loan Guarantees

Assume that in October 1994, shortly after the close of fiscal year 1994, a decision is made to increase the guarantee from 60 percent of the loan payments to 80 percent. This action is within the definition of direct modification because it is a federal government action that directly changes the estimated subsidy cost and the present value of outstanding loan guarantees by altering the terms of existing contracts.

The accounting standard on modifications of loan guarantees states that with respect to a direct or indirect modification of pre-1992 or post-1991 loan guarantees, the cost of modification is the excess of the post-modification liability of the loan guarantees over their pre-modification liability. The modification cost is recognized as modification expense when the loan guarantees are modified.

[32]A loan guarantee may guarantee both principal and interest payments. In that case, the estimate and recognition of loan guarantee liabilities should be based on defaults on both principal and interest payments.

[33]This assumes that no liability was previously recognized. If a liability has been recognized for the loan guarantees, the liability should be adjusted to the current estimate, and any increase in liability should be charged to default expense.

Accounting for the cost of modification takes the following steps:

(1) Calculate the Pre-modification Liability

The pre-modification liability is the present value of the net cash outflows of the loan guarantees estimated at the time of modification under pre-modification terms and discounted at the current discount rate.

It is estimated that under the pre-modification terms, a default payment of $1,500 would be made at the end of fiscal year 1997, and a net recovery of $500 from the sale of foreclosed assets would be received at the end of fiscal year 1998. The current discount rate for a maturity of 3 years is 4 percent. As shown in Table 33, the present value of the estimated net cash outflows discounted at 4 percent is $906. This is the pre-modification liability of the loan guarantees.

Table 33: Pre-modification Liability (in thousands of dollars, calculated at the current discount rate)

FY	Default Payments	Net Recoveries	Net Cash Outflow
1995			
1996			
1997	$1,500		$1,500
1998		$(500)	(500)
PV at 4%	$1,333	$(427)	$ 906

(2) Calculate The Post-modification Liability

The loan guarantees' post-modification liability is the present value of the loan guarantees' net cash outflows estimated at the time of modification under post-modification terms and discounted at the current discount rate.

The modification expands the guarantee from 60 percent to 80 percent. It is estimated that $2,500 of the principal repayments will default when the loans mature. With the expansion of the guarantee percentage, the credit program will pay 80 percent of the defaulted amounts, equal to $2,000, to lenders at the end of fiscal year 1997. A net recovery of $500 would be received from selling foreclosed assets at the end of fiscal year 1998. The cash outflows estimated under the post-modification terms are discounted

at the current discount rate of 4 percent. As shown in Table 34 below, The present value of the estimated net cash outflow is $1,351. This is the post-modification liability of the loan guarantees.

Table 34: Post-modification Liability (in thousands of dollars, calculated at the current discount rate)

FY	Default Payments	Net Recoveries	Net Cash Outflows
1995			
1996			
1997	$2,000		$2,000
1998		$(500)	(500)
PV at 4%	$1,778	$(427)	$1,351

(3) Calculate And Recognize The Cost of Modification

The cost of modification is the excess of the loan guarantees' post-modification liability over their pre-modification liability. Since the loan guarantees' post-modification liability is $1,351, and their pre-modification liability is $906, the cost of modification is $445, which is recognized as a subsidy expense for modifications. A subsidy appropriation of that amount is required before the modification can take place. The appropriated amount is paid to the financing account.

(4) Calculate The Change In The Book Value of The Liability

With respect to modifications of pre-1992 loan guarantees, the standard requires that when pre-1992 loan guarantees are directly modified, they be transferred to a financing account and the existing book value of the liability of the modified loan guarantees be changed to an amount equal to their post-modification liability. Any subsequent modification is treated as a modification of post-1991 loan guarantees.[34]

[34] The accounting standard states that when pre-1992 loan guarantees are indirectly modified, they are kept in a liquidating account, and that the liability of those loan guarantees is reassessed and adjusted to reflect any change in the liability resulting from the modification. Indirect modifications of pre-1992 loan guarantees are not illustrated in the Appendix.

Prior to the modification, the liability of the loan guarantees was recorded in a liquidating account at $1,000. Upon modification, the loan guarantees are transferred from the liquidating account to a financing account, since this is a direct modification. The liability is recorded in the financing account at the post-modification liability of $1,351. The change in book value of the liability is an increase of $351.

(5) Recognize a Gain or Loss

The accounting standard on loan guarantee modifications states that the change in the amount of liability of both pre-1992 and post-1991 loan guarantees resulting from a direct or indirect modification and the cost of modification will normally differ, due to the use of different discount rates or the use of different measurement methods. Any difference between the change in liability and the cost of modification is recognized as a gain or loss.

In this case, the cost of modification is $445, and the change in book value is $351. The difference of $94 is recognized as a gain.

When the loan guarantees are transferred from the liquidating account to the financing account, the liquidating account pays the financing account an amount equal to the loan guarantees' pre-modification liability of $906. The transfer of the loan guarantees has the following effects on the liquidating account: (1) the existing liability of the transferred loan guarantees equal to $1,000 is removed, (2) the fund balance is reduced by $906, which is the amount paid to the financing account, and (3) a gain of $94 is recognized.

The financing account records the liability of the loan guarantees at $1,351, which is their post-modification liability. It also records a fund balance of $1,351, which consists of the $906 received from the liquidating account, and the $445 appropriated to cover the cost of modification.

Statement of Federal Financial Accounting Standards No. 3: Accounting for Inventory and Related Property

Status

Issued	October 27, 1993
Effective Date	For fiscal years ending September 30, 1994 and thereafter
Volume I References	SFFAS No. 7, *Accounting for Revenue and Other Financing Sources* (recognition of revenue from forfeited property, recognition of gain or loss for pre-1992 foreclosed property, for transactions not recognized as revenues, gains, or other financing sources for sale of post-1991 foreclosed property, for revaluation of inventory and related property, for the sale of goods and services to the public, for intragovernmental sales of goods and services, and for the disposition of revenue as custodial transfers) SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees* (information related to foreclosed property)
Volume II References	Revenue (R40), Goods Held Under Price Support and Stabilization Programs (G40), Inventories (I60), Liabilities (L40), Nonrecourse Loans (N80), Operating Materials and Supplies (O20), Seized and Forfeited Property (S30), and Stockpiled Materials (S80)
Interpretations and Technical Releases	TR 4, *Reporting on Nonvalued Seized and Forfeited Property*, provides recommended disclosure guidance for all material non-valued seized property.
Affects	No other statements.
Affected by	SFFAS No. 7, paragraphs 264-269, affects SFFAS No. 3, paragraphs 69, 70, 72 and 74-77, plus Table 2, Summary of Accounting Standards, and Table 1, Summary of Accounting Standards--Forfeited Property, by providing additional accounting standards regarding revenue recognition for forfeited property.

Summary

This statement provides accounting standards that apply to several types of tangible property, other than long term fixed assets, held by federal government agencies. These accounting standards cover the following assets:

- inventory (i.e., items held for sale);
- operating materials and supplies;
- stockpile materials;
- seized and forfeited property;
- foreclosed property; and
- goods held under price support and stabilization programs (including nonrecourse loans and purchase agreements).

Inventory Held For Sale

The standards require reporting of inventory by categories as follows: (1) inventory held for sale, (2) inventory held in reserve for future use, (3) excess, obsolete, and unserviceable inventory, and (4) inventory held for repair.

The standards require historical cost or latest acquisition cost valuation of inventory held for sale and inventory held in reserve for future sale. The standards permit use of any other valuation method (e.g., standard cost) which reasonably approximates historical cost. When historical cost valuation is used, acceptable cost flow assumptions include the first-in, first-out, weighted average or moving average cost flow assumptions. The standards do not provide for use of the last-in, first-out cost flow assumption or lower of cost or market valuation. When latest acquisition cost valuation is used the inventory is revalued periodically and an allowance account is established for unrealized holding gains and losses.

Excess, obsolete and unserviceable inventory is to be valued at net realizable value. Inventory held for repair is to be valued at either historical cost or latest acquisition cost less an allowance for the estimated repair cost.

Operating Materials and Supplies

Operating materials and supplies are to be accounted for under the consumption method and valued at historical cost or any method approximating historical cost (e.g., standard cost or latest acquisition cost). When historical cost valuation is used, acceptable cost flow assumptions include the first-in, first-out, weighted average or moving average cost flow assumptions. In addition, categories for (1) operating materials and supplies held for use, (2) operating materials and supplies held in reserve for future use, or (3) excess, obsolete and unserviceable operating materials and supplies must be reported.

An exception to the consumption method is provided when (1) the operating materials and supplies are not significant amounts, (2) they are in the hands of the end user for use in normal operations, or (3) it is not cost-beneficial to apply the consumption method. In any of these events, the purchases method may be used.

Stockpile Materials

Stockpile materials are to be accounted for through the consumption method using the historical cost valuation or any method that reasonably approximates historical cost. When historical cost valuation is used, acceptable cost flow assumptions include the first-in, first-out, weighted average or moving average cost flow assumptions. The carrying amount of materials that have suffered (1) a permanent decline in value to an amount less than their cost or (2) damage or decay shall be reduced to the expected net realizable value of the material.

Seized and Forfeited Property

The market value of seized property other than monetary instruments is to be disclosed in the notes to the financial statements. Seized monetary instruments are recognized as assets with an offsetting liability. This treatment was provided to foster a higher level of control over seized monetary instruments.

Forfeited property is recognized as an asset upon forfeiture and valued at market value less any liens. Revenue recognition is deferred until sale except for monetary instruments. Special provisions are made for items seized in satisfaction of tax liabilities and for transfer of the property to government entities for their use.

Foreclosed Property

Foreclosed property must be classified as Post-1991 property or Pre-1992 property to remain consistent with the provisions of the Credit Reform Act of 1990. Post-1991 property is associated with loans or loan guarantees issued after September 30, 1991 and is valued at its net present value. Pre-1992 property is associated with loans or loan guarantees issued before September 30, 1991 and is valued at the lower of cost or net realizable value.

Goods Held Under Price Support and Stabilization Programs

Goods held under price support and stabilization programs (e.g., commodities) are valued at the lower of cost or net realizable value. For nonrecourse loan amounts the standards provide that allowances be established for expected losses and losses recognized if it is more likely than not that they will occur and the losses are measurable. For purchase agreements, the standards provide that contingent liabilities be established and losses recognized if it is more likely than not that a loss will occur and that the loss is measurable.

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Executive Summary

1. This is the third statement of recommended accounting standards issued by the Federal Accounting Standards Advisory Board (referred to as FASAB or the Board). The standards presented in this document apply to several types of tangible property, other than long term fixed assets, held by federal government agencies.

2. These accounting standards cover the following assets:

   - inventory (i.e., items held for sale);
   - operating materials and supplies;
   - stockpile materials;
   - seized and forfeited property;
   - foreclosed property; and
   - goods held under price support and stabilization programs (including nonrecourse loans and purchase agreements).[1]

3. The following tables summarize the provisions in the recommended accounting standards. The tables highlight the **major** provisions; they should not be substituted for close review of the standards themselves.

[1]As well as addressing the commodities acquired through price support and stabilization programs, this standard addresses nonrecourse loans and purchase agreements.

Table 1: Summary of Accounting Standards

Standard	Description	Valuation methods	Recognition requirements and comments
Inventory	Tangible personal property that is (1) held for sale, (2) in the process of production for sale, or (3) to be used in the provision of services for a fee.	(1) Historical cost or any other valuation methods which approximate historical cost (2) Latest acquisition cost	An asset upon receipt of title or goods. As cost of goods sold upon delivery to buyer. For latest acquisition cost, an allowance account will be established equal to the cumulative unrealized holding gains/losses associated with ending inventory. Categories will be established for inventory held for sale; inventory held in reserve for future sale; excess, obsolete and unserviceable inventory; and inventory held for repair.
Operating materials and supplies	Tangible personnel property to be consumed in normal operations	Historical cost or any other valuation methods which approximate historical cost.	The consumption method shall be applied. However, if operating materials and supplies are (1) not significant amounts, (2) in the hands of the end-user, or (3) if it is not cost beneficial to apply the consumption method, the purchases method may be applied. Categories will be established for operating materials and supplies; operating materials and supplies held in reserve for future use; excess, obsolete and unserviceable operating materials and supplies; and operating materials and supplies held for repair.
Stockpile materials	Strategic and critical materials held due to statutory requirements for use in national defense, conservation, or national emergencies	Historical cost or any other valuation methods which approximate historical cost	As an asset upon receipt of title or goods. As an expense upon disposal, use, or sale.

Table 2: Summary of Accounting Standards

Standard	Description	Valuation methods	Recognition requirements and comments
Seized and forfeited property	Monetary instruments and property acquired as a result of forfeiture proceedings	Market value	As an asset upon forfeiture with a deferred revenue established.[a] As revenue upon sale or disposition of nonmonetary forfeited property. As revenue upon forfeiture for monetary instruments.
Foreclosed property	Assets received in satisfaction of a loan receivable or as a result of a claim under a guaranteed or insured loan	Post-1991;[b] net present value Pre-1992;[c] lower of cost or net realizable value	As an asset upon foreclosure
Commodities	Items acquired, held, sold or otherwise disposed of to stabilize or support market prices	Lower of cost or net realizable value	As an asset upon receipt. As a loss on farm price support if the net realizable value is less than the cost at acquisition. As an expense upon disposal or use.
Commodity nonrecourse loans	Short-term loans with commodities pledged as collateral	The principal amount of the loan less any allowance for expected losses	As an asset upon issuance. As a loss on farm price support at reporting date if they are more likely than not and measurable.
Commodity purchase agreements	Agreements to purchase commodities at a given price at the option of the seller	Estimated amount of the contingent loss	As a contingent liability if the loss is more likely than not and measurable.

[a] Seized property other than monetary instruments would not be recognized as the entity's asset since it is not owned by the government. However, the market value of seized property should be disclosed in notes to the financial statements. This recognizes that the entity has a fiduciary responsibility for the property.
Seized monetary instruments are recognized as assets with an offsetting liability to recognize the potential for remission to the owners. This treatment was provided in order to maintain a higher level of financial control over seized monetary instruments.

[b] "Post-1991" refers to foreclosed property that is received in satisfaction of loans obligated or loan guarantees committed after September 30, 1991.

[c] "Pre-1992" refers to foreclosed property that is received in satisfaction of loans obligated or loan guarantees committed before October 1, 1991. In addition, any programs or agencies that are specifically exempt from the provisions of the Federal Credit Reform Act should follow accounting provisions for "pre-1992" property.

Introduction

Objective

4. In this Statement, the Board recommends accounting standards for six assets of the federal government and its entities. The first group of assets addressed, those formerly referred to as "inventory," includes inventory held for sale, operating materials and supplies, stockpile materials, and commodities. The decision to include other assets held for sale resulted in adding two items: (1) seized and forfeited property and (2) foreclosed property.

Approach

5. Following publication of the Board's Exposure Draft Accounting for Inventory and Related Property on January 8, 1993, the Board received comments from 44 organizations and individuals. A public hearing, at which eight people presented oral comments on the Exposure Draft, was held on April 21 and 22, 1993.

6. In preparing this Statement of recommended standards, the Board considered all the comments received and incorporated changes, as appropriate. The issues raised and the specific changes made are discussed in Appendix A, "Basis of the Board's Conclusions."

Materiality

7. The Board intends that the standards' application be limited to items that are material. "Materiality" has not been strictly defined in the accounting community; rather, it has been a matter of judgment on the part of preparers of financial statements and the auditors who attest to them. The Board relies on the Financial Accounting Standards Board's (FASB) concept as modified by certain concepts expressed in governmental auditing standards. Presented below is the Board's position on the issue of materiality as this time.

8. The accounting and reporting provisions of the Board's accounting standards need not be applied to immaterial items. The determination of whether an item is immaterial requires the exercise of considerable judgment, based on consideration of specific facts and circumstances.

9. FASB's Statement of Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information," discusses the concept of

materiality. According to this statement, the determination of whether an item is material depends on the degree to which omitting or misstating information about this item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement. This concept includes both qualitative and quantitative considerations. An item that is not considered material from a quantitative standpoint may be considered qualitatively material if it would influence or change the judgment of the financial statement user.

10. The Board believes that FASB's definition of materiality is generally appropriate for use in applying the accounting and reporting provisions of the Board's accounting standards. In the federal government environment, however, the definition is extended to apply to all financial information included in the annual financial report and, therefore, is not limited to the principal schedules and related notes.

11. In applying the concept of materiality, the needs of the users of the annual financial report should also be considered. In the federal government environment, such needs generally differ from those of users of commercial entity financial statements. For example, federal government financial statement user needs extend to having the ability to assess the efficiency and the effectiveness of the entity's programs. Further, compliance with budget and other finance-related laws, rules, and regulations is also a significant consideration of such users.

12. This is expressed well in the Government Auditing Standards (the "Yellow Book"):

    "In government audits the materiality level and/or threshold of acceptable risk may be lower than in similar-type audits in the private-sector because of the public accountability of the entity, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions." (Ch. 3, par. 33.)

13. While this standard applies to an auditor's evaluation of materiality rather than a preparer's, it does provide insight into the factors affecting materiality in the federal government.

14. Therefore, the accounting and reporting provisions of the Board's recommended standards should be applied to all items that would influence or change the users' judgment of the entity's efficiency and

effectiveness and its compliance with laws and regulations in a material manner.

15. In order to emphasize that materiality should be considered in applying all accounting standards, the Board has decided to place a notice at the end of each recommended accounting standard. The notice will read as follows:

The provisions of this statement need not be applied to immaterial items.

Effective Date

16. The Board recommends that the accounting standards presented in this Statement become effective for fiscal year ending September 30, 1994, and thereafter. Earlier implementation is encouraged.

Inventory

17. **Definition.** "Inventory" is tangible personal property that is (1) held for sale, (2) in the process of production for sale, or (3) to be consumed in the production of goods for sale or in the provision of services for a fee. The term "held for sale" shall be interpreted to include items for sale or transfer to (1) entities outside the federal government, or (2) other federal entities. The principal objective of the sale or transfer of inventory is to provide a product or service for a fee that generally recovers full cost or an identified portion of the cost. "Other federal entities" may include entities within the same organization/agency. Sales transactions may be executed through transfer of funds between federal entities; it is not essential that the transaction be an exchange of goods for cash or cash equivalents. In addition, inventory may be acquired through donation or barter. Inventory excludes some other assets held for sale, such as (1) stockpile materials, (2) seized and forfeited property, (3) foreclosed property, and (4) goods held under price support and stabilization programs. These items may be sold; however, the purpose of acquiring them is not to provide a product or a service for a fee.

18. Inventory shall be categorized as (1) inventory held for sale, (2) inventory held in reserve for future sale, (3) excess, obsolete and unserviceable inventory, or (4) inventory held for repair. These categories are defined in paragraphs 17, 27, 29, and 32 respectively.

19. **Recognition.** Inventory shall be recognized when title passes to the purchasing entity or when the goods are delivered to the purchasing entity. Upon sale (when the title passes or the goods are delivered) or upon use in the provision of a service, the related expense shall be recognized and the cost of those goods shall be removed from inventory. Delivery or constructive delivery shall be based on the terms of the contract regarding shipping and/or delivery.

20. **Valuation.** Inventory shall be valued at either (1) historical cost or (2) latest acquisition cost.

21. (1) Historical cost shall include all appropriate purchase, transportation and production costs incurred to bring the items to their current condition and location. Any abnormal costs, such as excessive handling or rework costs, shall be charged to operations of the period. Donated inventory shall be valued at its fair value at the time of donation. Inventory acquired through exchange of nonmonetary assets (e.g., barter) shall be valued at the fair value of the asset received at the time of the exchange. Any difference between the recorded amount of the asset surrendered and the fair value of the asset received shall be recognized as a gain or a loss.

22. The first-in, first-out (FIFO); weighted average; or moving average cost flow assumptions may be applied in arriving at the historical cost of ending inventory and cost of goods sold. In addition, any other valuation method may be used if the results reasonably approximate those of one of the above historical cost methods (e.g., a standard cost system).

23. (2) The latest acquisition cost method provides that the last invoice price[2] (i.e., the specific item's actual cost used in setting the current year stabilized standard [sales] price) be applied to all like units held including those units acquired through donation or nonmonetary exchange. The inventory shall be revalued periodically but at least at the end of each fiscal year. Revaluation results in recognition of unrealized holding gains/losses[3] in the ending inventory value. Upon adjustment for unrealized holding gains/losses, the latest acquisition cost method then results in an approximation of historical cost.

[2]This unit value is referred to as the latest acquisition cost for the remainder of this standard.

24. An allowance for unrealized holding gains/losses in inventory shall be established to capture these gains/losses. The ending balance of this allowance shall be the cumulative difference between the historical cost, based on estimated or actual valuation, and the latest acquisition cost of ending inventory. The balance shall be adjusted each time the inventory balance is adjusted. The adjustment necessary to bring the allowance to the appropriate balance shall be a component of cost of goods sold for the period as described below.

25. The cost of goods sold for the period shall be computed as follows:

    Beginning inventory at beginning-of-the-period latest acquisition cost
    less: beginning allowance for unrealized holding gains/losses
    plus: actual purchases
    Cost of Goods Available for Sale
    less: ending inventory at end-of-the-period latest acquisition cost
    plus: ending allowance for unrealized holding gains/losses
    Cost of Goods Sold

26. **Exception to Valuation.** Valuing inventories at expected net realizable value is acceptable if there is (1) an inability to determine approximate costs, (2) immediate marketability at quoted prices, and (3) unit interchangeability (e.g., petroleum reserves). Application of this exception may result in inventories being valued at greater than historical cost.

Other Categories of Inventory

27. **Inventory Held in Reserve for Future Sale.** Inventory stocks may be maintained because they are not readily available in the market or because there is more than a remote chance that they will eventually be needed (although not necessarily in the normal course of operations). These stocks shall be classified as inventory held in reserve for future sale. Inventory held in reserve for future sale shall be valued using the same basis as inventory held for sale in normal

[3]"Holding gains (or losses)" result from holding assets in periods of changing prices. Under historical cost methods, holding gains (or losses) are not separately recognized even though they exist. Under the latest acquisition cost method, holding gains (or losses) will be recognized in the valuation of inventory since that value is adjusted periodically to present the more current latest acquisition costs. These gains or losses are unrealized holding gains or losses. "Unrealized" refers to any gain or loss associated with inventory still held by the entity. "Realization" of the holding gain or loss occurs only when an item of inventory is sold.

operations. The value of inventory held in reserve for future sale shall be either (1) included in the inventory line item on the face of the financial statements with separate disclosure in footnotes or (2) shown as a separate line item on the face of the financial statements.

28. The criteria considered by management in identifying inventory held in reserve for future sale shall be disclosed. **Examples** of factors to be considered in developing the criteria are (1) all relevant costs associated with holding these items (including the storage and handling costs), (2) the expected replacement cost when needed, (3) the time required to replenish inventory, (4) the potential for deterioration or pilferage, and (5) the likelihood that a supply of the items will be available in the future.

29. **Excess, Obsolete, and Unserviceable Inventory.** "Excess inventory" is inventory stock that exceeds the demand expected in the normal course of operations because the amount on hand is more than can be sold in the foreseeable future and that does not meet management's criteria to be held in reserve for future sale. "Obsolete inventory" is inventory that is no longer needed due to changes in technology, laws, customs, or operations. "Unserviceable inventory" is damaged inventory that is more economical to dispose of than to repair. The category "excess, obsolete and unserviceable inventory" shall be either (1) included in the inventory line item on the face of the financial statements with separate disclosure in footnotes or (2) shown as a separate line item on the face of the financial statements.

30. Such inventory shall be valued at its expected net realizable value. The difference between the carrying amount of the inventory before identification as excess, obsolete or unserviceable and its expected net realizable value shall be recognized as a loss (or gain) and either separately reported or disclosed. Any subsequent adjustments to its net realizable value or any loss (or gain) upon disposal shall also be recognized as a loss (or gain).

31. Management shall develop and disclose in the financial statements its criteria for identifying excess, obsolete and unserviceable inventory.

32. **Inventory Held for Repair.** Inventory held for repair may be treated in one of two ways: (1) the allowance method or (2) the direct method.

(1) Under the allowance method, inventory held for repair shall be valued at the same value as a serviceable item. However, an allowance for repairs contra-asset account (i.e., repair allowance) shall be established. The annual (or other period) credit(s) required to bring the repair allowance to the current estimated cost of repairs shall be recognized as current period operating expenses. As the repairs are made the cost of repairs shall be charged (debited) to the allowance for repairs account.

33. (2) Under the direct method, inventory held for repair shall be valued at the same value as a serviceable item less the estimated repair costs. When the repair is actually made, the cost of the repair shall be capitalized in the inventory account up to the value of a serviceable item. Any difference between the initial estimated repair cost and the actual repair cost shall be either debited or credited to the repair expense account.

34. Transition to either of these two methods may result in recognizing an accumulated amount of needed repairs that were not previously accounted for. To avoid overstating repair expense for the first period that repair expense is accrued, prior period amounts are to be separately identified or estimated. The estimated amount to repair inventory that is attributable to prior periods shall be credited to the repair allowance under the repair allowance method or to the inventory account under the direct method and reported as an adjustment to equity.

Disclosure Requirements

35.
- General composition of inventory.
- Basis for determining inventory values; including the valuation method and any cost flow assumptions.
- Changes from prior year's accounting methods; if any.
- Balances for each of the following categories of inventory; inventory held for current sale, inventory held in reserve for future sale, excess, obsolete and unserviceable inventory, and inventory held for repair unless otherwise presented on the financial statements.
- Restrictions on the sale of material.
- The decision criteria for identifying the category to which inventory is assigned.

- Changes in the criteria for identifying the category to which inventory is assigned
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The provisions of this statement need not be applied to immaterial items.

Operating Materials And Supplies

36. **Definition.** "Operating materials and supplies" consist of tangible personal property to be consumed in normal operations. Excluded are (1) goods that have been acquired for use in constructing real property or in assembling equipment to be used by the entity, (2) stockpile materials, (3) goods held under price stabilization programs, (4) foreclosed property, (5) seized and forfeited property, and (6) inventory.

37. Operating materials and supplies shall be categorized as (1) operating materials and supplies held for use, (2) operating materials and supplies held in reserve for future use, or (3) excess, obsolete and unserviceable operating materials and supplies. These categories are defined in paragraphs 36, 45, and 47 respectively.

38. **Recognition.** The consumption method of accounting for the recognition of expenses shall be applied for operating materials and supplies. Operating materials and supplies shall be recognized and reported as assets when produced or purchased. "Purchased" is defined as when title passes to the purchasing entity. If the contract between the buyer and the seller is silent regarding passage of title, title is assumed to pass upon delivery of the goods. Delivery or constructive delivery shall be based on the terms of the contract regarding shipping and/or delivery.

39. The cost of goods shall be removed from operating materials and supplies (i.e., the asset account) and reported as an operating expense in the period they are issued to an end user for consumption in normal operations.

40. If (1) operating materials and supplies are not significant amounts, (2) they are in the hands of the end user for use in normal operations, or (3) it is not cost-beneficial to apply the consumption method of accounting, then the purchases method may be applied to operating materials and supplies. The purchases method provides that operating materials and supplies be expensed when purchased.

41. An end user is any component of a reporting entity that obtains goods for direct use in the component's normal operations. Any component of a reporting entity, including contractors, that maintains or stocks operating materials and supplies for future issuance shall **not** be considered an end user.

42. **Valuation Under the Consumption Method.** Operating materials and supplies shall be valued on the basis of historical cost.

43. Historical cost shall include all appropriate purchase and production costs incurred to bring the items to their current condition and location. Any abnormal costs, such as excessive handling or rework costs, shall be charged to operations of the period. Donated operating materials and supplies shall be valued at their fair value at the time of donation. Operating materials and supplies acquired through exchange of nonmonetary assets (e.g., barter) shall be valued at the fair value of the asset received at the time of the exchange. Any difference between the recorded amount of the asset surrendered and the fair value of the asset received shall be recognized as a gain or a loss.

44. The first-in, first-out (FIFO); weighted average; or moving average cost flow assumptions shall be applied in arriving at the historical cost of ending operating materials and supplies and cost of goods consumed. In addition, any other valuation method may be used if the results reasonably approximate those of one of the above historical cost methods (e.g., a standard cost or latest acquisition cost system).

Other Categories of Operating Materials and Supplies

45. **Operating Materials and Supplies Held in Reserve for Future Use.** Operating materials and supplies stocks may be maintained because they are not readily available in the market or because there is more than a remote chance that they will eventually be needed, although not necessarily in the normal course of operations. These stocks shall be classified as operating materials and supplies held in reserve for future use. Operating materials and supplies held in reserve for future use shall be valued using the same basis as operating materials and supplies held for use in normal operations. The value of operating materials and supplies held in reserve for future use shall be either (1) included in the operating materials and supplies line item on the face of the financial statements with separate disclosure in footnotes or (2) shown as a separate line item on the face of the

financial statements. Such materials and supplies shall be valued the same as operating materials and supplies held for use in normal operations.

46. The criteria considered by management in identifying operating materials and supplies held in reserve for future use shall be disclosed. Examples of factors to be considered in developing the criteria are (1) all relevant costs associated with holding these items (including the storage and handling costs); (2) the expected replacement cost when needed; (3) the time required to replenish operating materials and supplies; (4) the potential for deterioration or pilferage; and (5) the likelihood that a supply of the item will be available in the future.

47. **Excess, Obsolete, and Unserviceable Operating Materials and Supplies.** "Excess operating materials and supplies" are operating materials and supplies stocks that exceed the amount expected to be used in normal operations because the amount on hand is more than can be used in the foreseeable future and that do not meet management's criteria to be held in reserve for future use. "Obsolete operating materials and supplies" are operating materials and supplies that are no longer needed due to changes in technology, laws, customs, or operations. "Unserviceable operating materials and supplies" are operating materials and supplies that are physically damaged and cannot be consumed in operations. The category "excess, obsolete and unserviceable operating materials and supplies" shall be either (1) included in the operating materials and supplies line item on the face of the financial statements with separate disclosure in footnotes or (2) shown as a separate line item on the face of the financial statements.

48. Such operating materials and supplies shall be valued at their estimated net realizable value. The difference between the carrying amount of the operating materials and supplies before identification as excess, obsolete or unserviceable and their estimated net realizable value shall be recognized as a loss (or gain) and either reported separately or disclosed. Any subsequent adjustments to their estimated net realizable value or any loss (or gain) upon disposal shall also be recognized as a loss (or gain).

49. Management shall develop and disclose in the financial statements its criteria for identifying excess, obsolete, and unserviceable operating materials and supplies.

Disclosure Requirements

50.
- General composition of operating materials and supplies.
- Basis for determining operating materials and supplies values; including valuation method and any cost flow assumptions.
- Changes from prior year's accounting methods, if any.
- Balances for each of the categories of operating materials and supplies described above.
- Restrictions on the use of material.
- Decision criteria for identifying the category to which operating materials and supplies are assigned.
- Changes in the criteria for identifying the category to which operating materials and supplies are assigned.

The provisions of this statement need not be applied to immaterial items.

Stockpile Materials

51. **Definition.** "Stockpile materials" are strategic and critical materials held due to statutory requirements for use in national defense, conservation or national emergencies. They are not held with the intent of selling in the ordinary course of business. The following items are specifically excluded from stockpile materials: (1) items that are held by an agency for sale or use in normal operations (see proposed standards for inventory and operating materials and supplies), (2) items that are held for use in the event of an agency's operating emergency or contingency (see proposed standard for operating materials and supplies), and (3) materials acquired to support market prices (see proposed standard for goods held under price support and stabilization programs).

52. **Recognition.** The consumption method of accounting for the recognition of expense shall be applied for stockpile materials. These materials shall be recognized as assets and reported when produced or purchased. "Purchase" is defined as the date that title passes to the purchasing entity. If the contract between the buyer and the seller is silent regarding passage of title, title is assumed to pass upon delivery of the goods. The cost of stockpile materials shall be removed from stockpile materials and reported as an operating expense when issued for use or sale.

53. **Valuation.** Stockpile materials shall be valued on the basis of historical cost. Historical cost shall include all appropriate purchase, transportation and production costs incurred to bring the items to their current condition and location. Any abnormal costs, such as excessive handling or rework costs, shall be charged to operations of the period. The first-in, first-out (FIFO); weighted average; or moving average cost flow assumptions shall be applied in arriving at the historical cost of stockpile materials. In addition, any other valuation method may be used if the results reasonably approximate those of one of the above historical cost methods (e.g., a standard cost or latest acquisition cost system).

54. **Exception to Valuation.** The carrying amount of materials that have suffered (1) a permanent decline in value to an amount less than their cost or (2) damage or decay shall be reduced to the expected net realizable value of the materials. The decline in value shall be recognized as a loss or an expense[4] in the period in which it occurs.

55. **Held for Sale.** When stockpile materials are authorized to be sold, those materials shall be disclosed as stockpile materials held for sale. The materials authorized for sale shall be valued using the same basis used before they were authorized for sale. Any difference between the carrying amount of the stockpile materials held for sale and their estimated selling price shall be disclosed. The cost of stockpile materials shall be removed from stockpile materials and reported as cost of goods sold when sold. Any gain (or loss) upon disposal shall be recognized as a gain (or loss) at that time.

Disclosure Requirements

56.
- General composition of stockpile materials.
- Basis for valuing stockpile materials; including valuation method and any cost flow assumption.
- Changes from prior year's accounting methods, if any.
- Restrictions on the use of materials.
- Balances of stockpile materials in each category described above (i.e., stockpile materials and stockpile materials held for sale).

[4]The decline in value shall be considered an expense if it is an expected decline in the normal course of operations.

- Decision criteria for categorizing stockpile materials as held for sale.
- Changes in criteria for categorizing stockpile materials as held for sale

The provisions of this statement need not be applied to immaterial items.

Seized and Forfeited Property

57. As a consequence of various laws, certain property is seized by authorized law enforcement agencies. In some instances, there may be as many as three government entities involved with seized property. The first is the seizing agency. Second, the seizing agency may turn the property over to a custodial agency. Third, financial records may be maintained by a "central fund" created to support the seizure activities of multiple agencies. Alternatively, the seizing agency may carry out one or both of the custodial agency or central fund roles.

58. The seized assets may be subsequently forfeited to the government through abandonment or administrative or judicial procedures. The forfeited property is then sold, converted for use by the government, or transferred to other governmental entities. Because this property is first seized, then all or a portion of it is forfeited, this standard separately addresses the accounting and reporting for seized property and the accounting and reporting for forfeited property.

Seized Property

59. **Definition.** "Seized property" includes monetary instruments, real property and tangible personal property of others in the actual or constructive possession of the custodial agency.

60. **Recognition.** Seized property shall be accounted for in the financial records of the entity that is operating as the central fund.[5]

61. Seized monetary instruments shall be recognized as seized assets when seized. In addition, a liability shall be established in an amount equal to the seized asset value. Seized monetary instruments are recognized upon seizure due to (1) the fungible nature of monetary

[5]If the central fund is other than the seizing or custodial agency, the latter should maintain sufficient internal records to carry out its stewardship responsibility.

instruments and (2) the high level of control over the assets that is necessary.

62. Seized property other than monetary instruments shall be disclosed in the footnotes. The value of the seized property shall be accounted for in an agency's property management records until the property is forfeited, returned, or otherwise liquidated.

63. **Valuation.** Seized property shall be valued at its market value[6] when seized or, if market value cannot be readily determined, as soon thereafter as reasonably possible. Market value shall be based on the value of the property assuming an active market exists for the property. If no active market exists for the property in the general area in which it was seized, a value in the principal market nearest the place of seizure shall be used.

64. **Exceptions to Valuation.** Valuation of property seized under the Internal Revenue Code shall be based on the taxpayer's equity, that is, market value less any third-party liens.

65. Seized monetary instruments shall be valued at their market value.

Disclosure Requirements

66.
- Explanation of what constitutes a seizure and a general description of the composition of seized property.
- Method(s) of valuing seizures.
- Changes from prior year's accounting methods; if any.
- Analysis of change in seized property, including the dollar value and number of seized properties that are (1) on hand at the beginning of the year, (2) seized during the year, (3) disposed of during the year, and (4) on hand at the end of the year as well as known liens or other claims against the property. This information should be presented by type of seized property and method of disposition where material.

[6]"Market value" is the estimated amount that can be realized by disposing of an item through arm's length transactions in the marketplace or the price (usually representative) at which bona fide sales have been consummated for products of like kind, quality, and quantity in a particular market at any moment of time. For investments in marketable securities, the term refers to the per-unit market price of a security times the number of units of that security held.

Forfeited Property

67. This subsection defines "forfeited property" and presents the accounting and reporting standards for it. Presented below are examples of forfeited property.

- monetary instruments,
- intangible property,
- real property and tangible personal property,
- property acquired by the government in satisfaction of a tax liability, and
- unclaimed and abandoned merchandise.

68. **Definition.** "Forfeited property" consists of (1) monetary instruments, intangible property, real property, and tangible personal property acquired through forfeiture proceedings; (2) property acquired by the government to satisfy a tax liability; and (3) unclaimed and abandoned merchandise.

69. **Recognition and Valuation.** Monetary instruments shall be reclassified from seized monetary instruments to forfeited monetary instruments when forfeited. Monetary instruments shall be valued at their market value when a forfeiture judgment is obtained. When the asset is recorded, revenue shall be recognized in an amount equal to the value of the monetary instrument and the associated liability for possible remittance shall be removed.

70. Intangible property, real property and tangible personal property shall be recorded with an offsetting deferred revenue when forfeiture judgment is obtained. The property shall be valued at its fair value at the time of forfeiture. A valuation allowance shall be established for liens or claims from a third-party. This allowance shall be credited for the amount of any expected payments to third-party claimants.

71. Forfeited property that cannot be sold due to legal restrictions but which may be either donated or destroyed shall be subject to the disclosure requirements described below. However, no financial value shall be recognized for these items.

72. Revenue from the sale of property shall be recognized when the property is sold.

73. Property not held for sale may be

--placed into official use,
--transferred to another federal government agency,
--distributed to a state or local law enforcement agency, or
--distributed to a foreign government.

74. When a determination is made that property will be distributed in one of the ways described above and not held for sale, the property shall be reclassified as forfeited property held for donation or use. Revenue associated with property not disposed of through sale shall be recognized upon approval of distribution and the previously established deferred revenue shall be reversed.

75. Revenue shall be classified as it arises from sale or from disposition, and this distinction shall be maintained in the entity's accounting reports.

76. Property acquired by the government in satisfaction of a taxpayer's liability shall be recorded when title to the property passes to the federal government. At that time, a credit shall be made to the related account receivable. The property shall be valued at its market value less any third-party liens. Upon sale of the property, revenue shall be recognized in the amount of the sale proceeds and the property and the third-party liens are removed from the accounts.

77. Unclaimed and abandoned merchandise shall be recorded with an offsetting deferred revenue when statutory and/or regulatory requirements for forfeiture have been met. The merchandise shall be valued at its market value. Upon sale of the merchandise, revenue shall be recognized in the amount of the sale proceeds and the merchandise and the deferred revenue are removed from the accounts.

Disclosure Requirements

78.
- Composition of forfeited property.
- Method(s) of valuing forfeited property.
- Restrictions on the use or disposition of forfeited property.
- Changes from prior year's accounting methods, if any.
- Analysis of change in forfeited property providing the dollar value and number of forfeitures that (1) are on hand at the beginning of the year, (2) are made during the year, (3) are disposed of during the year and the method of disposition, and

(4) are on hand at the end of the year. This information would be presented by type of property forfeited where material.

- If available, an estimate of the value of property or funds to be distributed to federal, state and local agencies in future reporting periods.

The provisions of this statement need not be applied to immaterial items.

Table 1: Summary Of Accounting Standard—Forfeited Property

Category of property	Method of disposition	Valuation method	Recognized as assets	Recognized as revenue
Monetary instruments	Sale; proceeds credited to entity's fund	Market value	Upon seizure	Upon obtaining forfeiture judgment
Intangible property and real and tangible personal property acquired by forfeiture proceeding	Sale	Market value	Upon obtaining forfeiture judgment	Upon sale
	Transferred, distributed, or held for internal use	Market value	Upon obtaining forfeiture judgment	Upon obtaining approval to transfer, distribute or use internally
Property acquired to satisfy tax liability	Sale; proceeds credited to Treasury General Fund	Market value less amount of liens	Upon obtaining title to property	Upon sale of property
Unclaimed/ abandoned merchandise	Sale; proceeds used to reimburse other funds; excess credited to Treasury General Fund	Market value	U]pon meeting statutory and/or regulatory requirements	Upon sale

Foreclosed Property

79. **Definition.** The term "foreclosed property" means any asset received in satisfaction of a loan receivable or as a result of payment of a claim under a guaranteed or insured loan (excluding commodities acquired under price support programs). All properties included in foreclosed property are assumed to be held for sale.

80. In accordance with the Federal Credit Reform Act of 1990, the remainder of this standard will refer to specific provisions for pre-1992 foreclosed property and post-1991 foreclosed property. "Pre-1992 foreclosed property" refers to property associated with **direct loans** obligated or **loan guarantees** committed before October 1, 1991. "Post-1991 foreclosed property" refers to property associated with **direct loans** obligated or **loan guarantees** committed after September 30, 1991. The distinction is necessary because for budget

purposes, the cash flows associated with post-1991 direct loans and loan guarantees, including the cash flows associated with post-1991 foreclosed property, must be measured on a present value basis. However, pre-1992 foreclosed property need not be valued on this basis. Additionally, any programs that are specifically exempt from the use of present value techniques for determining the costs of direct loans and loan guarantees shall rely on the accounting principles provided for pre-1992 foreclosed property.[7]

81. **Valuation of Foreclosed Property.** Post-1991 foreclosed property is valued at the net present value of the projected future cash flows associated with the property. Pre-1992 foreclosed property is recorded at cost and adjusted to the lower of cost or its net realizable value; any difference is carried in a valuation allowance. Both of these methods are described further below. For either post-1991 or pre-1992 foreclosed property, other valuation methods may be used as an approximation for the above methods if no material differences in valuation will result.

82. **Net Present Value.** The first step in determining net present value is projecting the future cash flows associated with the property. The projected future cash flows shall include estimates of (1) the sales proceeds, (2) rent, management expense, and repair costs during the holding period, and (3) selling expenses (e.g., advertising and commissions). In estimating the sales proceeds, the entity's historical experience in selling property and the nature of the sale shall be considered. For instance, market value based on sales between willing buyers and sellers may not be appropriate for properties to be disposed of in a forced or liquidation sale. If the entity has historically been unable to realize the fair value of property, this shall be considered in estimating sales proceeds.

83. The second step is to discount these cash flows to their present value. In order to place the projected cash flows on a present value basis, a discount (interest) rate must be selected. The discount rates used shall be the same rates that were used to discount the cash flows of the related loans or guarantees.

[7]Section 506 of the Federal Credit Reform Act exempts specific agencies, such as the Federal Deposit Insurance Corporation and the Tennessee Valley Authority.

84. Following foreclosure, the net present value (measured in a manner consistent with the measurement at the time of foreclosure) shall be adjusted periodically to recognize both changes in the expected future cash flows and for accrual of interest due to the passage of time. Any adjustments to the carrying amounts shall be included in the presentation of "interest income" and the reestimate of "subsidy expense."[8]

85. **Net Realizable Value.** Pre-1992 foreclosed property held for sale should be reported in the entity's financial statements at expected net realizable value. The expected net realizable value shall be based on an estimate of the market value of the property adjusted for any expected losses and any other costs of the sale. The estimate of market value shall be based on (1) the market value of the property if an active market exists; (2) the market value of similar properties if no active market exists; or (3) a reasonable forecast of expected cash flows adjusted for estimates of all holding costs, including any cost of capital. In addition to considering market value, the expected net realizable value shall consider the entity's historical experience in disposing of foreclosed properties; i.e., if the entity is typically unable to obtain market value for properties, the expected net realizable value shall be adjusted to be consistent with historically experienced losses. Additionally, if the entity will not be able to sell the property under normal market conditions or is forced to sell the property within a given time, this factor shall be considered in arriving at net realizable value.

86. If the expected net realizable value is less than the cost,[9] a loss has occurred. This loss shall be charged to operations, and a valuation allowance shall be established. If the asset's net realizable value subsequently increases or decreases, this amount shall be credited or charged to results of operations and the valuation allowance adjusted. However, the asset value shall not be adjusted above cost.

87. **Assets Subject to Claims of Other Parties.** If the property is taken subject to claims of the lender, debtor, or other party, these

[8]See FASAB exposure draft No. 2, *Accounting for Direct Loans and Loan Guarantees*, September, 1992.

[9]Cost is the carrying amount of the loan at the time of foreclosure or, for a loan guarantee, the amount of the claim paid.

claims shall be accounted for in a valuation allowance. These claims can be in the form of a lien or a residual interest of the debtor or lender, etc. For post-1991 foreclosed property, these claims shall be recorded at their net present value at the time of foreclosure. The discount rate applied shall be the same rate that applies to the related foreclosed property. For post-1991 foreclosed property, any periodic changes in the net present value of the claim shall be offset by a charge or a credit to "interest income" and the reestimate of "subsidy expense," as appropriate under the standards for direct loans and loan guarantees. For pre-1992 foreclosed property, these claims shall be recorded at the expected amount of the cash required to settle the claims.

88. **Receipts and Disbursements During the Holding Period for Post-1991 Foreclosed Property.** Any receipts or disbursements associated with acquiring and holding post-1991 foreclosed property shall be charged or credited to foreclosed property. This shall include rental receipts, maintenance and repair expense, advertising costs, and any other elements of the projected cash flows considered in arriving at the net present value.

89. **Sale of Foreclosed Property.** Upon sale, any difference between the net carrying amount of foreclosed property and the net proceeds of the sale shall be recognized as a component of operating results. For post-1991 foreclosed property, interest income shall be accrued from the previous periodic adjustment in the carrying amount up to the sale date. The difference between the adjusted carrying amount and the net sales proceeds shall be recognized as a reestimate of "subsidy expense." For pre-1992 foreclosed property, this difference shall be recognized as a gain or a loss on the sale of foreclosed property.

90. **Assets Converted From Held-for-Sale Assets to Operating Assets.** Assets not sold but placed into operation shall be removed from foreclosed property when such action is taken. If reimbursement for the transfer of assets from one program to another is made, the proceeds from the transfer shall be treated in the same manner as a sale to a third-party.

Disclosure Requirements

91.
- Valuation basis used for foreclosed property.
- Changes from prior year's accounting methods, if any.

- Restrictions on the use/disposal of the property.
- Balances in the categories described above.
- Number of properties held and average holding period by type or category.
- Number of properties for which foreclosure proceedings are in process at the end of the period.

The provisions of this statement need not be applied to immaterial items.

Goods Held Under Price Support And Stabilization Programs

92. **Definition.** Goods acquired under price support and stabilization programs are referred to as commodities. "Commodities" are items of commerce or trade having an exchange value. They are acquired, held, sold, or otherwise disposed of to satisfy or help satisfy economic goals.

93. In conducting price support operations, the money is frequently disbursed in the form of "nonrecourse loans." Recipients of such loans pledge specific farm commodities as collateral for the loans and have the alternatives of redeeming the loans (repaying them with interest) or surrendering the commodities in exchange for the outstanding loan balance.

94. Besides acquiring commodities through surrender of collateral for nonrecourse loans, an entity may acquire commodities by a purchase settlement. A purchase settlement is exercised on the basis of a purchase agreement between a producer and the Commodity Credit Corporation (CCC). On the basis of the agreement, a producer has the option to sell commodities to CCC and receive full payment for the commodity at the price support rate. The amount of the purchase settlement is calculated by multiplying the price support rate by the number of units purchased by the CCC. Support price rates are set by law.

95. Because nonrecourse loans and purchase agreements are closely associated with the acquisition of the actual commodities, the three components of the price support program are addressed in this accounting standard.

96. **Recognition.** Nonrecourse loans shall be recognized as assets when the loan principal is disbursed. These loans shall be recorded at the

amount of the loan principal. Interest income shall be recognized as it is earned and an interest receivable established.

97. Purchase agreement settlements are executed at the option of the producer (seller). This creates an uncertainty regarding losses to be incurred by the purchaser. At financial statement dates a loss shall be recognized if information indicates that it is probable that a loss has been incurred on purchase agreements outstanding and the amount of the loss can be reasonably measured. The amount of the loss shall be estimated and may be based on the contract price and the expected net realizable value of the commodities to be acquired.

98. If the contingent loss is not recognized because it is less than probable or it is not reasonably measurable, disclosure of the contingency shall be made if it is at least reasonably possible that a loss may occur.

99. Commodities shall be recognized as assets and reported on the face of the financial statements upon the producer's surrender of title to satisfy a nonrecourse loan or upon purchase by the agency.

100. Revenue shall be recognized upon the sale of commodities. At the time of sale, the carrying amount of the commodities sold shall be removed from commodities and reported as cost of goods sold.

101. The carrying amount of commodities held for other purposes shall be removed from the commodities asset account and reported as an expense upon transfer of the commodity.

102. **Valuation.** All nonrecourse loans shall be valued at the loan amount. Losses on nonrecourse loans shall be recognized when it is more likely than not that the loans will not be totally collected. The phrase "more likely than not" means more than a 50 percent chance of loss occurrence. The loan amount shall be preserved in the asset account as the gross value of the loan. When the loss is recognized, a valuation allowance, "allowance for losses", (a contra-asset) shall be established to reduce the gross value to its expected net realizable value. The allowance shall be reestimated on each financial reporting date.

103. The liability for losses on purchase agreements shall be valued at the net of the contract price and the net realizable value of the commodities described in the purchase agreement.[10]

104. At the time of acquisition and for financial statement purposes, all commodities shall be valued at the lower of cost or net realizable value.

105. The cost for commodities acquired via a nonrecourse loan settlement is the amount of the loan principal (excluding interest), processing and packaging costs incurred after acquisition, plus other costs (e.g., transportation) incurred in taking title to the commodity.

106. The cost for commodities acquired via a purchase settlement is the unit price agreed upon in the purchase agreement multiplied by the number of units purchased by CCC plus other costs (e.g., transportation) incurred in taking title to the commodity.

107. For financial statement purposes, any adjustments necessary to reduce the carrying amount of commodities to the lower of cost or net realizable value shall be recognized as a loss on farm price support and reported in the current period. The adjustment to the carrying amount shall be recorded in a commodity valuation allowance. Recoveries of losses may be recognized up to the point of any previously recognized losses on the commodities, and the commodity valuation allowance reduced accordingly in the current period.

108. For cost determination, any of the following cost flow assumptions may be applied in arriving at inventory balances and cost of goods sold or transferred: first-in, first-out (FIFO); weighted average; moving average; and specific identification.

Disclosure Requirements

109.
- Basis for valuing commodities; including the valuation method and any cost flow assumptions.
- Changes from prior year's accounting methods, if any.
- Restrictions on the use, disposal, or sale of commodities

[10]Contract price is the amount the government would be committed to pay in exchange for the commodities.

- An analysis of change in the dollar value and volume of commodities, including those (1) on hand at the beginning of the year, (2) acquired during the year, (3) disposed of during the year by method of disposition, (4) on hand at the end of the year, (5) on hand at year's end and estimated to be donated or transferred during the coming period, and (6) that may be received as a result of surrender of collateral related to nonrecourse loans outstanding. The analysis should also show the dollar value and volume of purchase agreement commitments.

The provisions of this statement need not be applied to immaterial items.

Appendix A: Basis Of The Board's Conclusions

110. This Appendix discusses the substantive comments that the Board received from respondents to the Exposure Draft, *Accounting for Inventory and Related Property*, issued in January 1993. The Appendix explains the Board's conclusions on issues raised by the respondents. A separate section is identified for each of the six recommended standards.

Inventory

111. Several respondents questioned the need for the various inventory categories proposed; inventory held in reserve for future sale; and excess, obsolete and unserviceable inventory. Respondents and speakers stated that (1) the requirement to segregate inventory and inventory held in reserve for future sale could result in arbitrary and subjective balance sheet allocations, (2) the category for excess, obsolete and unserviceable is unnecessary and (3) it is not cost-effective to modify systems to capture this data. However, other respondents supported the categories and indicated that they would result in more meaningful information.

112. Based on the comment letters received and the presentations at the public hearing, the objections seemed to be based on the belief that the Board intended to develop rigid guidelines for the categorization of inventory. However, it is apparent that these or similar categories are used internally by organizations. The Board is merely attempting to improve disclosure related to these categories. The Board concluded that the four categories should be maintained. The same issue was raised with regard to operating materials and supplies and the same conclusion was reached.

113. Several respondents opposed identifying the holding costs associated with inventory held in reserve for future sale. They indicated that the information has no apparent utility value, that it was virtually impossible to compute and maintain incremental holding costs for the reserve, and that disclosure would not provide managers with useful information to make relevant decisions. They also indicated that this requirement would be too subjective and difficult to audit. The Board discussed this issue and concluded that the identification of holding cost was a broad issue and deserving of more detailed treatment than could be afforded in the inventory standard. The Board agreed to drop the disclosure requirement and to defer this issue until a later project

on cost issues. The same issue was raised with regard to operating materials and supplies and the same conclusion was reached.

114. In the exposure draft, the Board requested opinions on two presentation formats for cost of goods sold and the change in the allowance for holding gains and losses under latest acquisition cost (LAC) (Par. 87). The following two cost of goods sold computations under the latest acquisition cost method where presented:

Proposed presentation: (Appendix A)	**Alternative presentation: (Appendix B)**
Cost of Goods Sold:	Cost of Goods Sold:
Beginning Inventory at LAC	Beginning Inventory at LAC
Purchases	less: Allowance
Cost of Goods Available for Sale	Purchases
less: Ending Inventory at LAC	Cost of Goods Available for Sale
Cost of Goods Sold	less: Ending Inventory at LAC
	less: Allowance
	Cost of Goods Sold
Nonoperating Change (Change in the Allowance for Unrealized Holding Gain/Loss on Inventory)	

115. Most respondents to the question regarding the two alternative cost of goods sold computations indicated a preference for the alternative presentation from Appendix B. These respondents stated that changes in cost were "operating" in nature and should be included in the operating results. It was also noted that comparability would be improved under the alternative treatment since cost of goods sold would approximate historical cost. Two respondents provided examples of the "distortion of cost of goods sold" that may result under the proposed presentation. The examples showed that cost of goods sold as calculated under the first proposed treatment (Appendix A of the ED) might actually be less than it would have been under historical cost.

116. In reviewing the responses, it was noted that the "nonoperating change" seems to have been confused by some respondents with the "unrealized holding gain/loss" for the period. The full title, "Nonoperating Change - Change in the Balance of the Allowance for Unrealized Holding Gains/Losses" is, although cumbersome, more descriptive. The change in the balance is made up of decreases, due to liquidation of inventory or cost decreases, and increases, due to

holding more inventory or cost increases. The net change should not be confused with the "unrealized holding gain/loss" for the period.

117. The Board, after much discussion, decided to adopt the alternative presentation (Appendix B of the ED). This would avoid (1) confusion as to the significance of the "nonoperating change" and (2) distortion of the cost of goods sold. In addition, for those who wish to know the change in the allowance account, the Board decided that line items should be included in the calculation of the cost of goods sold to show the beginning and ending balances.

118. Some respondents believed that the Board should adopt the lower of cost or market (LCM) rule (traditional under Accounting Research Bulletin (ARB) 43) for valuing inventory. Respondents supporting the LCM rule stated that:

- it provides a basis for measuring the utility of inventory, and
- the operating performance financial reporting objective seems to require that matching or assigning revenues and expenses to the appropriate period be a primary concern.

119. In evaluating the LCM rule the Board considered some of the unique facets of the Federal environment:

- pricing is often based on full cost recovery regardless of changes in market pricing, and
- managers are often required to stock inventory based on legislative or mission concerns that are not driven by profit maximization (therefore, cost fluctuations are not as relevant to performance measurement).

120. The Board concluded that there was no need to include the LCM rule in the inventory standards.

121. The Board requested comments on the impact of historical cost accounting on performance measurement, and the costs and benefits of market value accounting. The majority of respondents that addressed these questions expressed a preference for historical cost accounting due to its verifiability and understandability. They also believed that market value methods were too costly to implement and subjective. Another said that for most government operations, the goal is cost recovery and market value has little relevance.

122. One Board member believes that market value information is more relevant to decision makers than historical cost information. This opinion is shared by many in the academic community. However, the Board devoted considerable resources to the issue of measuring and reporting on holding gains and losses, an essential component of market value accounting, and was unable to resolve the issues that arose in a manner that would have been cost-effective. The Board has decided to rely primarily on historical cost accounting for inventory.

123. The Board also requested comments on the standard cost using replacement cost method. The method was described in detail in Appendix C to the exposure draft. "Standard costs" are defined as predetermined or budgeted per-unit costs. Standard costs are commonly used in manufacturing concerns and are being adopted in service industries as well.

124. In a standard cost system, variances between the actual per-unit cost and the standard per-unit rate are identified. Variances are typically calculated for the individual cost components, such as materials or labor, included in the overall per-unit rate.

125. Standard costs also provide managers useful information for managing inventory costs. As an agency purchases inventory during the year and incurs operating costs, the actual costs are compared with the standard costs to identify why the cost variances occurred. Since inventory and operating managers are evaluated against the standard, the managers have an incentive to meet the standard, which, in turn, provides for effective inventory cost control.

126. The distinction between the traditional standard cost system and that outlined in the exposure draft relates to replacement cost information. The method on which comments were requested would require standard costs based on the next period's expected replacement costs and overhead rates. Further, no adjustment to historical cost amounts would have been required for external reporting purposes.

127. The majority of the respondents cited substantially the same problems for this method as they cited for market value accounting in general. The calculations were viewed as complex, costly and subjective.

128. One Board member is concerned that this method would be excluded under the recommended standard. The Board does not believe that

this is true. Standard cost systems, including replacement cost, are used internally in private industry to generate valuable management information. Standard cost information is then revised to approximate costs under historical cost bases because it is generally accepted accounting practices for financial reporting purposes. Therefore, a managerial costing system employing standards or replacement cost information that improves management's decision making could be entirely consistent with the standard so long as externally reported information approximates historical cost. Further, the Board expects to take up the issue of costing systems in a future project on cost measurement.

129. With regard to inventory held in reserve for future sale, one respondent indicated that the phrase "either reported or disclosed" (par. 39) implies off-balance sheet reporting. The respondent believes that this category should be reported on the balance sheet rather than disclosed. The Board concluded that the decision as to the level of detail shown on the balance sheet should be left to preparers and/or auditors. While the Board did not revise the standard to require reporting on the face of the financials, the language describing the reporting and disclosure options was clarified.

130. One respondent suggested that the standard be revised so that excess, obsolete and unserviceable inventory would be valued at the lower of cost or net realizable value rather than at net realizable value. The respondent indicated that any gains on excess, obsolete or unserviceable inventory due to valuation at net realizable value should be recognized only upon disposal of such inventory and not when identified as such or upon periodic revaluations. Private sector GAAP, per ARB 43, requires that losses be recognized prior to disposal of inventory but that gains not be recognized until realized. This one-sided treatment has been criticized over the years but has survived based on the principle of conservatism that has prevailed.

131. Since the Federal government does not operate in a "for-profit" environment and does not seek financing from investors who rely on audited financial statements to make decisions, the conservative position taken in the past is not as relevant. However, the Board concluded that no change to the standard was required.

132. Some respondents commented on the absence of the last-in, first-out cost flow (LIFO) method under acceptable cost flow assumptions;

stating that LIFO should be included as an acceptable option under historical cost since it tends to match current costs with current revenues. The Board did not include LIFO as an acceptable cost flow assumption due to the stale inventory values reported on the balance sheet as a result. However, the Board did permit use of any method that reasonably approximates historical cost under one of the acceptable cost flow assumptions. Therefore, LIFO could be acceptable for an entity whose inventory turns over rapidly since there may be little difference between LIFO and any other cost flow assumption.

133. One respondent requested that the standard specifically address goods: a) held on consignment, b) acquired through barter, c) donated, d) that must be maintained by statute but have no market value, or e) that will not be sold or consumed but which must be held (e.g., weights and measures). The Board concluded that goods held on consignment were not within the scope of this standard. Goods maintained by statute but having no market value, and goods that will not be sold or consumed but must be held would presumably be categorized as stockpile materials and therefore no change to the standards was warranted. The Board did decide that valuation of goods acquired through barter or donated should be addressed under the inventory, operating materials and supplies, and stockpile materials standards.

Operating Materials And Supplies

134. Respondents suggested that if a valuation method such as latest acquisition cost (LAC) is acceptable for inventory it should also be acceptable for operating materials and supplies. The Board agreed with this proposal since LAC approximates historical cost. Further, the Board believes that any method that approximates historical cost should be acceptable. The standard was revised accordingly.

Stockpile Materials

135. Respondents indicated that the definition of stockpile materials would encompass routinely held reserves as well as major stockpiles of materials. It was the Board's intention to include only those items specifically identified by law as being "stockpiled." Items routinely used but held in unusually large quantities would not be included in this category but would remain components of inventory or operating materials and supplies; possibly categorized as held in reserve for future sale or use.

136. In addition, one respondent identified helium reserves as being mandated by law for "conservation" purposes. The Board concluded that it would be consistent to include these reserves in stockpile materials. The definition has been clarified to limit stockpile materials to items held in order to comply with legal requirements established for purposes of defense, emergency or conservation.

137. As was the case for operating materials and supplies, respondents indicated that use of LAC would be appropriate for stockpile materials. The Board reached the same conclusion for this standard; that any method that approximates historical cost should be acceptable. The standard was revised accordingly.

138. One respondent suggested that an exception to permit market valuation for items that are interchangeable, have a ready market, and for which the unit cost is not determinable be added to the standard. The inventory standard provides this exception and the respondent suggested that it be available for stockpile material so that items such as strategic petroleum reserves could be valued at market value. The Board concluded that since these items are not routinely sold in large quantities the recognition of holding gains/losses may have an adverse impact on measurement of operating performance. Therefore, the exception was not added to the standard for stockpile materials.

Seized And Forfeited Assets

139. A respondent explained at the public hearing that a good portion of the forfeited assets are seized and valued under conditions which make accurate appraisals extremely difficult. As a result, there have been values reported for assets well in excess of what is eventually realized. The determination of the market value prior to the actual sale of the item is very difficult. The respondent has found that when the best estimate of market value is made on an item by item basis, the total value is still found to be overstated.

140. To avoid overstating deferred revenue, the respondent recommended that a valuation allowance be created to adjust the reported value of assets in the financial statements. The valuation allowance would be based on historical trends or other relevant information; in a manner similar to that used to establish an allowance for uncollectible receivables. For example, information over the last six months may show sale proceeds were 5% to 10% less than appraised values. Further, the respondent believes that use of the valuation allowance

would recognize the inherent difficulties in estimating market values and would present better financial information.

141. Although the proposal is not without merit, it may be an unnecessary exercise. Market value is an estimate of the amount to be realized upon disposal of the property and should take into account the marketplace in which the property is expected to be disposed of (e.g., auction, fire sale, retail or wholesale markets, etc.). The use of valuation allowances against any asset category is not prohibited. However, the Board does not believe it necessary to require the use of a valuation allowance in this circumstance.

142. One respondent requested that the standard require that, in addition to recording deferred revenue, deferred distributions be recorded. A respondent at the public hearing explained that historically as much as 50% of the forfeited property is eventually distributed to federal, state, and local law enforcement entities which participated in the case. It was further explained that once property has been forfeited, a participating state, local, or federal agency may have already applied to receive that asset because of its participation in the case. Therefore, the recording of deferred revenue could be accompanied, where appropriate, by the recording of an estimate of deferred distributions. The intent of this is to avoid reporting misleading information in the financial statements.

143. The deferred distribution would represent another level of estimates related to forfeited property. In discussions with representatives from other agencies that handle seized and forfeited property, the Board has been told that no reasonable estimate of deferred distributions was available.

144. In addition to the difficulty in estimating distributions, the Board notes that there is no legal requirement to make a specific distribution until an application has been approved. This is similar in a sense to dividends declared by for-profit enterprises. There is no legal obligation to make a payment until the actual declaration by the Board of Directors; and the entity does not record dividends payable until that time. Therefore, the Board has not revised the standard as suggested. However, the Board has added a disclosure requirement for any reasonable estimate of future distributions.

145. The comment letters also included proposals for miscellaneous changes to this standard:

    1) In that the government does not have ownership, seized monetary instruments should be disclosed rather than reported on the face of the financials.

    2) Seized property other than monetary instruments should be reported as assets, like monetary instruments, with a liability for possible remittance of equal value recorded.

    3) For non-monetary forfeited assets the disclosure requirements are adequate to ensure information is available to users. Therefore, non-monetary forfeited assets should not be reported on the face of the financial statements.

    4) At the time that forfeiture judgement is obtained, ownership of the property is effectively transferred to the federal agency and the government should recognize the revenue earned at that time rather than deferring it.

146. The first two suggestions relate to seized property. The Board considered these suggestions during its discussions of seized property. The Board did not revise the standard; this was based on (1) the desire to establish strong controls over monetary instruments and (2) the difficulties in valuing and uncertainties regarding disposition associated with seized non-monetary property.

147. The third and fourth items relate to forfeited property. The suggestion to disclose forfeited non-monetary instruments, item 3, would result in understatement of the entity's assets. Disclosure requirements should emphasize that the value reported is merely an "estimate" of the property's value. The suggestion to recognize revenue upon forfeiture, item 4, while theoretically correct was not adopted by the Board. Due to the difficulties in valuing forfeited property and the risk of overstating the revenue the Board decided to defer revenue recognition until the property was sold.

148. One respondent requested that the standard address valuation of property for which there is no value, which cannot be legally sold, but which can be donated to museums or other non-profit organizations (e.g., stuffed endangered species) or destroyed (e.g., narcotics). The

standard was revised to clarify the disclosure requirements and to indicate that no financial value need be reported for these items. Entities are not prohibited from reporting information regarding the dollar value of illegal assets seized if they so chose. The standard only relates to financial recognition and disclosure.

149. One respondent indicated that the analysis of change in seizures disclosure requirement is very detailed and should not be required for agencies with only incidental seizure activity. The Board has indicated that the standard is not intended to be applied to immaterial items.

150. One respondent noted that the definitions of seized and forfeited property seem to be limited to monetary instruments, real property and tangible personal property. The respondent asked that this definition be extended to intangible assets (e.g., savings and loan charters). The Board did broaden the definition to address intangible property.

151. One respondent explained that the exposure draft can be interpreted to advise agencies to account for the assets through the seizing agency's property records and financial statements. However, in most cases, the seizing agency is different from the custodial agency which may take possession of seized property. In addition, there may be a central fund created to support activities of multiple agencies. It was recommended that the standard be modified to recognize the distinction among "seizing agencies", "custodial agencies", and the "central fund" responsible for accounting and reporting for the seized property; and, to remind seizing agencies of their responsibilities to maintain sufficient internal records to carry out their stewardship responsibilities.

152. The exposure draft had defined "seized property" as being "in the actual or constructive possession of the **seizing agency**." The respondent has correctly pointed out that this is not always the case since custodial agencies frequently take possession and/or responsibility for seized property. Depending on the circumstances, each party may have a need to maintain property records regarding seized property. For example, a seizing agency may wish to track property that may be ultimately distributed to it. In addition, seizing agencies may maintain physical possession of the property during the forfeiture process. The Board has modified the definition to include seized property held by custodial agencies.

153. With regard to the request for a clear statement of which agency is to maintain records on seized property, the Board believes that central fund would be responsible for accounting for and reporting seized property, but that seizing agencies or custodial agencies may have a need for property records related to seized property and does not wish to preclude them from doing so. However, in preparing consolidated financial statements care should be taken to avoid double counting these items. With regard to forfeited property, ownership should be the determinant for an entity's recognition of an asset. However, an agency that maintains physical custody, but not ownership, of forfeited property is not precluded from maintaining property records although no asset should be recognized.

Foreclosed Property

154. Many respondents objected to the requirement to value post-1991 foreclosed property at net present value (NPV). The primary objections to the use of NPV were:

- NPV is not a more accurate valuation basis than net realizable value (NRV)
- NPV does not improve the information presented
- Difference between NPV and NRV is immaterial
- Loss of comparability with commercial enterprises
- Maintenance of two systems to value foreclosed property (pre-1992 and post-1991) is costly and unnecessary
- Changes in existing systems would be complicated and expensive
- Cash flows may not be forecast with sufficient accuracy to measure NPV

155. In proposing present value accounting, the Board's primary considerations were to carry out the intent of the Federal Credit Reform Act of 1990 (the Act) and to make financial reporting compatible with the budget. Since foreclosed property is a result of the original loan transaction or loan guarantee, reporting on this activity should be guided by the provisions of the Act.

156. An extensive discussion of the Board's overall decision to require present value accounting is presented in Recommended Accounting Standard No. 2, *Accounting for Direct Loans and Loan Guarantees* (see Appendix A). One of the objectives of financial reporting is to enable the reader to determine the status of budgetary resources, and whether those resources were acquired and used in accordance with

the enacted budget.[11] The Board believes that only by using the same basis can financial information be used to compare the actual results of operations with the budget.

157. However, the Board wishes to acknowledge that respondents may be correct in stating that in certain cases there may be only immaterial differences between net realizable value (or other methods) and NPV. The standard has been revised to indicate that if no material difference results, other valuation methods may be used as an approximation of the net present value of foreclosed property.

158. One respondent currently values foreclosed vessels at their acquisition price based on its own bid at the foreclosure sale. Following acquisition, the value is depreciated at one-percent per month. Gains or losses are recognized upon sale. The respondent believes that the current practice is more appropriate because: (1) the price paid at foreclosure sale represents the best valuation, (2) estimating future net cash flows requires assumptions and this would be less prudent than utilizing existing specific valuations, and (3) the entity has had to establish the value of the vessels in legal proceedings and has relied on the acquisition price to do so - utilizing a different value in financial records could jeopardize the entity's position in legal proceedings. The Board has not revised the standard as a result of this request. The Board believes that there are no unique circumstances in this case which would preclude conformance to the standard.

Goods Held Under Price Support And Stabilization Programs

159. The proposed standard required that nonrecourse loans be adjusted at time of disbursement to **recognize a loss if the market rate is lower than the loan rate**. This constituted a departure from current practice that is to adjust the loan values to their expected net realizable value at report date. Respondents expressed concern that the proposed method would result in recognizing losses without consideration of the underlying economic transaction (i.e., will the loans be repaid).

160. Based on two respondents' comments, the Board found that the approach originally proposed ignored the "probability" component in recognizing unrealized losses; these losses have typically been

[11]FASAB Exposure Draft, Objectives of Federal Financial Reporting, Vol. 1, par. 13.

recognized only if they are "probable and measurable. Nonrecourse loans, being short-lived, are similar in nature to notes or accounts receivable. Therefore, the Board referred to its recommended standard for accounts receivable. That standard states that:

> Losses on receivables should be recognized when it is more likely than not that the receivables will not be totally collected. The phrase "more likely than not" means more than a 50 percent chance of loss occurrence.
>
> An allowance for estimated uncollectible amounts should be recognized to reduce the gross amount of receivables to its net realizable value. The allowance for uncollectible amounts should be reestimated on each financial reporting date and when information indicates that the latest estimate is no longer correct. (FASAB, Recommended Accounting Standard 1, Paragraphs 44 and 45)

161. In addition, one respondent indicated that the originally proposed standard would have excluded loss recognition due to factors other than fluctuations in the market rates. Losses can occur due to (1) farmers' misuse or handling of the pledged commodities, or (2) fraud. Clearly the concept of loss recognition should be broadened in order to recognize these events. The Board modified the standard for nonrecourse loans to be more consistent with the accounts receivable standard and to encompass the Board's current thinking on the liability project.

162. One respondent argued that purchase agreements constitute a contingent liability. The proposed standard would require recognizing a liability and a loss **if the contract price exceeded the expected net realizable value of the commodities**. It is clear that at any given time the market price may be lower than the contract price but that due to cycles in the harvest and post-harvest market this may not be an indication that the contract will be executed and a loss realized. The Board revised the standard to provide for loss recognition in connection with purchase agreements if the loss is both probable and measurable.

Statement of Federal Financial Accounting Standards No. 4: Managerial Cost Accounting Standards and Concepts

Status

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Volume I References	SFFAC No. 1, *Objectives of Federal Financial Reporting* (provides discussion of core data and environmental data as well as types of reports) SFFAS No. 5, *Accounting for Liabilities of the Federal Government* (provides information on pension and other retirement benefit costs to arrive at full cost) SFFAS No. 7, *Accounting for Revenue and Other Financing Sources* (paragraphs 73 and 333-334 address imputed financing for inter-entity costs) SFFAS No. 9, *Deferral of Implementation Date of SFFAS No. 4*
Volume II References	Managerial Cost Accounting (M20)
Interpretations and Technical Releases	Interpretation No. 2, *Accounting for Treasury Judgment Fund Transactions* TR 1, *Audit Legal Letter Guidance* Interpretation No. 6, *Accounting for Imputed Intra-departmental Costs: An Interpretation of SFFAS No. 4*.
Affects	No other statements.
Affected by	SFFAS No. 9, *Deferral of Implementation Date of SFFAS No. 4*, defers the implementation date of SFFAS No. 4.

Summary

The managerial cost accounting concepts and standards contained in this statement are aimed at providing reliable and timely information on the full cost of federal programs, their activities, and outputs. The concepts of managerial cost accounting contained in this statement describe the relationship among cost accounting, financial reporting, and budgeting. The five standards set forth the fundamental elements of managerial cost accounting.

Managerial Cost Accounting Concepts

Managerial cost accounting should be a fundamental part of the financial management system and, to the extent practicable, should be integrated with other parts of the system. Managerial costing should use a basis of accounting, recognition, and measurement appropriate for the intended purpose. Cost information developed for different purposes should be drawn from a common data source, and output reports should be reconcilable to each other.

Managerial Cost Accounting Standards

Requirement for cost accounting - Each reporting entity should accumulate and report the costs of its activities on a regular basis for management information purposes. Costs may be accumulated either through the use of cost accounting systems or through the use of cost finding techniques.

Responsibility segments - Management of each reporting entity should define and establish responsibility segments. Managerial cost accounting should be performed to measure and report the costs of each segment's outputs. Special cost studies, if necessary, should be performed to determine the costs of outputs.

Full cost - Reporting entities should report the full costs of outputs in general purpose financial reports. The full cost of an output produced by a responsibility segment is the sum of (1) the costs of resources consumed by the segment that directly or indirectly contribute to the output, and (2) the costs of identifiable supporting services provided by other responsibility segments within the reporting entity, and by other reporting entities.

Inter-entity costs - Each entity's full cost should incorporate the full cost of goods and services that it receives from other entities. The entity providing the goods or services has the responsibility to provide the receiving entity with information on the full cost of such goods or services either through billing or other advice.

Recognition of inter-entity costs that are not fully reimbursed is limited to material items that (1) are significant to the receiving entity, (2) form an integral or necessary part of the receiving entity's output, and (3) can be identified or matched to the receiving entity with reasonable precision. Broad and general support services provided by an entity to all or most other entities generally should not be recognized unless such services form a vital and integral part of the operations or output of the receiving entity.

Costing methodology - Costs of resources consumed by responsibility segments should be accumulated by type of resource. Outputs produced by responsibility segments should be accumulated and, if practicable, measured in units. The full costs of resources that directly or indirectly contribute to the production of outputs should be assigned to outputs through costing methodologies or cost finding techniques that are most appropriate to the segment's operating environment and should be followed consistently.

The cost assignments should be performed using the following methods listed in the order of preference: (a) directly tracing costs wherever feasible and economically practicable, (b) assigning costs on a cause-and-effect basis, or (c) allocating costs on a reasonable and consistent basis.

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Executive Summary

1. The managerial cost accounting concepts and standards contained in this statement are aimed at providing reliable and timely information on the full cost of federal programs, their activities, and outputs. The cost information can be used by the Congress and federal executives in making decisions about allocating federal resources, authorizing and modifying programs, and evaluating program performance. The cost information can also be used by program managers in making managerial decisions to improve operating economy and efficiency.

2. The concepts of managerial cost accounting contained in this statement describe the relationship among cost accounting, financial reporting, and budgeting. The five standards set forth the fundamental elements of managerial cost accounting: (1) accumulating and reporting costs of activities on a regular basis for management information purposes, (2) establishing responsibility segments to match costs with outputs, (3) determining full costs of government goods and services, (4) recognizing the costs of goods and services provided among federal entities, and (5) using appropriate costing methodologies to accumulate and assign costs to outputs.

3. These standards are based on sound cost accounting concepts and are broad enough to allow maximum flexibility for agency managers to develop costing methods that are best suited to their operational environment. Also, the managerial cost accounting standards and practices will evolve and improve as agencies gain experience in using them. The following is a summary of the concepts and standards contained in this statement.

Managerial Cost Accounting Concepts

4. Managerial cost accounting should be a fundamental part of the financial management system and, to the extent practicable, should be integrated with other parts of the system. Managerial costing should use a basis of accounting, recognition, and measurement appropriate for the intended purpose. Cost information developed for different purposes should be drawn from a common data source, and output reports should be reconcilable to each other.

Managerial Cost Accounting Standards

Requirement for cost accounting

5. Each reporting entity should accumulate and report the costs of its activities on a regular basis for management information purposes. Costs may be accumulated either through the use of cost accounting systems or through the use of cost finding techniques.

Responsibility segments

6. Management of each reporting entity should define and establish responsibility segments. Managerial cost accounting should be performed to measure and report the costs of each segment's outputs. Special cost studies, if necessary, should be performed to determine the costs of outputs.

Full cost

7. Reporting entities should report the full costs of outputs in general purpose financial reports. The full cost of an output produced by a responsibility segment is the sum of (1) the costs of resources consumed by the segment that directly or indirectly contribute to the output, and (2) the costs of identifiable supporting services provided by other responsibility segments within the reporting entity, and by other reporting entities.

Inter-entity costs

8. Each entity's full cost should incorporate the full cost of goods and services that it receives from other entities. The entity providing the goods or services has the responsibility to provide the receiving entity with information on the full cost of such goods or services either through billing or other advice.

9. Recognition of inter-entity costs that are not fully reimbursed is limited to material items that (1) are significant to the receiving entity, (2) form an integral or necessary part of the receiving entity's output, and (3) can be identified or matched to the receiving entity with reasonable precision. Broad and general support services provided by an entity to all or most other entities generally should not be recognized unless such services form a vital and integral part of the operations or output of the receiving entity.

Costing methodology

10. Costs of resources consumed by responsibility segments should be accumulated by type of resource. Outputs produced by responsibility segments should be accumulated and, if practicable, measured in

units. The full costs of resources that directly or indirectly contribute to the production of outputs should be assigned to outputs through costing methodologies or cost finding techniques that are most appropriate to the segment's operating environment and should be followed consistently.

11. The cost assignments should be performed using the following methods listed in the order of preference: (a) directly tracing costs wherever feasible and economically practicable. (b) assigning costs on a cause-and-effect basis, or (c) allocating costs on a reasonable and consistent basis.

12. These accounting standards need not be applied to items that are qualitatively and quantitatively immaterial. The Board recommends that the managerial accounting standards of this Statement become effective for fiscal periods beginning after September 30, 1996. Earlier implementation is encouraged.

Introduction

Background

13. Reliable information on the costs of federal programs and activities is crucial for effective management of government operations. In Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, Objectives of Federal Financial Reporting, issued in 1993, it is stated that the objectives of federal financial reporting are to provide useful information to assist internal and external users in assessing the budget integrity, operating performance, stewardship, and systems and control of the federal government.[1]

14. Managerial cost accounting is especially important for fulfilling the objective of assessing operating performance. In relation to that objective, it is stated in SFFAC No. 1 that federal financial reporting should provide information that helps users to determine:

    - Costs of specific programs and activities and the composition of, and changes in, those costs;
    - Efforts and accomplishments associated with federal programs and their changes over time and in relation to costs; and
    - Efficiency and effectiveness of the government's management of its assets and liabilities.[2]

15. It is further stated in SFFAC No. 1 that "The topics of costs and performance measurement are related because it is by associating cost with activities or cost objectives that accounting can make much of its contribution to reporting on performance."[3] "Cost" is the monetary value of resources used or sacrificed or liabilities incurred to achieve an objective, such as to acquire or produce a good or to perform an activity or service. Costs incurred may benefit current and future periods. In financial accounting and reporting, the costs that apply to an entity's operations for the current accounting period are recognized as expenses of that period.

[1]Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting* (September 2, 1993), pars. 110 and 111.

[2]Ibid., pars. 126-130.

[3]Ibid., par. 192.

16. The Chief Financial Officers Act of 1990 includes among the functions of chief financial officers "the development and reporting of cost information" and "the systematic measurement of performance."[4] In July 1993, Congress passed the Government Performance and Results Act (GPRA) which mandates performance measurement by federal agencies.[5] In September 1993, in his report to the President on the National Performance Review (NPR), Vice President Al Gore recommended an action which required the Federal Accounting Standards Advisory Board to issue a set of cost accounting standards for all federal activities.[6] Those standards will provide a method for identifying the unit cost of all government activities.

17. In early 1994, the Federal Accounting Standards Advisory Board (the Board) convened an advisory group to help develop standards for managerial cost accounting in the federal government. The group included members from government, business, and academe. Their views and proposals have been considered by the Board, and their work contributed greatly in developing this document.

Users Of Federal Cost Information

18. The cost of government is a concern to the public as well as to the federal government itself. Most government service efforts and accomplishments cannot be measured in financial terms alone. Unlike private business, there is no "bottom line" or profit index to help measure public sector performance. However, government service efforts and accomplishments can be evaluated using both financial and non-financial measures, and "cost" is an important financial measure for government programs. Internal and external federal information users identified below will find these standards helpful in assessing operating performance, stewardship, systems, and control of the federal government.

19. *Government managers* are the primary users of cost information. They are responsible for carrying out program objectives with resources entrusted to them. Reliable and timely cost information

[4]104 Stat. 2938 (See particularly 31 U.S.C. sec 902).

[5]107 Stat. 285 (See particularly, 31 U.S.C. sections 1101, 1105, 1115, 1116-1119, 9703, 9704).

[6]Vice President Al Gore, Creating A Government That Works Better & Costs Less, Accompanying Report of the National Performance Review (September 1993), p. 59.

helps them ensure that resources are spent to achieve expected results and outputs, and alerts them to waste and inefficiency.

20. *Congress and federal executives*, including the President, make policy decisions on program priorities and allocate resources among programs. These officials need cost information to compare alternative courses of action and to make program authorization decisions by assessing costs and benefits. They also need cost information to evaluate program performance.

21. *Citizens*, including news media and interest groups, are concerned with the costs and results of federal programs that affect their interests. They need program cost information to judge whether resources are allocated to programs rationally and if the programs operate efficiently and effectively.

Objectives

22. The managerial cost accounting concepts and standards presented here are intended for all the user groups identified above. These standards are aimed at achieving three general objectives:

- Provide program managers[7] with relevant and reliable information relating costs to outputs and activities. Based on this information, program managers can respond to inquiries about the costs of the activities they manage. The cost information will assist them in improving operational economy and efficiency;
- Provide relevant and reliable cost information to assist the Congress and executives in making decisions about allocating federal resources, authorizing and modifying programs, and evaluating program performance; and
- Ensure consistency between costs reported in general purpose financial reports and costs reported to program managers. This includes standardizing terminology for managerial cost accounting to improve communication among federal organizations and users of cost information.

[7]Statement of Federal Financial Accounting Concepts No. 1, Objectives of Financial Reporting, defined "Program managers" as individuals who manage federal programs, and stated that "Their concerns include operating plans, program operations, and budget execution." SFFAC No. 1, par. 85.

Scope Of Standards

23. This statement contains managerial cost concepts and five standards for the federal government. The five standards address the following topics:

    (1) Requirement for cost accounting,
    (2) Responsibility segments,
    (3) Full cost,
    (4) Inter-entity costs, and
    (5) Costing methodology.

    The essence of each standard is briefly stated in a box followed by detailed explanations. **However, both the words in the boxes and the entire text of explanations constitute the requirements of the standards.**

24. These standards are based on sound cost accounting concepts and allow sufficient flexibility for agencies to develop managerial cost accounting practices that are suited to their specific operating environments. Also, it is expected that cost accounting standards and practices will evolve and improve as agencies gain experience in using them.

25. Other Statements of Federal Financial Accounting Standards (SFFAS) address recognition and measurement of assets and liabilities. For additional guidance, readers should consult: SFFAS No. 1, *Accounting for Selected Assets and Liabilities*; SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees*; and SFFAS No. 3, *Accounting for Inventory and Related Property.* The Board is working on and will soon complete other recognition and measurement projects related to revenues, liabilities, property, plant, and equipment, and other elements of financial statements.[8]

Terminology

26. Managerial cost accounting information, to be useful, must rely on consistent and uniform terminology for concepts, practices, and techniques. Consistent and uniform use of terminology can help avoid

[8]See FASAB Exposure Drafts, *Accounting for Liabilities of the Federal Government* (November 7, 1994); *Accounting for Property, Plant, and Equipment* (February 28, 1995); and *Revenue and Other Financing Sources* (Pending).

confusion and mis-communication among organizations and individuals.

27. As a start toward developing consistent managerial cost accounting terminology within the federal government, this statement includes a glossary of basic cost accounting terms.

Materiality

28. Except as otherwise noted, the accounting and reporting provisions of these accounting standards need not be applied to items that are qualitatively or quantitatively immaterial.

29. The determination of whether an item is material depends on the degree to which omitting information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission.

Effective Date

30. The Board recommends that the accounting standards of this Statement become effective for fiscal periods beginning after September 30, 1996. Earlier implementation is encouraged.

Purposes Of Using Cost Information

31. There are many different purposes for which cost information may be used by the federal government. The focus of this statement is on cost information needed to improve federal financial management and managerial decision making.

32. In managing federal government programs, cost information is essential in the following five areas: (1) budgeting and cost control, (2) performance measurement, (3) determining reimbursements and setting fees and prices, (4) program evaluations, and (5) making economic choice decisions. Each of these uses is discussed below.

Budgeting And Cost Control

33. Information on the costs of program activities can be used as a basis to estimate future costs in preparing and reviewing budgets. Once budgets are approved and executed, cost information serves as a feedback to budgets. Using cost information, federal managers can

control and reduce costs, and find and avoid waste. For example, with appropriate cost information, federal managers can:

- Compare costs with known or assumed benefits of activities, identify value-added and non-value-added activities, and make decisions to reduce resources devoted to activities that are not cost-effective;
- Compare and determine reasons for variances between actual and budgeted costs of an activity or a product;
- Compare cost changes over time and identify their causes;
- Identify and reduce excess capacity costs; and
- Compare costs of similar activities and find causes for cost differences, if any.

Performance Measurement

34. Measuring performance is a means of improving program efficiency, effectiveness, and program results. One of the stated purposes of the GPRA of 1993 is to ". . .improve the confidence of the American people in the capability of the federal government, by systematically holding federal agencies accountable for achieving program results."

35. Measuring costs is an integral part of measuring performance in terms of efficiency and cost-effectiveness. Efficiency is measured by relating outputs to inputs. It is often expressed by the cost per unit of output. While effectiveness in itself is measured by the outcome or the degree to which a predetermined objective is met, it is commonly combined with cost information to show "cost-effectiveness." Thus, the service efforts and accomplishments of a government entity can be evaluated with the following measures:

    (1) Measures of service efforts which include the costs of resources used to provide the services and non-financial measures;

    (2) Measures of accomplishments which are outputs (the quantity of services provided) and outcomes (the results of those services); and

    (3) Measures that relate efforts to accomplishments, Such as cost per unit of output or cost-effectiveness.

36. Thus, as stated previously, performance measurement requires both financial and non-financial measures. Cost is a necessary element for performance measurement, but is not the only element.

Determining Reimbursements And Setting Fees And Prices

37. Cost information is an important basis in setting fees and reimbursements. Pricing and costing, however, are two different concepts. Setting prices is a policy matter, sometimes governed by statutory provisions and regulations, and other times by managerial or public policies. Thus, the price of a good or service does not necessarily equal the cost of the good or the service determined under a particular set of principles. Nevertheless, cost is an important consideration in setting government prices. With certain exceptions, OMB requires:[9]

- With respect to goods and services that the government provides in its sovereign capacity to a particular group of individuals as a special benefit, user charges should be sufficient to recover the full cost of those goods and services; and
- With respect to goods and services that the government provides under business-like conditions, user charges for those goods and services need not be limited to the recovery of full cost and may yield a net revenue.

38. Also, cost information is important in calculating reimbursements for products and services provided by one government agency to another. Even if fees or reimbursements do not recover the full costs due to policy or economic constraints, management needs to be aware of the difference between cost and price. With this information, program managers can properly inform the public, the Congress, and federal executives about the costs of providing the goods or services.

Program Evaluations

39. Costs of federal resources required by programs are an important factor in making policy decisions related to program authorization, modification, and discontinuation. These decisions are usually subject to policy constraints, and often require the consideration of social and economic costs and benefits affecting different sectors of the

[9]OMB Circular A-25, User Charges (Revised July 8, 1993).

economy and society. Nevertheless, the costs of federal resources required are an important factor. Information on program costs can be used as a basis for cost-benefit considerations.

Economic Choice Decisions

40. Often, agencies and programs face decisions involving choices among alternative actions, such as whether to do a project in-house or contract it out; to accept or reject a proposal; or to continue or drop a product or service. Making these decisions requires cost comparisons among available alternatives.

Managerial Cost Accounting Concepts

Managerial cost accounting should be a fundamental part of the financial management system and, to the extent practicable, should be integrated with other parts of the system. Managerial costing should use a basis of accounting, recognition, and measurement appropriate for the intended purpose. Cost information developed for different purposes should be drawn from a common data source, and output reports should be reconcilable to each other.

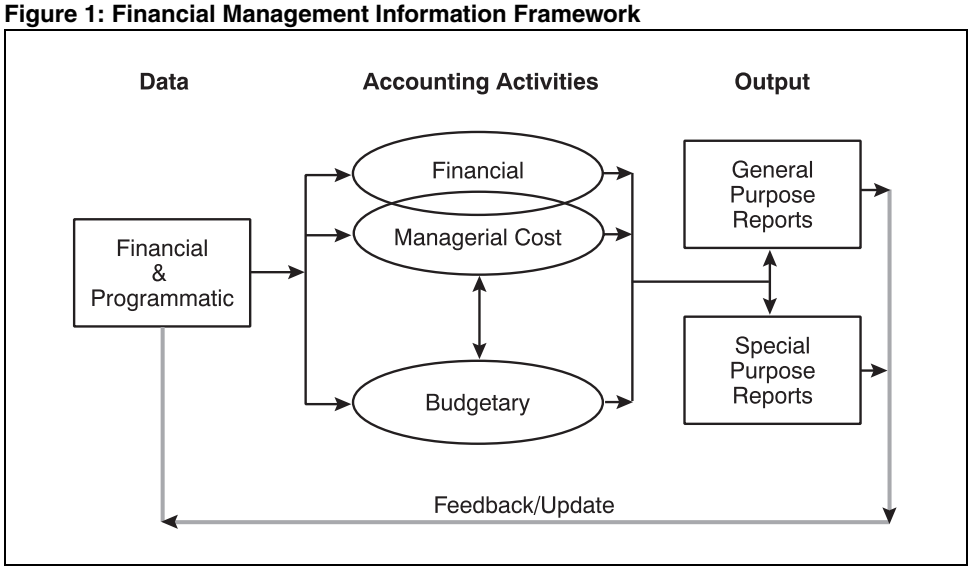
41. Managerial cost accounting should be an essential element of proper financial planning, control, and evaluation for any organization or activity that uses resources having monetary value. Managerial cost accounting is a basic part of the financial management system in that it supports and provides data to the budgetary and financial accounting functions and, by itself, provides useful information for both internal and external users.

Role Of Managerial Cost Accounting In Financial Management

42. Managerial cost accounting is the process of accumulating, measuring, analyzing, interpreting, and reporting cost information useful to both internal and external groups concerned with the way in which the organization uses, accounts for, safeguards, and controls its resources to meet its objectives. Managerial cost accounting, therefore, is the servant of both budgetary and financial accounting and reporting because it assists those systems in providing information. Also, it

provides useful information directly to management. These relationships are shown in Figure 1.

Figure 1: Financial Management Information Framework



Common Data Source

43. The information flow within a financial management system begins with a basic information pool or common data source. This data source consists of all financial and programmatic information used by the budgetary, cost, and financial accounting processes. It includes all financial and much non-financial data, such as environmental data, that are necessary for budgeting and financial reporting.[10] The common data source also includes evaluation and decision information developed as a result of prior reporting and feedback. Other types of data may be included based upon perceived needs and purposes related to the ultimate users of the information.

44. The common data source may include many different kinds of data. It is far more than the information about financial transactions found in the standard general ledger, although that is a significant part of the data source. Few organizations or entities maintain all these data in

[10]The makeup of core data and environmental data is discussed in Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, Chapter 7, and, therefore, a detailed discussion is not provided here.

any one system or location. Furthermore, the use of the term "data source" is not meant to imply the use of computerized systems for source information. Instead, the term is used in a broad way to include many sources of information.

45. Managerial cost accounting, financial accounting, and budgetary accounting draw information as needed from the common data source. The data obtained by each of these is processed to attain specific objectives by reporting useful information.

Relationship to Financial Accounting

46. As shown in Figure 1 by their overlap, managerial cost accounting and financial accounting are closely related or integrated. To some degree, this is due to the historical development of cost accounting as a method for more detailed scorekeeping with the requirement to provide inventory values for external financial reporting purposes.[11] In part, it is because cost information generally originates with transactions recorded for financial accounting purposes.

47. While inventory valuation is still part of the fundamental relationship, managerial cost accounting serves financial accounting in several other ways. Fundamentally, managerial cost accounting should assist financial accounting in determining the results of operations during a fiscal period by providing relevant data that are accumulated to produce operating expenses. These data include the allocation of capitalized costs to periods of time or units of usage.

48. Traditionally, managerial cost accounting information pertaining to financial accounting has involved costs of past transactions and the assignment of transaction value to fiscal periods and outputs. These purposes and uses are closely aligned with the financial accounting activity and traditional external financial reporting. This past cost aspect has been acknowledged in *Objectives of Federal Financial Reporting* which states that "financial accounting is largely concerned with assigning the value of past transactions to appropriate time periods."[12]

[11]Coulthurst, Nigel and John Piper, "The State of Cost and Management Accounting," Management Accounting, April 1986.

[12]Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, par. 168.

Relationship to Budgetary Accounting

49. Managerial cost accounting should also provide budgetary accounting with cost information. However, the two are not as closely aligned as is the case with financial accounting (see Figure 1). Mostly, this is because costs are usually recorded, accumulated, and allocated by managerial cost accounting on an accrual basis of accounting which is different from the obligation or cash basis generally used in budgetary accounting.

50. Still, managerial cost accounting does provide cost information to budgetary accounting for use in preparing yearly and long-term budgets for required materials, supplies, equipment, human resources, and other resources needed to produce different levels of outputs. Managerial cost accounting also helps in making many budgetary decisions such as those concerning future capital expenditures and purchase/lease alternatives.

51. It is important to note that the Board's authority does not extend to recommending budgetary standards or budgetary concepts, and that is not the purpose of this statement.[13] However, the Board is committed to providing relevant and reliable cost accounting information that supports budget planning, formulation, and execution.

Cost Information for Management Purposes

52. Managerial cost accounting produces information directly for management use, sometimes employing data produced by the budgetary and financial accounting processes. Cost information is used for many different purposes which can be generally classified into five types: performance measurement; cost reduction and control; determination of reimbursements and fee or price setting; program authorization, modification, and discontinuation decisions; and decisions to contract out work or make other changes in the methods of production.

53. To meet these needs, managerial cost accounting should use basic cost data and non-financial or programmatic data. For example, it tracks units of output produced and input used including the amount of labor in terms of employees or employee-hours. Sometimes, information from cost analysis is used to compare actual to predetermined or anticipated costs. An organization may use cost estimates, cost studies, and cost finding techniques.

[13]Memorandum of Understanding establishing the FASAB, October 10, 1990.

54. While managerial cost accounting is concerned not only with past costs and future costs, one of its most important features is the use of present costs to assist management. This current cost aspect of managerial cost accounting is referred to in the *Objectives of Federal Financial Reporting* where is states that "accounting data may be further assigned, allocated, or associated with units of activity or production, segments of organizations, etc., within the same time period. These kinds of intraperiod allocations are developed most extensively in the branch of accounting called cost accounting. Neither the FASB nor the GASB has devoted much attention to this branch of accounting, but the FASAB, because of its unique mission, will need to do so."[14] Managerial cost accounting information pertaining to present costs is most often used for controlling and reducing those costs, controlling work processes, and measuring current performance.

Reporting Relationships

55. Proper financial management requires that the three accounting processes work closely together to provide useful reporting to both internal and external users. The internal-external dual focus of federal reporting has been established in the *Objectives of Federal Financial Reporting*. It states that "The FASAB and its sponsors believe that any description of federal financial reporting objectives should consider the needs of both internal and external users and the decisions they make." In addition, it says that "the FASAB... considers the information needs of both internal and external users. In part, this is because the distinction between internal and external users is in many ways less significant for the federal government than for other entities." It goes on to classify the users of financial information into four major groups: program managers, executives, the Congress, and citizens.[15] These categories include both internal and external users.

56. Federal financial reporting encompasses general and special purpose reports to meet the needs of the four user groups. Information produced by managerial cost accounting appears in or influences both

[14]Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, par. 174.

[15]Ibid., pars. 23, 25, and par. 75.

types of reports.[16] As discussed above, managerial cost accounting should provide information for use by both financial accounting and budgetary accounting. That information is used by those processes in producing both general purpose and special purpose reports.

57. Managerial cost accounting also results in reports of its own. Most often these are special purpose reports designed for internal users, typically program and line managers. However, they may be for groups generally considered external users.

58. One of the most important aspects of reporting in which managerial cost accounting plays a large role is that of performance reporting. Measuring and reporting actual performance against established goals is essential to assess governmental accountability. Cost information is necessary in establishing strategic goals, measuring service efforts and accomplishments, and relating efforts to accomplishments. The importance of cost information in relation to performance measurement and performance reporting has been recognized in the *Objectives of Federal Financial Reporting*, which said "One reason for performing cost accounting is to assist in performance measurement" and it also stated that "The topics of cost and performance measurement are related because it is by associating cost with activities or 'cost objectives' that accounting can make much of its contribution to reporting on performance."[17]

Basis Of Accounting And Recognition/ measurement Methods

59. Costs may be measured, analyzed, and reported in many ways. A particular cost measurement has meaning only when considering its purpose. The measurement of costs can vary depending upon the circumstances and purpose for which the measurement is to be used. In *Objectives of Federal Financial Reporting*, it is stated that "the Board's own focus is on developing generally accepted accounting standards for reporting on the financial operations, financial position, and financial condition of the federal government and its component entities and other useful financial information. This implies a variety

[16]The types of general purpose and special purpose reports are discussed in Statement of Federal Financial Accounting Concepts No. 1, Objectives of Federal Financial Reporting, Chapter 7.

[17]Ibid., par. 174 and par. 192.

of measures of costs and other information that complements the information available in the budget [emphasis added]."[18]

60. In addition, it is stated that "In defining the proper measurement, assignment, and allocation of cost for a given purpose, selecting the appropriate accounting method and whether to use full costing should be carefully considered."[19] Further, it added that "The accrual basis of accounting generally provides a better matching of costs to the production of goods and services, but its use and application for any given purpose must be carefully evaluated."[20]

61. Therefore, managerial cost accounting should provide cost information using a basis of accounting and recognition/measurement standards that are appropriate for the intended use of the information. When managerial cost accounting is used to supply information for use by financial accounting and financial reporting, that information should be consistent with the basis of accounting and recognition/measurement standards required by federal accounting principles. Traditionally this has meant the use of accrual accounting and historical cost measurement, particularly in general purpose reports.

62. When managerial cost accounting is used to supply information for the preparation and review of budgets, cost data should be consistent with the basis of accounting and recognition/measurement used in financial reporting, but may be adjusted to meet the budgetary information needs.

63. Special purpose cost studies and analyses are sometimes performed for decision making. In those studies and analyses, management may need to develop cost data beyond those currently reported in general purpose financial reports. For example, in making planning decisions, management may develop replacement costs and capital costs. However, the basis and methods used should be appropriate for the circumstances and consistent with the intended purposes.

[18]Ibid., par. 191.

[19]Ibid., par. 196.

[20]Ibid., par. 197.

Reconciliation Of Information

64. Different bases of accounting will produce different costs for the same item, activity, or entity. This can confuse users of cost information. Therefore, reports that use different accounting bases or different recognition and measurement methods should be reconcilable, and should fully explain those bases and methods. Regardless of the type of report in which it is presented, cost information should ultimately be traceable back to the original common data source.

65. To be reconcilable, the amount of the differences in the information reported should be ascertainable and the reasons for the differences should be explainable. In some situations, informational differences may be clearly understandable without further explanation. However, other cases may require a narrative statement concerning the differences. In complicated situations, a schedule or table may be required to fully explain the differences.

66. Financial reporting has long recognized the necessity for reconciliation between information reported on different accounting bases. Reconciliations have been required in federal financial reports to show and explain significant differences between budget reports and financial statements prepared in accordance with generally accepted accounting principles.

Managerial Cost Accounting Standards

Requirement For Cost Accounting

Each reporting entity[21] should accumulate and report the cost of its activities on a regular basis for management information purposes. Costs may be accumulated either through the use of cost accounting systems or through the use of cost finding techniques.

[21]The term "reporting entity" as used in this document conveys the same meaning as defined in FASAB Statement of Recommended Accounting Concepts No. 2, *Entity and Display* (May 1995).

67. Cost information is essential to effective financial management and should play an important role in federal financial reporting. Managerial cost accounting processes are the means of providing cost information in an efficient and reliable manner on a continuing basis.

Need For Consistent Cost Accounting On A Regular Basis

68. To perform managerial cost accounting on a "regular basis" means that entities should establish procedures to accumulate and report costs continuously, routinely, and consistently for management information purposes. Consistent and regular cost accounting is needed to meet the second objective of federal financial reporting which states information should be provided to help the user determine the costs of providing specific programs and activities and the composition of, and changes in those costs. That objective also requires the reporting of performance information of federal programs and the changes over time in that performance in relation to the costs.

69. The requirement for managerial cost accounting on a regular and consistent basis supports recent legislative actions. The CFO Act of 1990 states that agency CFOs shall provide for the development and reporting of cost information and the periodic measurement of performance. In addition, the GPRA of 1993 requires each agency, for each program, to establish performance indicators and measure or assess relevant outputs, service levels, and outcomes of each program as a basis for comparing actual results with established goals. The nature of these legislative mandates requires reporting entities to develop and report cost information on a consistent and regular basis.

70. The managerial cost accounting processes consist of collecting data from the common data source, processing that data, and reporting cost and output information in general purpose and special purpose reports. Appropriate procedures and practices should also be established to enable the collection, measurement, accumulation, analysis, interpretation, and communication of cost information. This can be accomplished through the use of a cost accounting system or the use of cost finding techniques and other cost studies and analyses. A cost accounting "system" is an organized grouping of methods and activities designed to consistently produce reliable cost information.

Basic Cost Accounting Processes

71. Regardless of whether a reporting entity uses a cost accounting system or cost finding techniques, the methods and procedures followed should be designed to perform at least a certain minimum level of cost accounting and provide a basic amount of cost

information necessary to accomplish the many objectives associated with planning, decision making, control, and reporting. The more important of these minimum criteria for cost accounting are associated with the standards in the remainder of this statement. Others are also important.

- Responsibility Segments - Cost information should be collected by responsibility segments which have been identified by management and outputs should be defined for each responsibility segment.[22]
- Full Costing - Each reporting entity should measure the full cost of outputs so that total operational costs and total unit costs of outputs can be determined. "Full cost" includes the cost of goods or services provided by other entities when the applicable criteria are met.[23]
- Costing Methodology - The costing methodology used (e.g., activity-based costing, job order costing, standard costing, etc.) should be appropriate for management's needs and the operating environment.[24]
- Performance Measurement - Cost accounting should provide information needed to determine and report service efforts and accomplishments and information necessary to meet the requirements of the GPRA or interface with a system that provides such information. This includes the quantity of inputs and outputs and other non-financial information needed in the measurement of performance.
- Reporting Frequency - Cost information should be reported in a timely manner and on a regular basis consistent with the needs of management and the requirements of both budgetary and financial reporting.
- Standard General Ledger - Managerial cost accounting should be integrated with general financial accounting. Both depend on the standard general ledger for basic financial transaction data.
- Precision of Information - Cost information supplied to internal and external users should be reliable and useful in making

[22]See standard in this statement concerning responsibility segments.

[23]See standard concerning full costs and standard concerning inter-entity costing.

[24]See standard concerning costing methodology.

evaluations or decisions. At the same time, unnecessary precision and refinement of data should be avoided.

- Special Situations - The managerial cost accounting processes should be designed to accommodate any of management's special cost information needs that may arise due to unusual or special situations or circumstances. If such cost information is needed on a regular basis, appropriate procedures to provide it should be developed.
- Documentation - All managerial cost accounting activities, processes, and procedures should be documented by a manual, handbook, or guidebook of applicable accounting operations. This reference should outline the applicable activities, provide instructions for procedures and practices to be followed, list the cost accounts and subsidiary accounts related to the standard general ledger, and contain examples of forms and other documents used.

Complexity Of Cost Accounting Processes

72. While each entity's managerial cost accounting should meet the basics discussed above, this standard does not specify the degree of complexity or sophistication of any managerial cost accounting process. Each reporting entity should determine the appropriate detail for its cost accounting processes and procedures based on several factors. These include the:

- nature of the entity's operations;
- precision desired and needed in cost information;
- practicality of data collection and processing;
- availability of electronic data handling facilities;
- cost of installing, operating, and maintaining the cost accounting processes; and
- any specific information needs of management.

73. Some entities may find that they can purchase basic "off-the-shelf" cost accounting programs, systems, or processes, or adapt those of other federal agencies. All entities should consider using similar or compatible cost accounting processes throughout their component units to facilitate comparison and consolidation of cost information.

Cost Findings, Studies, And Analyses

74. A cost accounting system is a continuous and systematic cost accounting process which may be designed to accumulate and assign costs to a variety of objects routinely or as desired by the management. Such a system may be best for some reporting entities.

75. Some entities may not need a sophisticated system to perform detailed cost accumulation and assignment. They need to accumulate and report costs regularly as required by this standard, but they may determine and analyze costs through special cost studies and analyses. Also, some entities may use a combination of a system supplemented by cost studies.

76. Cost information may be developed and savings achieved in some cases by the use of special cost studies or cost analyses to develop information helpful in certain decision making situations. In addition, cost finding techniques may be used to determine the cost of products or services. Cost finding is a method for determining the cost of producing goods or services using appropriate procedures. Cost finding techniques may also be useful for computing costs in cases where the information is not needed on a recurring basis.

Responsibility Segments

Management of each reporting entity should define and establish responsibility segments. Managerial cost accounting should be performed to measure and report the costs of each segment's outputs. Special cost studies, if necessary, should also be performed to determine the costs of outputs.

77. The standard states that the management of each reporting entity should define and establish responsibility segments. This section explains the concept of responsibility segment, purposes of segmentation, and how responsibility segments can be structured.

Defining Responsibility Segments

78. A responsibility segment is a component of a reporting entity[25] that is responsible for carrying out a mission, conducting a major line of activity, or producing one or a group of related products or services. In addition, responsibility segments usually possess the following characteristics:

    (1) Their managers report to the entity's top management directly;

[25]The term "reporting entity" referred to in this document conveys the same meaning as defined in FASAB Statement of Recommended Accounting Concepts No. 2, *Entity and Display* (May 1995).

(2) Their resources and results of operations can be clearly distinguished from those of other segments of the entity.[26]

79. A responsibility segment is a unit for which managerial cost accounting is performed. Entities may use a centralized accounting system or segment-based systems to provide cost information for each segment. For each segment, managerial cost accounting should:

(1) Define and accumulate outputs, and if feasible, quantify each type of output in units;

(2) Accumulate costs and quantitative units of resources consumed in producing the outputs; and

(3) Assign costs to outputs, and calculate the cost per unit of each type of output.

80. Some reporting entities may have only one responsibility segment, if they perform one single mission or one type of service. Other reporting entities may have several responsibility segments. Also, a sub-organization of the federal government may be a reporting entity in itself and, at the same time, it may also be a responsibility segment of a higher level reporting entity to which it belongs. The Forest Service, for example, may be a reporting entity because it may meet the reporting entity criteria. As such, it may establish responsibility segments for itself. At the same time, the Forest Service may be regarded as a responsibility segment of the Department of Agriculture, of which it is a component.

81. However, for a given reporting entity, its management should establish one or more responsibility segments to perform managerial cost accounting functions.

Purposes Of Segmentation

82. A basic purpose of dividing an entity into segments is to determine and report the costs of services and products that each segment produces and delivers. Many federal departments and agencies manage

[26]These two characteristics make responsibility segments, as the term is used in this document, differ from cost centers. A cost center can be at any level of an organization and may not report to the top management directly. As will be explained later, a responsibility segment can contain cost centers in itself.

programs that produce a variety of goods and services. Accounting for entity-wide revenues and expenses in aggregate would serve financial reporting for the entity, but would not serve costing purposes. In order to determine the cost of each type of service or product, it is necessary to divide an entity into segments such that each segment is responsible for certain types of services or products. Each segment can then be used as a vehicle for accumulating costs incurred by the segment to match with its outputs. Each segment can use a cost methodology that is best suited to its operations.

83. Another important purpose of segmentation is to facilitate cost control and management. Cost information provided for each segment helps managers to examine costs of specific resources consumed and activities performed in each segment. Managers can analyze cost variances in both dollars and the units of resources consumed against budgets or standards. Since each segment performs a particular pattern of processes and activities to produce its output, managers can analyze those processes and activities to compare their costs with the value they contribute to the output.

84. For entities that consist of components engaging in diverse lines of activities, it is desirable to provide financial reports that display information for significant components individually and of the entity in its entirety.[27] Some entities may find costs accumulated by segments useful in support of financial reporting by components.

85. For internal management, segmentation could also facilitate performance measurement. Since each segment is responsible for a mission, or a line of activity to produce a certain type of output, performance goals can be set for each segment based on its specific tasks and operating patterns. Information on costs, outputs, and outcomes related to each segment can be used to measure its performance against the goals. The results of the segment performance measurement could also support external reporting on performance measures for the entire reporting entity or its major programs.

[27]This point is discussed in FASAB Statement of Recommended Accounting Concepts No. 2, *Entity and Display*, pars. 75-76.

Structuring Responsibility Segments

86. Reporting entity management should define and structure its responsibility segments. The designation of responsibility segments should be based on the following factors: (a) the entity's organization structure, (b) its lines of responsibilities and missions, (c) its outputs (goods or services it delivers), and (d) budget accounts and funding authorities. However, the predominant factor is the reporting entity's organization structure and its existing responsibility components, such as bureaus, administrations, offices, and divisions within a department.

87. The U.S. General Services Administration, for example, provides five distinct services: (1) managing public buildings, (2) distributing supplies, (3) providing travel and transportation services, (4) managing information resources (including communication and data processing services), and (5) disposal of real properties. Each of those service areas could be designated as a responsibility segment. The Department of Veterans Affairs (VA), among its other services, provides health care to veterans, pays veterans' compensation and pension benefits, and provides home loans and home loan guarantees to veterans. Each of these program areas could constitute a responsibility segment.

88. Since responsibility segments are major parts of an entity, some segments may carry more than one program. Some programs may be jointly managed by two or more segments. Thus, each segment must accumulate costs for each type of output produced for various programs. To accomplish this, a network of cost centers can be established within a segment to accumulate costs. Managers of each cost center will be provided with information to control and manage costs within their area of responsibility. Depending on operational patterns and cost methods, cost centers can be structured along different dimensions, such as organizational units, operating processes, and activities.

Full Cost

Reporting entities should report the full costs of outputs in general purpose financial reports. The full cost of an output produced by a responsibility segment is the sum of (1) the costs of resources consumed by the segment that directly or indirectly contribute to the output, and (2) the costs of identifiable supporting services provided by other responsibility segments within the reporting entity, and by other reporting entities.

89. This standard states that reporting entities should measure and report the full costs of their outputs in general purpose financial reports. "Outputs" means products and services generated from the consumption of resources. The full cost of a responsibility segment's output is the total amount of resources used to produce the output. This includes direct and indirect costs that contribute to the output, regardless of funding sources. It also includes costs of supporting services provided by other responsibility segments or entities. The standard does not require full cost reporting in federal entities' internal reports or special purpose cost studies. Entity management can decide on a case-by-case basis whether full cost is appropriate and should be used for internal reporting and special purpose cost studies.

Direct Costs

90. Direct costs are costs that can be specifically identified with an output. All direct costs should be included in the full cost of outputs. Typical direct costs in the production of an output include:

    (a) Salaries and other benefits for employees who work directly on the output;

    (b) Materials and supplies used in the work;

    (c) Various costs associated with office space, equipment, facilities, and utilities that are used exclusively to produce the output; and

    (d) Costs of goods or services received from other segments or entities that are used to produce the output (See discussions and explanations in the next section on "Inter-Entity Costs").

Indirect Costs

91. Indirect costs are costs of resources that are jointly or commonly used to produce two or more types of outputs but are not specifically identifiable with any of the outputs. Typical examples of indirect costs include costs of general administrative services, general research and technical support, security, rent, employee health and recreation facilities, and operating and maintenance costs for buildings, equipment, and utilities. There are two levels of indirect costs:

    (a) Indirect costs incurred within a responsibility segment. These indirect costs should be assigned to outputs on a cause-and-effect basis, if such an assignment is economically feasible, or through reasonable allocations. (See discussions on cost assignments in the "Costing Methodology" section.)

(b) Costs of support services that a responsibility segment receives from other segments or entities. The support costs should be first directly traced or assigned to various segments that receive the support services. They should then be assigned to outputs.

92. A reporting entity and its responsibility segments may incur general management and administrative support costs that cannot be traced, assigned, or allocated to segments and their outputs. These unassigned costs are part of the organization costs, and they should be reported on the entity's financial statements (such as the Statement of Net Costs) as costs not assigned to programs.[28]

Certain Cost Elements

Costs of Employees' Benefits

93. Employee benefits include:

(a) Health and life insurance benefits for current employees covered in part by the government's contribution to health and life insurance premiums;

(b) Pension benefits for employees, their survivors, and dependents, covered by defined pension plans such as Civil Service Retirement System (CSRS), Federal Employees Retirement Plan (FERS), and Military Retirement System (MRS);

(c) Health and life insurance benefits for retired employees, their survivors and dependents, covered in part by the government's contribution to health and life insurance premiums, and referred to as "other retirement benefits" (ORB) in this document;

(d) Other postemployment benefits (OPEB) for terminated and inactive employees, which include severance payments, training and counseling, continued health care, and unemployment and workers compensation.

94. Most of the employee benefit programs are covered by trust funds administered by the Office of Personnel Management (OPM) and the Department of Defense (DoD). Contributions to the trust funds come

[28]A similar explanation is provided in FASAB Statement of Recommended Accounting Concepts No. 2, *Entity and Display*, par. 95.

from three sources: current and retired employees, employing agencies, and direct appropriations. The management expenses of the trust funds are paid with the funds' receipts.

95. Federal financial accounting standards require that the employing entity accrue the costs to the federal government of providing pension and ORB benefits to employees and recognize the costs as an expense when the benefits are earned.[29] The employing entity should recognize those expenses regardless of whether the benefits are funded by the reporting entity or by direct appropriations to the trust funds. This principle should also be applied to health and life insurance benefits for current employees and comparable benefits for military personnel. The costs of employee benefits incurred by responsibility segments should be directly traced or assigned to outputs.

96. OPEB costs include severance payments, counseling and training, health care, and workers compensation benefits paid to former or inactive employees. OPEB costs are often incurred as a result of such events as reductions in force or on-the-job injuries of employees. Federal financial accounting standards require that OPEB costs be reported as an expense for the period during which a future outflow or other sacrifice of resources is probable and measurable on the basis of events occurring on or before the accounting date.[30]

97. Since the recognition of OPEB costs is linked to the occurrence of an OPEB event rather then the production of output, in many instances, assigning OPEB costs recognized for a period to output of that period would distort the cost of output. In special purpose cost studies or cost findings, management may distribute OPEB costs over a number of years in the past to determine the costs of the outputs that the OPEB recipients helped to produce.

Costs of Public Assistance and Social Insurance Programs

98. Major costs of welfare, insurance, and grant programs are the costs of resources transferred from the federal government to individuals and

[29]FASAB Exposure Draft, *Accounting for Liabilities of the Federal Government* (November 7, 1994), pars. 62-99.

[30]Ibid., pars. 100-102.

state and local governments. Some of them are referred to as "transfer payments." The following are some typical public assistance and insurance programs:

- Grants, such as aid to state and local governments;
- Subsidies, such as agricultural commodity price support and stabilization programs;
- Credit and insurance costs, such as the Family Education Loan Program and Savings Association Insurance;
- Welfare payments such as Aid to Families with Dependent Children (AFDC); and,
- Social insurance, such as the Old Age, Survivors, and Disability Insurance Program.

99. The full cost of such a program includes: (a) the costs of federal resources that have been or will be transferred to individuals and state/local governments, and (b) the costs of operating the programs. These two types of costs should be recognized on a basis of accounting that is prescribed within the Federal Financial Accounting Standards. These two types of costs should be separately identified so that each can be used for different analytic purposes.

100. The costs resulting from transfer payments are determined by the level of grants, subsidies, entitlement benefits, credit subsidies, or loss payments made under insurance and guarantee agreements. They are also determined by the number of eligible persons who receive the transfer payments. The program cost of AFDC, for example, depends on the average payment per family, the number of eligible families, and the federal government's share in the payments (some payments are made by state and local governments). Information on this type of cost is useful for making policy decisions about levels of subsidies or benefits, eligibility of recipients, and how transfer payments are made. This cost information is also useful for measuring the cost-effectiveness of a transfer payment program.

101. Program operating costs, on the other hand, are costs of managing the program and delivering the payments. They include the costs of personnel, supplies, equipment, and offices. The costs are related to such activities as screening benefit recipients for eligibility, keeping their accounts, making payments and collections, answering inquiries, etc. Information on this type of cost is useful in measuring the efficiency of program operations.

Costs related to Property, Plant and Equipment

102. **Depreciation expense.** General property, plant, and equipment are used in the production of goods and services. Their consumption is recognized as depreciation expense. The depreciation expense incurred by responsibility segments should be included in the full costs of the goods and services that the segments produce.

103. **Recognizing property acquisition costs as expenses.** The costs of acquiring or constructing federal mission and heritage property, plant, and equipment may be charged to expenses at the time the acquisition costs are incurred.[31] Since the recognition of these expenses is linked to property acquisition rather than production of goods and services, those expenses should not be included in the full costs of goods and services. However, they are part of the costs of the entity or the program that makes the property acquisitions.

Non-production costs

104. A responsibility segment may incur and recognize costs that are linked to events other than the production of goods and services. Two examples of these non-production costs were discussed earlier: (1) OPEB costs that are recognized as expenses when an OPEB event occurs, and (2) certain property acquisition costs that are recognized as expenses at the time of acquisition. Other non-production costs include reorganization costs, and nonrecurring cleanup costs resulting from facility abandonments that are not accrued. Since these costs are recognized for a period in which a particular event occurs, assigning these costs to goods and service produced in that period would distort the production costs. In special purpose cost studies, management may have reasons to determine historical output costs by distributing some of these costs to outputs over a number of past periods. Such distribution may be appropriate when: (a) experience shows that the costs are recurring in a regular pattern, **and** (b) a nexus can be established between the costs and the production of outputs that may have benefited from those costs.

[31] In FASAB Exposure Draft, *Accounting for Property, Plant, and Equipment*, the Board proposed that the costs of acquiring or constructing "federal mission" and "heritage" property, plant, and equipment be recognized as expenses when the costs are incurred. See the ED, pars. 98-117, pages 29-34.

Inter-entity Costs

Each entity's full cost should incorporate the full cost of goods and services that it receives from other entities. The entity providing the goods or services has the responsibility to provide the receiving entity with information on the full cost of such goods or services either through billing or other advice.

Recognition of inter-entity costs that are not fully reimbursed is limited to material items that (1) are significant to the receiving entity, (2) form an integral or necessary part of the receiving entity's output, and (3) can be identified or matched to the receiving entity with reasonable precision. Broad and general support services provided by an entity to all or most other entities should not be recognized unless such services form a vital and integral part of the operations or output of the receiving entity.

105. As stated in the preceding standard, to fully account for the costs of the goods and services they produce, reporting entities should include the cost of goods and services received from other entities. Knowledge of these costs is helpful to top level management in controlling and assessing the operating environment. It is also helpful to other users in evaluating overall program costs and performance and in making decisions about resource allocations and changes in programs.

Inter-entity Activities

106. Within the federal government, some reporting entities rely on other federal entities to help them achieve their missions. Often this involves support services, but may include the provision of goods. Sometimes these arrangements may be stipulated by law, but others are established by mutual agreement of the entities involved. Such relationships can be classified into two types depending upon funding methods.

- Provision of goods or services with reimbursement—In this situation, one entity agrees to provide goods or services to another with reimbursement at an agreed-upon price. The reimbursement price may or may not be enough to recover full costs. Usually the agreement is voluntarily established through an inter-agency agreement. Revolving funds can also be included in this group, because they are usually established to recover costs through sale of their outputs to other government entities. They are usually meant to be self-sustaining through their sales, without receiving additional appropriations. However, they do not always charge enough to cover full costs.
- Provision of goods or services without reimbursement—One entity provides goods or services to another entity free of charge.

The agreement may be voluntary, legally mandated, or inherently established in the mission of the providing entity.

107. Recently, consideration has been given to expanding the concept of inter-entity support within the federal government. Under this concept, entities could sell their outputs on a competitive basis. Entities would have the authority to purchase goods or services from any federal or private provider. This is seen as a way to improve government efficiency through competition since inefficient government providers would be forced to improve or stop providing these goods or services. This could result in consolidating support services in fewer governmental entities. Underlying this concept is the requirement that all costs be recognized in developing the price at which goods and services would be sold to other entities.

Accounting And Implementation Guidance

108. If an entity provides goods or services to another entity, regardless of whether full reimbursement is received, the providing entity should continue to recognize in its accounting records the full cost of those goods or services. The full costs of the goods or services provided should also be reported to the receiving entity by the providing entity.

109. The receiving entity should recognize in its accounting records the full cost of the goods or services it receives as an expense or, if appropriate, as an asset (such as work-in-process inventory). The information on costs of non-reimbursed or under-reimbursed goods or services should be available from the providing entity. However, if such cost information is not provided, or is partially provided, a reasonable estimate may be used by the receiving entity. The estimate should be of the cost of the goods or services received (the estimate may be based on the market value of the goods or services received if an estimate of the cost cannot be made). To the extent that reimbursement is less than full cost, the receiving entity should recognize the difference in its accounting records as a financing

source.[32] Inter-entity expenses/assets and financing sources would be eliminated for any consolidated financial statements covering both entities.

110. Implementation of this standard on inter-entity costing should be accomplished in a practical and consistent manner by the various federal entities. Therefore, the Office of Management and Budget, with assistance from the FASAB staff, should identify the specific inter-entity costs for entities to begin recognizing. OMB should then issue guidance identifying these costs. These particular inter-entity costs should be specified in accordance with this standard including the recognition criteria presented below. The OMB should consider information and advice from Treasury, GAO, and other agencies in developing the implementation guidance. It is anticipated that the largest and most important inter-entity costs will be identified first. As entities gain experience in the application of the standard, recognition of other inter-entity costs may be specified in future guidance or required by future standards.

Recognition Criteria

111. Ideally, all inter-entity costs should be recognized. This is especially important when those costs constitute inputs to government goods or services provided to non-federal entities for a fee or user charge. The fees and user charges should recover the full costs of those goods and services.[33] Thus, the cost of inter-entity goods or services needs to be recognized by the receiving entity in order to determine fees or user charges for goods and services sold outside the federal government. Such recognition, however, should be made in accordance with the implementation guidance issued by OMB as discussed above.

[32]See Statement of Recommended Federal Accounting Concepts No. 2, *Entity and Display*, par. 65. See also, FASAB Exposure Draft, *Accounting for Liabilities of the Federal Government*, pars. 62-99, pages 26-46, which addresses accounting for pensions and other retirement benefits (ORB). The payment of pension and ORB costs for an entity by another entity has often been likened to providing goods and services. In the case of pensions, employees of the reporting entity provide services to that entity and part of the salary-related cost is paid by a different entity. The pension administering entity does not provide goods or services to the reporting entity (other than normal pension administration services), but rather pays their costs directly. The difference is subtle but important. However, the accounting is similar. This document is consistent with the section of the liabilities exposure draft dealing with accounting for pensions and other retirement benefits.

[33]OMB Circular A-25 addresses user charges by federal entities.

112. However, the situation is often different with goods or services transferred within the federal government that do not involve eventual sales to entities outside the federal government. The federal government in its entirety is an economic entity. Therefore, it is reasonable to expect some flow of goods or services between reporting entities as those entities assist each other in fulfilling their missions and operating objectives. There are some cases in which the cost of non-reimbursed or under-reimbursed goods or services received from other entities need not be recognized as part of the cost of the receiving entity. The following general criteria are provided to help in determining the types of inter-entity costs that should or should not be recognized.

- Materiality—As with other accounting standards, the provisions of this standard need not be applied to immaterial items. However, in the context of deciding which inter-entity transactions are to be recognized, materiality, as used here, is directed to the individual inter-entity transaction rather than to all inter-entity transactions as a whole. **Under this concept, a much more limited recognition is intended than would be achieved by reference to the general materiality concept.**

  In this context, then, materiality should be considered in terms of the importance of the inter-entity transaction to the receiving entity. The importance of the transactions, and thereby their recognition, should be judged in light of the following factors:
- Significance to the entity—The cost of the good or service is large enough that management should be aware of the cost when making decisions.
- Directness of relationship to the entity's operations—The good or service provided is an integral part of and necessary to the output produced by the entity.
- Identifiability—The cost of the good or service provided to the entity can be matched to the entity with reasonable precision.

  The determination of whether the cost is material requires the exercise of considerable judgment, based on the specific facts and circumstances of each transaction.
- Broad, general support—Some entities provide broad, general support to many, if not all, reporting entities in the federal government. Most often this type of support involves the establishment of policies and/or the provision of general

guidance. The costs of such broad services should not be recognized as an expense (or asset) by the receiving entities when there is no reimbursement of costs. Thus the standard does not apply when support is of a general nature provided to all or most entities of the federal government.

An example of this situation can be found in the Office of Management and Budget which establishes policy and provides general guidance to all parts of the executive branch of government. The costs of OMB should not be spread over all reporting entities because the services provided are (1) general and broad in scope, (2) provided to almost all reporting entities in the executive branch, and (3) not specifically or directly tied to the receiving entity's outputs.

On the other hand, some services provided, under certain circumstances, should still be recognized even though they may be considered broad and general in nature if such services are integral to the operations of the receiving entity. Such services include check writing by the Department of Treasury or legal activities performed by the Department of Justice. For example, when the issuance of checks is integral to the operations of an entity (e.g., the Internal Revenue Service and the Social Security Administration), the receiving entity should include the full cost of issuing checks in the full cost of its outputs. However, if the issuance of checks is insignificant and incidental to the operations of an entity, the entity should not normally recognize that cost.

113. The decision as to whether the cost of non-reimbursed or under-reimbursed goods and services should be recognized requires the use of judgement. None of the criteria listed above are, by themselves, fully or exclusively determinative. They should be considered in combination. Ultimately, inclusion or exclusion of the cost should be decided based on the specific facts and circumstances of each case, with consideration of the degree to which inclusion or exclusion would change or influence the actions and decisions of a reasonable person relying on the information provided.

Accounting Example

114. The following tables provide an example of the accounting entries to be made when the receiving entity (Agency R) recognizes an expense for services received from a providing entity (Agency P) on a non-

reimbursable basis. In the example, the full costs of these services to Agency P are $100,000.

115. Agency R recognizes an "Expense of services provided by Agency P" equal to the full cost of the services received. It also recognizes a financing source, "Services provided by Agency P," equal to the amount not reimbursed, which in this case is the full $100,000. Agency P recognizes an "Expense of services provided to Agency R" equal to the full cost of the services provided with a credit to "Appropriations used."

Table 1: Agency R's Accounting Entries*

	Debit	Credit
Expense of services provided by Agency P	$100,000	
Services provided by Agency P		$100,000

Note: This example shows the cost recognized as an expense. However, as discussed in the text, it may be an asset.

Table 2: Agency P's Accounting Entries

	Debit	Credit
Expense of services provided by Agency R	$100,000	
Appropriated capital		$100,000
Fund balance with Treasury	$100,000	
Appropriated capital used		$100,000

Costing Methodology

Costs of resources consumed by responsibility segments should be accumulated by type of resource. Outputs produced by responsibility segments should be accumulated and, if practicable, measured in units. The full costs of resources that directly or indirectly contribute to the production of outputs should be assigned to outputs through costing methodologies or cost finding techniques that are most appropriate to the segment's operating environment and should be followed consistently.

The cost assignments should be performed by the following methods listed in the order of preference: (a) directly tracing costs wherever feasible and economically practicable, (b) assigning costs on a cause-and-effect basis, or (c) allocating costs on a reasonable and consistent basis.

116. This standard addresses two aspects of costing: cost accumulation and cost assignment. Each of them is explained and discussed below.

Cost Accumulation

117. Cost accumulation is the process of collecting cost data in an organized way. The standard requires that costs be accumulated by responsibility segments. The accumulation is for costs incurred within each responsibility segment, and does not involve the assignment or allocation of costs incurred by other supporting segments, which will be discussed in the latter part of this section.

118. In the section of this document relating to "Responsibility segments," it was explained that: "A responsibility segment is a component of a reporting entity, that is responsible for carrying out a mission, conducting a major line of activity, or producing one or a group of related products or services." The accumulation of costs by responsibility segments does not mean that each responsibility segment must have its own accounting system. The reporting entity may have a centralized accounting system, but the system should be capable of identifying costs with responsibility segments.

119. This standard also requires that the accumulated costs be classified by type of resource, such as costs of employees, materials, capital, utilities, rent, etc. When appropriate and cost effective, information on quantitative units related to various cost categories should be maintained. For example, staff-days may be reported for staff salaries and benefits, and gallons of gasoline consumed for gasoline costs. The quantitative units are useful for cost assignments, and are indispensable for measuring efficiency in using resources.

Cost Assignment

120. The term "cost assignment" refers to the process that identifies accumulated costs with reporting periods and cost objects. The assignment of costs to time periods is to recognize costs either as expenses or assets for each reporting period. It is governed by accounting standards on recognition of assets and expenses, and will not be addressed in this document. This section addresses cost assignment to cost objects. The word "assignment" used in this document includes various methods of attributing costs, such as direct tracing, cause-and-effect basis, and cost allocations.

121. The term "cost object" refers to an activity or item whose cost is to be measured.[34] In a broad sense, a cost object can be an organizational division, program, activity, task, product, service, or customer. However, the purpose of cost accounting by a responsibility segment is to measure the costs of its outputs. Thus, the final cost objects of a responsibility segment are its outputs: the services or products that the segment produces and delivers, the missions or tasks that the segment performs, or the customers or markets that the responsibility segment serves. There may be intermediate cost objects that are used in the course of the cost assignment process.

122. Some responsibility segments of an entity may provide supporting services or deliver intermediate products to other segments within the same entity. The costs of the supporting services and intermediate products should be assigned to the segments that receive the services and products. This is referred to as the intra-entity cost assignments. Also, in accordance with the inter-entity cost standard discussed in the preceding section, an entity should recognize inter-entity costs for goods and services received from other federal entities. The inter-entity costs should also be assigned to the responsibility segments that use the inter-entity services and products.

123. Thus, with respect to each responsibility segment, the costs that are to be assigned to outputs include: (a) direct and indirect costs incurred within the responsibility segment, (b) costs of other responsibility segments that are assigned to the segment, and (c) inter-entity costs recognized by the receiving entity and assigned to the segment. If a

[34]Some literature, the CASB pronouncements for example, use the term "cost objective" for the same meaning.

responsibility segment produces one kind of output only, costs of resources used to produce the output are assigned to the output.

124. This standard is intended to establish a principle, rather than a methodology, for cost assignment. Also cost assignments may be performed in cost findings and studies or may be performed within a system on a regular basis. In principle, costs should be assigned to outputs in one of the methods listed below in the order of preference:

(a) Directly tracing costs wherever economically feasible;

(b) Assigning costs on a cause-and-effect basis; and

(c) Allocating costs on a reasonable and consistent basis.

125. These principles apply to all levels of cost assignments including: (1) assigning inter-entity costs to segments, (2) assigning the costs of support services and intermediate products among segments of an entity (the intra-entity cost assignments), and (3) assigning direct and indirect costs to outputs.

Directly tracing costs to outputs

126. Direct tracing applies to resources that are directly used in the production of an output. Examples of such resources include materials that are used in the production, employees who directly worked on the output, facilities and equipment used exclusively in the production of the output, and goods or services received from other entities that are directly used in the production of the output.

127. The method of direct cost tracing usually relies on the observation, counting, and/or recording of the consumption of resource units, such as staff hours or days that are spent on a project or assignment, or gallons of fuel consumed in a transport mission. Direct tracing also applies to specific resources that are dedicated to particular outputs.

128. Direct cost tracing often minimizes distortion and ensures accuracy in cost assignments. However, it can be a relatively costly process. It should be applied only to items that account for a substantial portion of the cost of an output and only when it is economically feasible. For example, it is usually unnecessary to trace the cost of office supplies (pens, papers, computer disks, etc.) to various activities or outputs.

The cost of so doing usually outweighs the benefit of the increased accuracy in assigning the resources.

Assigning costs on a cause-and-effect basis

129. For the costs that are not directly traced to outputs, it is preferable that they be assigned to them on a cause-and-effect basis. As mentioned earlier, the ultimate cost objects of a responsibility segment are its outputs. For costs that are not traced to the ultimate objects (outputs), intermediate objects can be established as links between resource costs and outputs. The links reflect a cause-and-effect relationship between resource costs and outputs. Costs that have a similar cause-and-effect relationship to outputs can be grouped into cost pools. (This similar relationship is referred to in some literature as the "cost pool homogeneity concept.")

130. Activities or work elements that contribute to or support the production of outputs are commonly used as intermediate objects. This is based on the premise that on one hand, outputs require the performance of certain activities, and on the other hand the activities cause costs. Thus, an activity is considered a linkage between the cause and the effect. (See also, discussions on Activity-Based Costing later in this section.) In its policy statement, the Cost Accounting Standards Board expressed a similar view:

> "The preferred presentation of the relationship between the pooled cost and the benefiting cost objectives is a measure of the activity (input) of the function or functions represented by the pool of cost. This relationship can be measured in circumstances where there is direct and definitive relationship between the function or functions and the benefiting cost objectives."[35]

131. For example, a computer technology department provides technical support to other departments of an organization. The costs of the department may be assigned to other departments on a cause-and-effect basis through two steps. In the first step, the costs are assigned to the activities of the department, such as hardware installation and maintenance, software design and installation, or programming adjustments. In the second step, the costs of these activities are

[35]Cost Accounting Standards Board, Restatement of Objectives, Policies and Concepts, par. 2915.

further assigned to other departments based on their consumption of the technical services.

132. Sometimes, an intermediate product, rather than an activity, can be used as a link between the costs and outputs. For example, a hospital laboratory's costs can first be assigned to various medical tests it runs. The costs of the tests can then be assigned to the operating units of the hospital that ordered the tests.

Allocating costs

133. Sometimes, it might not be economically feasible to directly trace or assign costs on a cause-and-effect basis. These may include general management and support costs, depreciation, rent, maintenance, security, and utilities associated with facilities that are commonly used by various segments.

134. These supporting costs can be allocated to segments and outputs on a prorated basis. The cost allocations may involve two steps. The first step allocates the costs of support services to segments, and the second step allocates those costs to the outputs of each segment. The cost allocations are usually based on a relevant common denominator such as the number of employees, square footage of office space, or the amount of direct costs incurred in segments.

135. Suppose the total cost of a personnel department for a fiscal year is $500,000, and it is allocated to two segments based on the number of employees of the two segments: segment A has 300 employees, and segment B has 200 employees. On the prorated basis, segment A should be allocated 60 percent, or $300,000 of the personnel cost, and segment B should be allocated 40 percent, or $200,000 of the personnel department cost. The allocation is shown below:

Table 3: The Allocation of the Personnel Dept. Costs

Segment	Employees	Percent	Allocated amount
A	300	60	$300,000
B	200	40	$200,000
Total	**500**	**100**	**$500,000**

136. For cost allocation purposes, indirect costs may be grouped into pools, and each pool is subject to one allocation base. Costs grouped into one pool should have similar characteristics. The allocation base should be used consistently to allow cost comparison from one period to another.

137. Cost allocation is a relatively simple method of assigning indirect costs to cost objects. Users of the cost information should be aware that distortions in product costing often result from arbitrary cost allocations. In most cases, there is little correlation between an indirect cost and the allocation base, and the allocation is arbitrary. To assist cost analyses and cost findings, cost accounting should segregate costs that are traced or assigned to outputs from costs that are allocated to outputs.

Assigning common costs

138. Facility and personnel resources may be shared by two or more activities either at the same time or in different times during a fiscal year. For example, a military aircraft maintained for war readiness may be used in peacetime to transport cargo. As another example, a plant may be used to process two or more products.

139. The cost assignment principles discussed in this section should apply to assigning costs to activities or outputs that share the use of resources. Costs that can be traced to each of the activities (or outputs) should be assigned to them directly. These include direct operating costs of each of the activities. For the military aircraft used in peacetime to transport cargo, for example, the costs of fuel and supplies, additional personnel who worked on the cargo, and other costs incidental to the transportation should be directly assigned to the transportation services.

140. To determine the full cost of each of the activities or outputs that share resources, indirect common costs should be assigned to those activities. The term "common costs" refers to the costs of maintaining and operating facilities and other resources that cannot be directly traced to any one of the activities or outputs that share the resources.[36]

[36]This definition is adapted from Statement No. 1 on Management Accounting: Management Accounting Glossary, published by the National Association of Accountants (Montvale, New Jersey: 1991), page 15.

Common costs should be assigned to activities either on a cause-and-effect basis, if feasible, or through reasonable allocations.

141. Sometimes management may find it useful to designate primary and secondary activities that share resources. Primary activity is the primary purpose or mission for which the resources are made available. Secondary activities are those activities that are performed only if they will not interfere with the primary activity. Management can then determine two types of costs: (1) the costs that are necessary for the primary activity and are unavoidable even without the secondary activities, and (2) the costs that are caused by the secondary activities and are incremental to the costs of the primary activity. This type of cost information can be produced through cost findings, and may help management in making resource allocation and capacity utilization decisions.

Cost-benefit considerations

142. Throughout the discussions of this section, it is stated that a cost accumulation and assignment method would be used when it is economically feasible. A method is economically feasible if the benefits resulting from implementing the method outweigh its costs. It is not advantageous to use a costing method if it requires a large amount of resources and yet produces information of little value to users.

143. As a general rule, directly tracing costs and assigning costs on a cause-and-effect basis are more expensive than cost allocations, because they require detailed analyses and record-keeping for costs and activities. However, they are preferable because they produce more reliable cost information than cost allocations.

Selecting A Costing Methodology

144. This standard does not require the use of a particular type of costing system or costing methodology. Federal entities are engaged in a broad range of diverse operations. A costing system appropriate for one type of operation may not be appropriate for other operations. At many federal agencies, cost accounting practices are either relatively new or experimental. It is too early to tell which cost systems are best for specific types of operations. As experience and research in cost accounting progress, reporting entities and responsibility segments may find a preferred costing methodology for their operations.

145. Agency and program management is in the best position to select a type of costing system that would meet its needs. In making the selection, management should evaluate alternative costing methods and select those that provide the best results under its operating environment.

146. The standard requires that a costing methodology, once adopted, be used consistently. Consistent use provides cost information that can be compared from year to year. However, this requirement does not preclude necessary improvements and refinements to the system or methodology, so long as the effect of any change is documented and explained. On the contrary, improvements are encouraged.

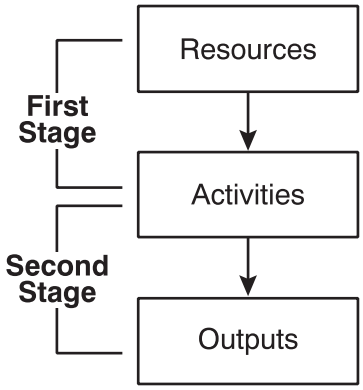
147. Several costing methodologies have been successful in the private sector and in some government entities. Four are briefly described below for agency consideration. It should be noted in particular that activity-based costing has gained broad acceptance by manufacturing and service industries as an effective managerial tool. Federal entities are encouraged to study its potential within their own operations. In the following paragraphs, activity-based costing will be introduced with other well known costing methodologies, namely job order costing and process costing. Standard costing is also mentioned as an important cost management tool. It is important to note that those costing methodologies are not mutually exclusive. Both activity-based costing and standard costing can be applied to job order or process costing systems.

Activity-based costing (ABC)

148. ABC focuses on the activities of a production cycle, based on the premises that (a) an output requires activities to produce, and (b) activities consume resources. ABC systems use cost drivers to assign costs through activities to outputs. The ABC cost assignment is a two-stage procedure. The first stage assigns the costs of resources to activities and the second stage assigns activity costs to outputs. The procedure is illustrated in the following figure.[37]

[37]The figure and the accompanying discussions are based on Robin Cooper, Robert S. Kaplan, Lawrence S. Maisel, Eileen Morrissey, and Ronald M. Oehm, Implementing Activity-Based Cost Management (Montvale, NJ: Institute of Management Accountants, 1992), pages 9-13.

Figure 2: The Activity-Based Two Stage Costing Procedure



149. Implementing an ABC system requires four major steps: (1) identify activities performed in a responsibility segment to produce outputs, (2) assign or map resources to the activities, (3) identify outputs for which the activities are performed, and (4) assign activity costs to the outputs. Each of the steps is briefly explained below.

(1) Identify activities. This step requires an in-depth analysis of the operating processes of each responsibility segment. Each process may consist of one or more activities required by outputs. Activities may be classified into unit-level, batch-level, product sustaining, and facility sustaining activities.[38] Management may combine related small activities into larger activities to avoid excessive costing efforts.

(2) Assign resource costs to activities. This step assigns resource costs to the activities identified in step 1. The resource costs include direct and indirect costs usually recorded in general ledger accounts. Depending on feasibility and cost-benefit considerations, resource costs may be assigned to activities in three ways: (a) direct tracing; (b) estimation based on surveys, interviews, or statistical sampling; or (c) allocations.

[38]Cooper, Kaplan, et al. page 20.

(3) Identify outputs. This step identifies all of the outputs for which activities are performed and resources are consumed by a responsibility segment. The outputs can be products, services, or customers (persons or entities to whom a federal agency is required to provide goods or services). Omitting any output would result in overcharging costs to other outputs.

(4) Assign activity costs to outputs. In this step, activity costs are assigned to outputs using activity drivers. Activity drivers assign activity costs to outputs based on individual outputs' consumption or demand for activities. For example, a driver may be the number of times an activity is performed in producing a specific type of output (the transaction driver), or the length of time an activity is performed (the duration driver).

150. ABC can be used in conjunction with job order costing or process costing. For example, making direct loans to the public involves a series of processes, such as loan origination, credit review for individual applicants, preparing loan documents, valuation of collateral, making loan disbursements, computing fees and periodic payments, keeping records, and making collections. These are the "first category" activities that directly affect individual loans. ABC can be applied to this category of activities.

151. The direct loan operations also involve "second category" activities, such as those performed by loan officers to review and assess a portfolio of loans and make policy changes that affect an entire portfolio. If ABC is not used, the costs of the loan officers may be allocated to direct loans based on the number of loans disbursed, or based on the staff hours spent on processing all the loans. However, such an allocation tends to be arbitrary, because some loans require more of their time than others. Under ABC, the costs of loan officers would first be assigned to their portfolio review and workout activities that they perform, then the activity costs would be assigned to the groups of loans for which the activities are performed.

152. A major advantage of using ABC is that it avoids or minimizes distortions in product costing that result from arbitrary allocations of indirect costs. By tracing costs through activities, ABC provides more accurate service or product costs. Experience in the private sector shows that by providing accurate cost measures, ABC has helped improve product costing, strategic pricing, and profit planning.

153. Also important is that ABC encourages management to evaluate the efficiency and cost-effectiveness of activities. Some ABC systems rank activities by the degree to which they add value to the organization or its outputs. Managers use such value rankings to focus their cost reduction programs. ABC encourages management to identify and examine (a) what activities are really needed (value-added activities) in order to accomplish a mission, deliver a service, or meet customer demand, (b) how activities can be modified to achieve cost savings or product improvements, and (c) what activities do not actually add value to services or products (non-value-added activities). ABC integrates with cycle time analysis and value-added analysis.

Job order costing

154. Job order costing is a costing methodology that accumulates and assigns costs to discrete jobs. The word "jobs" refers to products, projects, assignments, or a group of similar outputs.

155. Each job has a number or code to accumulate costs. Resources spent are identified with the job code. Costs are traced to individual jobs to the extent economically feasible. Costs that cannot be directly traced are assigned to jobs either on a cause-and-effect basis or allocation basis.

156. Job order costing is appropriate for responsibility segments that produce special order products, or perform projects and assignments that differ in duration, complexity, or input requirements. Typical situations in the federal government in which job order costing would be appropriate are legal cases, audit assignments, research projects, and repair work for ships, aircraft, or vehicles.

Process costing

157. Process costing is a method that accumulates costs by individual processing divisions (organization divisions that perform production processes). These processing divisions are involved in a continuous production flow, with each division contributing towards the completion of the end products. The output of a processing division either becomes the input of the next processing division or becomes a part of the end product.

158. Each division accumulates costs, assigns the costs to its outputs, and calculates the unit cost of its output. For each period, divisions prepare a cost and production report, showing the costs, the completed units, and the work-in-process volume. When a certain number of completed units are transferred from a division to the next division, the costs of those units are also transferred and are eventually incorporated into the costs of the end product. Thus, the cost flow follows the physical flow of the production. The unit cost of the end product is the sum of the unit costs of all the divisions.

159. Process costing is appropriate for production of goods or services with the following characteristics: (a) the production involves a regular pattern of process, (b) its output consists of homogeneous units, and (c) all units are produced through the same process procedures. In the private sector, process costing is used by such industries as flour mills, steel foundries, oil refineries, and chemical processing plants. In government, it may be used by some activities that involve repetitive process procedures to deliver a large volume of similar goods or services. An example would be making entitlement benefit payments, which involves a series of consecutive processes for reviewing applications to establish their eligibility, computing the amount of benefits, and issuing checks.

Standard costing

160. Standard costs are carefully predetermined or expected costs that can be applied to activities, services, or products on a per unit basis. Horngren describes standard costing as follows:

> "A set of standards outlines how a task should be accomplished in nonfinancial terms (minutes, board feet) and how much it should cost. As work is being done, actual costs incurred are compared with standard costs for various tasks or activities to reveal variances. This feedback helps discover better ways of adhering to standards, of altering standards, and of accomplishing objectives."[39]

161. Many organizations frequently review and update the standards to assure that they encourage improvements in efficiency and are within an attainable range.

[39]Horngren, Charles T. and George Foster, Cost Accounting, A Managerial Emphasis, 7th ed. (Prentice Hall, Englewood Cliffs: New Jersey, 1991), page 222.

162. Standard costing helps managers to formulate budgets, control costs, and measure performance. It can be used in conjunction with job order costing, process costing, and activity-based costing. It can be applied to specific outputs or activities, and it can also be applied to a responsibility segment in aggregate by comparing total actual costs with total standard costs based on outputs produced within a certain time period. Typical situations in the federal government in which standard costing would be appropriate are operations that produce services or products on a consistently repetitive basis. Agencies are encouraged to use standard costing in those situations.

Appendix A: Basis For Conclusions

The Nature of Concepts and Standards

163. The difference between accounting concepts and standards is significant. Statements of concepts are more general than statements of standards. Standards are intended to be specific guidance and authoritative in nature. Concepts generally do not contain specific recommendations that would, when issued by the Board's sponsors, become authoritative requirements for federal agencies. Concepts, instead, provide general guidance both to the Board and others. They are also intended to help preparers and users of financial information better understand federal accounting and financial reporting. While the differences can be easily stated, in reality the line between concepts and standards is often broad and presents many gray areas for interpretation.

164. When the Board began the project on managerial cost accounting, it anticipated the issuance of a recommended Statement of Concepts. Given the meager use of cost accounting within many federal agencies, a Statement of Concepts would provide both the Board and preparers of federal financial reports with overall guidance in the area and an indication of the future direction the Board might take in developing standards. However, as the Board and staff began working on the project, it became clear that action was needed to recommend standards for the development of cost information.

165. Cost accounting standards were needed because users of financial information, especially taxpayers and members of Congress, began putting more emphasis on the cost of government programs, products, and activities. The efforts to reduce government spending, control the deficit, and improve government functions necessitated information about the true costs of government. In addition, passage of the CFO Act and the GPRA required agencies to provide cost information as a part of improving their financial management and reporting. Furthermore, the NPR issued a recommendation that the Board move rapidly to recommend cost accounting standards.

166. The Board established the Cost Accounting Task Force to provide advise and guidance on the cost accounting project. On the task force

were many individuals knowledgeable about cost accounting in the private sector as well as the limited federal cost accounting activities. The task force also recommended the establishment of cost accounting standards.

167. The Board issued the exposure draft as a recommended statement of standards. The Board knew, however, that since cost accounting is relatively new in the federal environment, the final statement necessarily would contain some conceptual material. Although the exposure draft did not present any direct questions concerning whether parts of the draft should be viewed as concepts, the issue did arise in public hearings held in November 1994, and January 1995. In addition, a few respondents who mailed in their comments addressed the point.

168. Most of those commenting on the issue stated that they viewed the exposure draft as being somewhat conceptual in nature. Many of those thought that this was appropriate and supported the document and the conceptual material it presented. A few respondents were concerned about the ability to audit some of the standards because of the conceptual nature of the document. Several suggested that the final statement be segregated into concepts and standards and both be issued in one statement.

169. The Board decided that some parts of the final statement would contain information that should be presented as concepts while other parts would be better presented as standards. Therefore, the final statement should be a "hybrid" issuance containing both concepts and standards. The title of the document was changed to "Managerial Cost Accounting Concepts and Standards for the Federal Government." (The Board decided that the material presented in the exposure draft as the first standard that addressed the relationship among managerial cost accounting, financial reporting, and budgeting should be presented as concepts. The other materials were more in the nature of standards.)

Relationship Among Cost Accounting, Financial Reporting, And Budgeting

170. The Board considers it important for financial preparers and users of financial reports to understand the relationship of cost accounting to the more traditional areas of general financial accounting, financial reporting, and budgeting. It views cost accounting as a basic and integral part of an entity's financial management system. Therefore,

the Board included a standard on this relationship within the exposure draft.

171. The standard addressed the role of managerial cost accounting in financial management and explained how it provides cost information relevant to budgeting, financial reporting, management control, and many decision making processes. The standard discussed the use of a common data source for cost accounting, financial accounting, and budgeting. It explained how the costs may be determined using different bases of accounting and different recognition and measurement methods depending upon the intended use of the information. It also emphasized the need for reconciliation of cost data which may be presented differently in various financial reports. The standard stated that all cost information, regardless of how presented, should be traceable back to the original common data source.

172. Most exposure draft respondents who provided comments on this standard stated that the level of detail presented was about right given the desire of the Board to address cost accounting at a high level. Most respondents agreed with the need to draw cost accounting data from a common data source that is also the source of financial and budgetary data. Some respondents were concerned that the use of the term "data source" was too closely allied with automated or computerized operations and that the term may be misinterpreted. The Board, however, believes that the term is adequately explained. In fact, the exposure draft clearly stated that this term was not meant to imply the use of computerized systems for source information.

173. Data reconciliation for reports containing cost information developed on different bases of accounting or using different recognition or measurement methods received overwhelming support from respondents to the exposure draft. They said that the ability to reconcile differing cost information is necessary to ensure data integrity, avoid confusion on the part of financial statement users, and support stewardship responsibilities.

174. Many who commented on whether the exposure draft should be viewed as a statement of concepts or a statement of standards implied that this particular standard on relationships of cost accounting to other financial management functions was basically conceptual in nature. The Board agreed and concluded that this section is more in

the nature of an explanation of how cost accounting provides useful information and how it fits in with the overall financial management system as opposed to a standard which places a requirement on an entity. The Board decided that this material would be better presented in the final statement as recommended concepts.

Requirement For Cost Accounting

175. The cost accounting task force recommended that a standard be included in the exposure draft requiring each reporting entity to establish cost accounting systems and procedures for its activities. They believed this was necessary to ensure the generation of required cost information.

176. The Board agreed to include the standard in the exposure draft. The standard defined "system" in a broad way as simply an organized grouping of methods and activities designed to consistently produce reliable cost information. The explanations and discussions section of the exposure draft contained information on several factors that would help managers decide how complex and sophisticated their cost accounting system should be. It noted that the system could be constrained by the (1) nature of the entity's operations, (2) precision needed in cost information, (3) practicality of data collection and processing, (4) availability of electronic data handling, (5) expected cost of the system itself, and (6) any specific management information needs.

177. The exposure draft also listed ten minimum criteria that should be met by all managerial cost accounting systems. Four of these were related directly to the other standards in the exposure draft (responsibility segments, full costing, costing methodology, and unused capacity costs). The six remaining criteria were concerned with ensuring that the cost data produced was reliable, consistent, and useful. These criteria were (1) ensuring the ability to assist in measurement of performance, (2) reporting information on a timely and consistent basis, (3) integrating cost accounting with the standard general ledger, (4) determining a reasonable and useful level of data precision, (5) accommodating special information needs of management, and (6) documenting the system through a manual or handbook. The standard also allowed for the use of cost finding techniques and special cost studies or analyses.

178. A large number of respondents to the exposure draft supported the requirement for cost accounting systems. They stated that such a requirement is necessary to ensure that appropriate cost data are recorded. They also said that having a requirement for cost systems will help agencies to more easily meet the requirements of the CFO Act and the GPRA. Some qualified their support by stating that the standard should allow an exemption for small entities since establishment of a full cost accounting system may not be cost-beneficial to them. The Board decided that such an exemption would be inappropriate since the standards should apply to all federal activities. Furthermore, it should be far easier for small entities to perform managerial cost accounting in most cases.

179. Those who were negative toward the standard provided several reasons. Several expressed concern about whether accounting standard-setting bodies should require or determine how accounting data are produced. They noted that other accounting standard-setting organizations have stated only what information is required and how that information is displayed in financial statements, not how the information is developed.

180. The Board believes that it should not be constrained by what other standard-setters do. Other standard-setters so far have concerned themselves mainly with entities' external reporting. This is understandable because their mission is to assure that the financial position and results of operations are presented in a fair, reliable, and consistent manner to financial statement users who are external to the reporting entity.

181. FASAB is different in that it has determined that some of the users of federal government financial reports are internal to the government. Given the nature and size of the federal government, internal users often do not have the same type of access to cost information that may be available in commercial enterprises. In addition, the Board views cost accounting information as vital to both internal and external users. The Board has previously determined in its *Objectives of Financial Reporting* that cost information should be reported to meet the needs of Congress, federal executives, and others.

182. Some respondents to the exposure draft were concerned that the requirement for a cost accounting system, along with the system criteria, would not allow management enough flexibility. They seemed

to consider the requirement for a system to mean that cost accounting activities had to be automated with computers and that software had to be developed and employed in a "full-blown" system, as one put it. They believe that such an elaborate system may not be needed in some cases where informal procedures or methods would suffice.

183. The Board does not intend to prescribe an elaborate managerial cost accounting system for every federal organization. It believed that the standard proposed in the ED was sufficiently broad to allow managerial flexibility in the system design. However, the Board does recognize that the term "system" may connotate to some a requirement for computerization and sophisticated methodologies.

184. Others stated that establishing the requirement for cost systems should be the responsibility of OMB or JFMIP. Some of the respondents were concerned about the degree to which the standard may overlap with JFMIP's responsibility to set requirements for cost accounting systems. The NPR recommends setting requirements for cost accounting systems as a responsibility of JFMIP, while asking the Board to provide the cost accounting standards.[40]

185. The Board proposed the requirement for systems to ensure that cost information is produced and reported in a reliable and consistent manner, and emphasized that this was the intent. The point is not whether the information is produced through the use of a system or through other techniques. The Board believes that, in many cases, cost accounting systems will be established as a natural consequence of requiring cost information. Many government agencies are very large and complex organizations, and it is unrealistic to think that they can develop cost data without relying on a system to do so. Other small agencies or reporting entities may not need a system to develop cost data in a regular, consistent, and reliable manner.

186. The Board, therefore, changed the standard to emphasize producing cost accounting information in a reliable and consistent manner. This can be done through the use of cost accounting systems or cost finding techniques. In either case, the main intent of the original standard is preserved. In addition, the concerns expressed over whether the

[40]Office of the Vice President, Improving Financial Management, Accompanying Report of the National Performance Review (September 1993), page 24.

Board or some other organization should establish the requirement for cost "systems" are solved.

Responsibility Segments

187. As stated in the ED, a responsibility segment is a component of a reporting entity that is responsible for carrying out a mission, conducting a major line of activity, or producing one or a group of related products or services.

188. The proposal for using responsibility segments in the ED was based on the view that most federal departments and agencies are engaged in more than one line of activity, or producing more than one type of service or product. Furthermore, the activities that an agency performs may differ from each other significantly in required resources and operations. The ED used the Department of Veterans Affairs (VA) as an example. Among its activities, VA administers hospitals and nursing homes to provide health care to veterans, and it also administers direct home loan and loan guarantee programs. These lines of activities are significantly different in operation patterns. The Board believes that for entities that are engaged in diverse activities, identifying responsibility segments is necessary for identifying resources consumed by a distinct line of activity with the outputs of that activity.

189. A majority of respondents supported the requirement for responsibility segments and agreed with the advantages of the requirement. They expressed the view that segmentation provides a basic framework to trace and assign costs to outputs. They also believed that segmentation provides management with the flexibility of choosing a costing methodology that is best suited for a line of activity. The respondents also stated that information generated by responsibility segments can be used to measure performance and to assess accountability.

190. Several respondents, however, presented arguments against using responsibility segments. One such argument was that responsibility segments would constitute an unnecessary layer that conflicts with financial reporting and budgeting systems. The Board disagrees with this view. A responsibility segment is not, and should not be, an additional layer to the organization and the budget structure. It is an accounting mechanism to capture data generated in operations by various components of an organization in its existing structure.

Organization and budget structures can be changed for better management but not for the sake of accounting. Accounting may influence but cannot dictate such changes.

191. The Board believes that accounting by segment will help provide information useful to program managers and other users of financial reports. Entity-wide financial reports provide information on the overall financial position and operating results of an entity in aggregate. Such reports, although useful for many purposes, are not sufficient for cost management. A fundamental undertaking of managerial cost accounting is to match costs with activities and outputs. The purpose of segmentation is to segregate entity-wide data by major lines of activities and their outputs. Information related to each segment should tell managers and other users of financial reports about the segment's specific outputs, the activities performed, and resources consumed to produce the outputs.

192. Furthermore, segment-based reporting need not be in conflict with entity-wide financial reporting. They can use a common source of data, such as accounting data collected by the standard general ledger or the budget execution reports. To perform segment-based accounting and reporting, the general accounting or budget execution data can be traced and assigned to segments. The Statement of Federal Financial Accounting Concepts No. 2, *Entity and Display*, discusses a reporting approach similar to the segment-based accounting and reporting:

> "With some organizations, and even suborganizations, the activities of one or more programs or other components are as important to the readers of financial statements as are activities of the entity as a whole. This would be particularly true for a department composed of many bureaus, administrations, agencies, services, etc., and particularly if their programs are dissimilar. In those instances, consideration should be given to the preferability of reporting the assets, liabilities, revenues, expenses, etc., of both the significant components individually and of the entity in its entirety."[41]

193. Another argument against requiring responsibility segments was that the requirement is overly prescriptive and would constrain agency management from selecting among various cost collection methods. The Board believes the standard gives management adequate flexibility in structuring cost accounting. As the standard states, it is

[41]FASAB Statement of Recommended Accounting Concepts 2, *Entity and Display*, par. 75.

for the management of each entity to decide how segments should be defined, and how similar products and services can be grouped into one segment.

194. Furthermore, segments are the largest components of an entity. Management has the flexibility to use any cost collection method within each segment. Within a segment, management may define sub-units, functions, projects, business processes, activities, or a combination of them as cost centers to accumulate costs. The costs accumulated at lower levels can then be aggregated to the segment level.

195. In fact, a segment may contain multiple levels of responsibility or cost centers. For example, if veterans health care is defined as one of the DVA's responsibility segments, this segment may define its hospitals, clinics, and nursing homes as responsibility centers. Each hospital, clinic, and nursing home may further define their functional units, activities, or business processes as cost centers.

196. Some respondents correctly pointed out that requiring broad responsibility segments, rather than prescribing traditional cost centers, provides opportunity for entities to use activity-based costing or any other costing methods that they may find appropriate.

197. Several respondents who supported the use of responsibility segments interpreted the wording of the proposed standard as requiring that each segment perform managerial cost accounting. They pointed out that for some entities, it is more effective and economical to perform centralized managerial cost accounting. Such centralized accounting is capable of accumulating costs by segments and assigning costs among them. The respondents requested that the wording be revised to provide this flexibility.

198. The Board agrees with this request. The Board believes that entity management should have the discretion to decide whether managerial cost accounting is performed at the entity or segment level, so long as the segment cost information is provided to managers and other users. Thus, the standard recommended in this statement does not require that responsibility segments perform managerial cost accounting.

Full Cost

199. As stated in the ED, the full cost of an output produced by a responsibility segment is the sum of direct and indirect costs that contribute to the output, including the costs of supporting services provided by other segments and entities.

200. The outputs of a responsibility segment are considered as cost objects.[42] However, in most circumstances, the full costs of intermediate objects, such as activities, processes, projects, programs, or organization units, must also be measured in order to derive the full costs of their outputs. (See ED Par. 173) The full cost information related to outputs as well as those intermediate objects are useful in measuring efficiency and cost-effectiveness.

Usefulness of full cost information

201. **Program evaluation and authorization.** Most respondents supported the full cost standard. They recognized that it is particularly important to determine and report the full cost of a program. Information on full costs of programs can be used in program evaluations. Such evaluations typically relate the full costs of programs to their outputs and outcomes. Decision-makers in the Congress and the federal government at all levels as well as the public should be provided with information on the full costs of programs and their outputs. The full cost information, when used with information on program outputs and outcomes, can aid the Congress and federal executives in making decisions on program authorization and modifications.

202. **Cost awareness.** Most respondents also agreed that the standard has the advantage of promoting cost awareness. Entity and segment managers should be aware of the costs that are incurred or assigned to their operations. Without the awareness, managing and controlling costs are impossible. The full cost information has not been available and will not likely to be without an accounting standard requiring it.

203. **Setting fees and prices for government goods and services.** Many respondents agreed that full cost should be considered as a primary basis for setting fees and reimbursements for government goods and services. As pointed out in the ED, it is a federal policy that,

[42]"Cost object" is defined as an activity, output, or item whose cost is to be measured. In a broad sense, a cost object can be an organizational division, a function, task, product, service, or a customer. See Glossary.

with certain exceptions, user charges (prices or fees) should be sufficient to recover the full cost of goods, services, and resources provided by the federal government as sovereign.[43] The policy further states that when the government sells goods and services under business-like conditions rather than in a sovereign capacity, user charges should be based on market prices and may yield a net revenue in excess of the full cost. The objectives of the policy are to: (1) ensure that government goods and services are provided on a self-sustaining basis, (2) promote efficient allocation of national resources, and (3) allow fair competition with comparable goods and services provided by the private sector.

204. To implement the policy, full cost information is necessary. Only with reliable full cost information can management ensure that user charges fully recover the costs.[44] Even in some exceptional cases in which user charges are exempted or restricted by law, agencies that provide the goods and services would nevertheless need the full cost information to assess the extent to which costs are not recovered.

205. **Making cost comparisons.** Respondents agreed that the full cost of outputs provides a valid basis for cost comparisons. One of them emphasized the importance of calculating the unit cost of output on the full cost basis. The Board agrees with his view. If an output can be measured in units, its unit cost should be calculated on the full cost basis.

206. The unit cost of a service or product, calculated on a full cost basis, can be compared with a similar service or product produced by other entities either in the federal government or in the private sector. The comparison would not be valid if it is not conducted on a full cost basis.

[43]OMB Circular No. A-25, User Charges.

[44]The standard of determining full cost discussed in this document, however, should not be construed as a standard for setting fees, prices, and reimbursements. Federal entities should comply with laws and regulations related to pricing policies in general and for specific types of goods and services. Those laws and regulations (including OMB Circular A-25) may prescribe costing requirements other than the full cost standard discussed in this document. Full cost defined by this standard can serve as a point of reference for managerial decisions. However, it is not intended to supersede any costing concept that management is required or permitted by law to use in pricing goods and services.

207. One of the available cost management tools is trend analysis. In trend analysis, unit costs of a service or product over a number of consecutive periods are examined to find a trend of increases or decreases. This analysis can be valid only when the unit costs of all periods are measured on a consistent basis, such as the full cost basis. When the full cost basis is used, the analyst can further examine the components of the unit cost, such as direct labor and material costs, overhead costs, and costs of services received from other segments or entities. Through examining the various components of the full unit cost, program managers can pinpoint specific areas that contributed to cost increases or decreases.

208. If activity-based costing is used, the cost components would be associated with activities. The trend analysis for activity-based cost components can provide information related to the efficiency of the activities. Managers can also analyze the extent that the individual activities add value to program outputs and objectives.

Limitations of Full Cost Information

209. Several respondents cautioned the Board against "uncritical advocacy" of full costs. They pointed out that full cost is not relevant to all decision-making situations. They explained that some decisions require other cost concepts such as variable, differential, or incremental costs. Thus, some of them said that the Board should not singularly emphasize full cost.

210. The Board is aware of the notion that different cost concepts should be used for different purposes so that the use of a cost concept is relevant to a particular decision-making purpose. For this reason, the Board discussed the limitations and usefulness of full cost in the ED at length. (See ED pars 133 through 146.) Quoting from Anthony and Young, the ED pointed out that full costs are not appropriate for alternative choice decisions such as the decision to (1) add or drop a product or service, (2) perform work in-house or contract out for it, and (3) accept or reject a special request. For these decisions, the appropriate information is differential costs.[45]

211. However, the full cost standard is an accounting standard, rather than a cost analysis or decision-making standard. It requires that full cost

[45]Robert N. Anthony and David W. Young, Management Control in Nonprofit Organizations, 5th ed. (Burr Ridge, Illinois: Richard D. Irwin Co., 1994) page 235.

information be compiled and reported through cost accounting. In no way does it limit cost analysts and decision-makers to the use of full cost alone in all situations. The Board believes that when the full cost information, instead of any portion of it, is made available, analysts and decision-makers will have a comprehensive data source to develop the cost concepts that they need in their analyses.

212. Some respondents pointed out that full cost requires a complex process of cost assignments and allocations. The Board believes that the assignment of indirect costs is a necessary procedure to obtain full cost. It can be performed through an appropriate costing methodology. As discussed in the costing methodology section of the ED, some modern costing methodologies are available to make rational and reliable cost assignments. However, the Board must caution that the full cost information, like any other accounting information, can only be as good as how it is prepared. For example, it can be unreliable or inaccurate, if arbitrary or irrational cost allocations are used excessively. Thus, the Board recommended a costing methodology standard. Program managers should critically review costing methodologies and techniques used to derive the cost information.

Inclusion or Exclusion of Certain Costs

213. A number of respondents were opposed to the inclusion of accrued employee benefit costs and costs of services provided by other entities that are not reimbursed. (The subject of inter-entity costs will be discussed in the next section.) They argued that these costs are not funded with their budgetary resources and are beyond their control. A large portion of employee benefit costs, including accrued retirement benefit costs, are funded through appropriations to trust funds managed by OPM and DoD. The Board believes that as a principle, full cost should include the costs of all resources applied to a program, activity, and its outputs, regardless of funding sources. For financial reporting, the Board has stated its position that the full costs of employee pension and other retirement benefits determined on an actuarial basis, including the amounts that are funded to the trust funds directly, should be recognized as an expense in the employer entity's financial reports.[46] The Board does not find a good rationale to depart from this principle in managerial costing.

[46] FASAB Exposure Draft, *Accounting for Liabilities of the Federal Government* (Nov. 1994), pars. 80-99, pages 32-46.

214. The ED states that some costs should be recognized as a period expense rather than the costs of goods and services (output costs). Examples include the costs of "other post employment benefits" (OPEB), reorganization costs, and acquisition costs of Federal "mission" and "heritage" property, plant, and equipment which are recognized as expenses at the time of acquisition.[47] These costs will be recognized as expenses for the period in which the related events take place, and are referred to as "period expenses." The ED explained that since these expenses do not contribute to the outputs of the period in which they are incurred, they should not be included in the output costs.

215. The OPEB costs, for example, may be recognized as expenses for a period in which a reduction in force or an employee injury takes place.[48] It is not appropriate to attribute the entire OPEB costs to the output costs of that period. Several respondents expressed the view that OPEB costs should be included in full cost. There is no doubt that OPEB costs, as well as other period expenses, are part of the full cost of an entity or a program. They may also be part of the full costs of outputs over many years in which the employees contributed to the production of the outputs. However, they are not the production costs for the period during which they are incurred. Thus, the Board concluded that in cost studies, management may distribute some of the period expenses, such as OPEB costs, to outputs over a number of past periods if (a) experience shows that the OPEB costs are recurring in a regular pattern , and (b) a nexus can be established between the OPEB costs and the outputs produced in those past periods. The Board finds no reason to change this position.

216. Some respondents contended that full cost should include unused capacity costs. As will be explained in a later section on unused capacity costs, the Board has decided not to recommend a standard on measuring unused capacity costs. Thus, to assure valid cost comparisons, full costs should not exclude unused capacity costs.

[47] "Federal mission PP&E" and "heritage assets" are explained in FASAB Exposure Draft, *Accounting for Property, Plant, and Equipment* (February 28, 1995), pars. 98-115, pages 29-33.

[48] FASAB Exposure Draft, *Accounting for Liabilities of the Federal Government* (Nov. 7, 1994), pars. 100-102, pages 47-48.

Controllable and Uncontrollable Costs

217. Some respondents believed that the managers of a responsibility segment should be held accountable only for costs that they can control, and their performance should not be evaluated for costs beyond their control. They found that the full cost reporting would obscure the distinction between controllable and uncontrollable costs. For performance measurement or other purposes, some entities may want to make a distinction between controllable and uncontrollable costs with respect to an individual responsibility segment or a cost center. The full cost information need not interfere with this distinction. This standard does not require the use of full cost for internal reports. If some entities choose full cost for internal reporting, the internal reports can provide a distinction between controllable and uncontrollable costs with respect to individual segments.

218. Ultimately, most costs are controllable at a certain level of the entity. If some of them are not controllable at a lower level of the organization, they may very well be controllable at a higher level. Each segment should concern itself with the costs that are assigned to it on a cause-and-effect basis. These costs are often incurred because of a segment's demand and use of services from other segments or entities. Although the service-receiving segment has no control over the efficiency in producing the service, it can influence the costs by changing the demand for the service. For an entity's top management, full cost reporting provides it with an overview of how the entity's various costs, including the general and administrative costs, are incurred and assigned to the entity's segments. The full cost reporting also makes the entity's top management aware of the costs of services that it receives from other entities. The management can closely review those costs and determine whether actions are needed to control them.

Centralized Accounting

219. The proposed standard in the ED states that "Responsibility segments should be capable of measuring the full costs of their outputs." Several respondents stated that the full costs of segments, programs, and their outputs can be more effectively measured by entities through centralized accounting, rather than by individual segments. They further stated that it would not be cost-beneficial for segments to measure and report the full costs of their activities and outputs on a regular basis (such as monthly basis). The Board agrees that many entities may find it more economical and effective to measure full costs through centralized accounting. Moreover, the Board believes that it should be for entity management to decide as to how frequently

the full cost information should be made available in its internal reports. Thus, the wording of the standard has been changed. The full cost requirement is now limited to external reporting via general purpose financial reports.

Costs of Outcomes

220. A respondent suggested that in addition to the full cost of outputs, the standard should also require reporting the full cost of program outcomes. As discussed in the ED, the Board believes that performance measurement of a program requires three major elements: the full cost of the program, its outputs, and its outcomes. (See ED pars 37 and 38) The full cost of a program and its outputs, once measured according to this standard can be related to the outcome of the program to measure its cost effectiveness.

221. This standard does not require a direct measurement of the cost of outcomes because in most instances, program outcomes need to be measured with methodologies beyond those discussed in this document. GPRA defined "outcome measure" as an "assessment of the results of a program activity compared to its intended purpose."[49] Many programs' policy objectives and intended results are socio-economic or scientific in nature, or involve national defense. The assessment of the program results require expert knowledge in those areas. Thus, unlike costs and outputs, outcomes are not always measured in quantitative or monetary terms.

222. Moreover, unlike costs and outputs that are measured for each accounting and reporting period, such as a quarter or a year, outcome measurement may be long-term in nature. For example, the Senate Report on GPRA states that "Outcome measurement cannot be done until a program or project reaches a point of maturity (usually at least several years of full operation for programs continuing indefinitely) or at completion." Although all programs cost money, some of them may produce positive results, while others may produce no results or negative results.

223. Because of the complexities in measuring outcomes, the costing principles and methodologies discussed in this document cannot be used to measure the cost of outcomes. The Board believes that the full cost of a program and its outcome should be measured independently,

[49]The Government Performance and Results Act of 1993, PL 103-62, sec 4.

using methodologies appropriate to costs and to outcomes. Once each of them is measured, they can then be related to review the cost-effectiveness of the program.

Inter-entity Costs

224. It is not unusual in the federal government for one agency to provide goods or services to another agency. Sometimes this may be required by law, and often it is a very efficient method of conducting business for the agencies involved and for the government as a whole. In many cases, the agency receiving such goods or services will reimburse the providing agency in accordance with some agreed-upon price. Often, however, there is no charge, or there is a charge that is not sufficient to cover the providing agency's full cost. When such "free" or lower-than-cost items are used in the production of the receiving agency's outputs, the result can be an understatement of the full cost of final outputs by the receiving agency.

Survey of Non-Reimbursed Costs

225. The Board recognized that these non-reimbursed or under-reimbursed goods and services could distort the determination of a reporting entity's full cost of outputs, but it was uncertain of the extent to which this occurs. To identify examples of non-reimbursed inter-entity costs, the Board conducted a limited survey of federal agencies. Of the 22 agencies responding to the survey request, 13 indicated that they provide some type of service or good that is not reimbursed. These covered a wide range of activities, but most of the costs involved were for salaries and salary-related benefits of those employees performing the work. In most cases, the costs were funded through direct appropriations to the providing agencies; however, those agencies could not specifically identify the total amounts involved. Several provided estimates, which ranged from $360 thousand dollars per year to about $180 million per year. Several examples of non-reimbursed inter-entity activities identified in the survey are listed below by providing entity:

- Department of Agriculture -- Provides market data, pesticide data, food specification information, water supply forecasts, and other agricultural information. Thirty-six federal agencies regularly receive all or some of this information.

- Department of Commerce -- Provides accounting and grant administration services, computer access and reports, and consultation services to several agencies.

- Department of State -- Provides space and facilities for other agencies in its buildings in the U.S. and overseas.

- General Services Administration -- In some cases, it provides policy and regulatory development services, property management services, and contract award and administration to other agencies without reimbursement.

- National Science Foundation -- Administers a research grant program on engineering and computer science for the Department of Defense.

226. The Board noted that the survey was restricted to non-reimbursed costs between different agencies. As such, the results did not necessarily represent all of the kinds and amounts of transactions and costs between different reporting entities. The survey was also limited to those non-reimbursed costs which the agencies could easily identify in order to respond quickly to the questionnaire. Nevertheless, there were indications that some non-reimbursed costs may be significant in amount.

Usefulness of Recognition

227. Some respondents to the exposure draft stated that recognition of inter-entity[50] costs would have limited usefulness for managers since they cannot control the cost of items provided by other agencies. In some circumstances, they cannot control the amounts of inter-entity goods or services that must be used in the production of their outputs.

228. The Board realizes that recognition of non-reimbursed or under-reimbursed inter-entity costs will not always have the same degree of usefulness for all levels of management. However, as stated in the standard on full costs, to fully account for the costs of the goods and services they produce, reporting entities will need to include the cost of goods and services received from other entities. Cost reduction and control, performance evaluation, and process improvement depend on knowledge of the full costs of producing outputs, including production costs incurred by other federal entities. These costs are most

[50]Full cost, as discussed in the full cost standard, contemplates both intra-entity costs and inter-entity costs applicable to a responsibility segment. This standard elaborates on inter-entity costs. Intra-entity costing is accomplished through the costing methodology selected for use within the reporting entity since these costs are passed among responsibility segments.

important for use by the entity's top-level management (and to a lesser degree by line managers) in controlling and assessing the operating environment and in making decisions about how best to acquire those goods and services. Knowledge of full cost, including the extent of inter-entity costs, is also important to external users, especially the Congress and taxpayers, in making decisions concerning various programs and allocating resources throughout the government.

229. In addition, the Board believes that, without the recognition of non-reimbursed and under-reimbursed inter-entity costs, the receiving entity has little incentive to control the use of these resources. While they may appear to be "free" to the receiving entity, the costs are absorbed somewhere in the government. If the receiving entity were charged for these costs, top-level management would then have more incentive to economize and control the use of these resources as well as make better decisions concerning how and where to acquire them. This would help reduce overall costs to the taxpayer and provide the other benefits associated with full-costing by responsibility segment.

230. The recognition of all inter-entity costs is also important when an entity produces goods or services that are sold outside of the federal government. For the entity to recover the government's full cost on the sale, knowledge of the total cost, including costs incurred by other federal entities, is vital to the establishment of an appropriate price.

The Use of Estimates

231. The standard places the responsibility on the providing entity to supply the receiving entity with information on the full costs of non-reimbursed or under-reimbursed inter-entity goods and services. This is appropriate since only the providing entity is likely to have such information. Implementation of the standard on full costing should make this requirement fairly easy for the providing entity to fulfill. If, for some reason, the providing entity cannot or does not supply the cost information, the receiving entity has no way to recognize the costs other than through estimation.

232. The Board anticipated this possibility, and requires the receiving entity to use an estimate of the cost of those goods and services if the actual cost information is not provided. The estimate must be reasonable and should be aimed at determining realistic costs incurred by the providing entity. However, if such a cost estimate cannot be made, the receiving entity may base the estimate on the market value of the goods or services.

233. Some respondents to the exposure draft stated that the use of estimates would be too problematic and unreliable and that the receiving entity would not have enough information to make the estimate. Some were concerned that the use of estimates would cause arguments between reporting entities over the cost. Others were concerned that some entities do not have experienced personnel to make such estimates. A few were concerned about the audit implications of using an estimate.

234. Some respondents expressed concern over the possible use of market values in making the estimate. Some of these respondents stated that government-type goods and services are not often produced outside government and, therefore, such market values may not exist. Others stated that market value does not always bear a direct relationship to true cost or that market values change too rapidly to be of any use.

235. The Board realizes the problems associated with the use of estimates. However, implementation of the other managerial cost accounting standards in this statement by the providing entities should considerably lessen the need for receiving entities to make estimates of inter-entity costs. The Board also believes that, if the inter-entity costs meet the recognition criteria established by the standard, and cost information is not received, then use of a reasonable estimate of cost is preferable to no recognition at all.

236. Estimates are often used in accounting and financial reporting. The recognition of cost based on estimation is not new and can be reliable so long as the estimate is reasonable and based on a rational and systematic method. The Board also realizes that the use of estimation necessarily implies the use of professional judgement. This does not negate the value of the estimate to users of the financial information and should not present a problem in relation to audit requirements.

237. The Board realizes that market values may not always be available for many kinds of inter-entity goods and services. Nevertheless, if such values are available, they can be a good basis for estimating cost if no other basis can be established. Although market values may not be directly related to costs of production and they may fluctuate, they may also be viewed as a fairly reliable guide to the costs an entity might have to incur to obtain inter-entity goods and services from a non-governmental source. As with the determination of all estimates,

use of market values as an estimation basis requires the use of judgement and professional care.

238. The Board also realizes that there may be some implementation problems such as disagreements with providing entities over an estimated cost or with the lack of trained personnel to make estimates. These problems are of a practical nature and can be resolved by management. In that regard, they are not unlike other problems faced when implementing any new or changed accounting standard such as making changes to systems and methods and training personnel on the new requirements. Both providing and receiving entities should work closely with each other to resolve any costing problems just as they would to solve any non-accounting related situations.

Recognition Criteria

239. It is clear to the Board that the recognition of each and every non-reimbursed or under-reimbursed inter-entity cost is not possible. The federal government is a very large and complex entity and it is normal to expect some flow of goods and services between its activities as a natural and reasonable method of completing missions and objectives. The Board decided that only certain non-reimbursed or under-reimbursed inter-entity costs should be addressed. The standard, therefore, includes criteria for recognition which will limit the application of the standard to only those items deemed most significant and important.

240. The criteria address the materiality of the non-reimbursed inter-entity cost, whether it is a part of broad and general support for all entities, and whether it is needed to help determine a price to non-governmental entities. The materiality criterion considers materiality in the context of the importance of the item to the receiving entity. Under this criterion, whether an item of inter-entity cost is recognized depends upon three points. The first of these is significance to the receiving entity, i.e. whether the item is important enough that management should be aware of its cost in decision making circumstances. The second is the degree to which the goods or services are an integral and necessary part of the receiving entity's output. The third is the degree to which the good or service can be matched to the specific receiving entity with reasonable precision.

241. The criterion of broad and general support recognizes that some entities provide support to all or most other federal entities, generally

as a matter of their mission. The costs of broad and general services should not be recognized by the receiving entity when no reimbursement has been made. However, if the service is an integral and necessary part of the receiving entity's operations and outputs, those costs should be recognized.

242. The criteria also recognize that there are certain cases in which inter-entity costs need to be recognized because there could be an effect upon a resulting price to a non-governmental entity. If a federal entity sells outputs to a non-federal entity, it is usually required to recover the full cost of those goods or services. While cost is not the sole determinant of final price, knowledge of the actual full cost of production to the government as a whole is necessary to ensure that the price is appropriately established at a level that will recover all costs.

243. Most of the respondents to the exposure draft agreed with the recognition criteria. However, a few were concerned about how the criteria might be interpreted and whether the standards were too general in nature. The Board realizes that considerable judgement is required to apply these criteria and notes that the specific facts and circumstances in each case must be considered. This concern, along with other implementation concerns, led the Board to make certain decisions about implementation discussed below under "Implementation Issues."

Consolidation

244. The standard requires that, when non-reimbursed or under-reimbursed inter-entity costs are recognized, the receiving entity should recognize the full costs of the goods or services received as an expense (or asset) and, to the extent that reimbursement is less than full cost, the difference is to be recognized as a financing source. At the same time, of course, the providing entity would continue to recognize the full costs of goods and services provided, and any off-setting reimbursements, in its accounting records. Several respondents to the exposure draft were concerned about the possibility of "double-counting" of costs and others raised concerns about the ability to eliminate these transactions in consolidations.

245. Both the providing entity and the receiving entity are separate reporting entities. Each should recognize in its accounting records and financial reports the true costs of operations and any revenues received. The providing entity incurs a cost in providing the goods or

services even though they are sent to another entity. It may also receive a partial payment or reimbursement. These transactions and events should be reflected in its accounting. The receiving entity, as a separate reporting entity, should also recognize its total cost of production. The full cost of non-reimbursed or under-reimbursed goods or services ultimately contributing to its outputs should be reflected in the costs of production. To the extent that reimbursement is not made for those costs, the receiving entity is utilizing a separate source of financing, namely the providing entity. Again, this fact is reflected in the accounting. The result is that costs recognized but not actually paid are off-set by the imputed financing source. While the entity's financial position is not affected, the real costs of production are reflected.

246. The only possibility for "double-counting" of costs occurs when consolidated financial reports are prepared for a reporting entity that includes both the providing entity and the receiving entity. In preparing such statements, the standard calls for elimination of the inter-entity transactions. In effect, this is no different from the elimination of transactions for which full reimbursement has been made. The only additional transaction to be eliminated is the recognition of the imputed financing source by the receiving entity. The recognition of costs by both the providing entity and the receiving entity and any actual reimbursements would be eliminated anyway if payment for the inter-entity costs were made.

247. The Board realizes that identification and tracking of transactions that must be eliminated for consolidated reports can become complex and difficult. However, this is a practical implementation problem that management should be able to overcome through the use of transaction coding or some other identification method. It likely will require changes in methods and systems currently in use and may require additional training of personnel. The Board has decided upon a method to ease implementation problems as discussed below.

Implementation Issues

248. As discussed above, the Board realizes that there may be problems in implementing the standard on inter-entity costing. Recognition of non-reimbursed or under-reimbursed inter-entity costs is a new concept to federal entities and involves a new way of thinking about costs. There is concern that application of the standard may be inconsistent among federal entities. In addition, there could be problems, particularly at first, in developing estimates of costs; in revising accounting systems

and procedures to accommodate these requirements; and in training personnel to accomplish the task. Furthermore, the Board recognizes the concern that some have about the elimination of inter-entity cost transactions for consolidated reporting since the accounting procedures may be complicated.

249. As a result of these problems and concerns, the Board has expressed the need to take a measured, step-by-step, practical approach to implementation of this standard. Therefore, the Board has decided that, in implementing the standard, it recommends that OMB, with assistance from the FASAB staff, should identify the specific inter-entity costs for entities to begin recognizing and OMB should then issue guidance identifying those costs. OMB should consider the requirements of the standard including the recognition criteria in developing the guidance and it should also consider suggestions and information provided by Treasury, GAO, and other agencies. The Board anticipates the largest and most important inter-entity costs will be identified first, followed by others as entities gain experience in the application of the standard. This approach is seen as a practical way to ensure uniformity in the application and implementation of the standard and to provide time and experience in overcoming any other practical problems which may arise. Also, the Board may recommend specific inter-entity costs for recognition in possible future recommended standards.

Costing Methodology

250. The ED discussed cost accumulation and assignment principles. The ED states that costs should be accumulated by responsibility segments, and the accumulated costs should be classified by type of resource such as costs of employees, material, capital, utilities, rent, etc. The ED states that "The accumulation of costs by responsibility segments does not mean that each responsibility segment must have its own accounting system. The reporting entity may have a centralized accounting system, but the system should be capable of identifying costs with responsibility segments." (See ED par. 170)

251. The ED discussed three cost assignment principles: (a) directly tracing costs wherever feasible and economically practical, (b) assigning costs on a cause-and-effect basis, or (c) allocating costs on a reasonable and consistent basis. These principles apply to costs of services provided by a segment to other segments, as well as assigning costs to ultimate outputs of a segment.

252. The ED then provided brief descriptions of available costing methodologies: activity-base costing (ABC), job order costing, process costing, and standard costing. The ED pointed out that these costing methodologies are not mutually exclusive. For example, standard costing can be used within ABC. ABC and standard costing combined can then be used with either job order costing or process costing.

253. Most respondents believed that the requirement for cost accumulation by responsibility segment is appropriate. Some of them stated that costs are accumulated at levels lower than segments such as cost centers, processes, or activities within a segment. Such accumulation is consistent with the standard so long as the costs will be aggregated at the segment level. Some of the respondents stated that the requirement is currently feasible because their systems are designed to accumulate expenses by segments and by resource types. Others, however, stated that they must upgrade their general accounting systems in order to meet the standard requirement.

254. All the respondents agreed with the cost assignment principles. One respondent, while supporting the principles, stated that the principles should be explicitly ranked by preference. The Board intended to express an preference among the principles. It stated in the proposed standard that direct cost tracing should be used "wherever it is feasible and economically practical." The Board further stated in the ED that "for the costs that are not directly traced to outputs, it is preferable that they be assigned to them on a cause-and-effect basis." (See ED par. 182) However, for cost-benefit considerations, assigning costs by allocations cannot be avoided. The Board emphasized that cost allocations should be performed on a rational basis. It also cautioned that allocations can be arbitrary and thus may result in distortions. (See ED par. 190) To make the intent of preference more explicit, the Board has added words to the standard to indicate that the principles are listed by preference.

255. All the respondents approved the descriptions of available costing methodologies. Some of them stated that the materials included are clear and provide adequate guidance. The respondents agreed with the Board's position that because federal activities are highly diverse, it is not practical to require a particular costing method for a particular type of activity at this time. However, it is appropriate to require that each entity select a costing methodology that is best suited to its operations and use that methodology consistently.

256. The Board encouraged government entities to study the potential use of ABC in their operations (ED par. 200). This was well received by the respondents. Eighteen respondents supported ABC. Most of them said that ABC can be effective when combined with any of the other costing methodologies. Seven respondents from federal agencies stated that they believed ABC is appropriate for their activities and were considering using it. In addition, two respondents stated that the use of standard costing should also be encouraged. The Board continues to believe that as federal agencies are going through stages in the development of their managerial costing, more sophisticated and refined costing methods, such as ABC and standard costing, should be considered and used to minimize arbitrary cost allocations and to improve full cost information.

257. The Board considered whether the costing methodology section should be recommended as a concept or a standard. It concluded that it should be a standard. The Board believes that cost accumulation and assignment principles contained in this section are definitive and should be followed by federal entities. Only by adhering to the principles and by continuous refinement of costing methodologies, can reliable full cost information be achieved.

Unused Capacity Costs

258. The ED proposed a standard, which, if adopted, would have required that entities measure the cost of unused operating capacity and report it as a separate expense. For this purpose, some entities, such as DoD, must separate operating capacity from "readiness capacities" which are reserved for war and emergency mobilization rather than normal operations. The operating capacity can be measured in terms of "practical capacity" which is the maximum units of output that the available capacity can produce taking the normal stoppage and interruptions into consideration. Unused capacity is the excess of practical capacity over actual outputs.

259. A number of respondents appreciated the importance of the proposed requirement. They stated that capacity cost information would be very useful in improving the cost and capacity management of federal agencies. Several respondents from the private sector urged that the proposal be adopted immediately.

260. Most respondents from federal agencies, however, stated that capacity measurements involve very complex issues and are not feasible to

implement at this time. If the proposed requirement were adopted, agencies would encounter two major types of difficulties. First, they lack guidance on defining and measuring various types of capacity. For example, respondents from DoD stated that it is difficult to develop criteria that can be used to differentiate defense operating capacity costs from mobilization capacity costs. Civilian agencies engaging in administrative, policy making, and regulatory activities also indicated difficulties in defining their practical capacities. Second, respondents of many agencies stated that they do not have the accounting capability to provide reliable capacity measures. Without such capability, unused capacity costs could be improperly estimated and the resulting information could be misleading.

261. Many respondents were also opposed to the proposed standard on the basis of cost-benefit considerations. They estimated that accounting for capacity costs would require substantial time and efforts to implement. This would require the use of their limited accounting personnel and equipment. Respondents from some agencies do not perceive that they have an over-capacity problem. Thus, it is very uncertain whether capacity accounting results, if produced, could be used to improve their operations.

262. After considering the responses to the ED, the Board is convinced that it is premature to recommend capacity accounting either as a standard or as a concept. The Board is aware that federal agencies have limited personnel and other resources for accounting. They must devote those limited resources to improving general financial reporting and to establishing the more fundamental elements of managerial cost accounting. Thus, it would not be cost beneficial to implement capacity costing at this time.

263. Managing capacity costs is a part of cost management. Although this document does not recommend a standard for measuring capacity costs, the full cost information required by the full cost standard will help management in identifying capacity utilization problems. Some respondents stated that the capacity accounting concepts would be useful to capital intensive, industrial-type activities and activities that deliver repetitive services that are measurable in units. The Board is aware that there are on-going research efforts on the subject in the private accounting communities. Thus, the Board may reconsider capacity accounting in the future.

Effective Date

264. The Board holds the view that managerial cost accounting has been needed across the federal government for a long time. Since the standards are quite general and address only the highest levels of cost accounting, the Board felt that they should be implemented quickly. The earlier managerial cost accounting is started, the earlier the benefits will be seen in managing and controlling federal programs and activities. The Board also believes that an effective date far into the future would not serve to quickly change the government's tendency to neglect cost accounting. Therefore, in the exposure draft, the effective date was set for fiscal periods beginning after September 30, 1995 (i.e., beginning in fiscal year 1996).

265. A majority of respondents to the exposure draft commented that this date was too early and said that they foresee problems with implementation at September 30, 1995. Many reasons were given for a delay in implementation. Chief among these were (1) difficulty in obtaining funding to make necessary changes in financial systems before September 30, 1995, (2) a lack of trained accounting personnel and equipment, and (3) a need for time to develop or modify appropriate cost accounting methodologies and systems and develop management awareness and support. Respondents suggested implementation dates ranging from one to five years after the fiscal year 1996 date given in the exposure draft.

266. The Board recognized the validity of the concerns of many respondents over funding, training, and development of costing activities. However, it also recognized that federal agencies must be able to develop cost information very soon to meet the requirements of the GPRA. It also noted that reporting entities do not have to possess sophisticated cost accounting systems to meet the requirements in these standards. Federal agencies can take a gradual approach to the development of cost systems, if necessary, while developing basic cost information through other means in the short term.

267. Nevertheless, the Board agreed that the implementation date in the exposure draft may be a problem for many federal agencies since cost accounting is relatively new to most of them and the recommended implementation date is very near. The Board decided, therefore, to delay the implementation date by one additional year and make the standards effective for periods beginning after September 30, 1996, with earlier implementation encouraged.

Glossary

268 Early on in the development of the managerial cost accounting project, the task force determined that many problems can result in cost accounting from the use of similar terms to mean different things. It concluded that the use of consistent cost accounting terminology is necessary to avoid confusion and mis-communication. Therefore, it recommended that the Board attach a glossary to the exposure draft which would define many of the cost accounting terms used.

269. The Board agreed with this recommendation. It also decided that the establishment of uniform cost accounting terminology within the federal government is so important that the glossary should contain not only definitions for terms used in the statement, but also definitions for other important cost accounting terms even if those terms are not used directly in the text of the statement. This glossary would serve as the beginning of a uniform and consistent cost accounting terminology for use within the federal government.

270. Comments were received from only one respondent to the exposure draft concerning the glossary. That respondent did not suggest changing any of the definitions provided in the glossary, but only suggested some additions. The Board decided that the glossary is sufficient for the time being and should be retained in the final statement as an appendix. However, it also decided that it may issue additions to the glossary at a later date as more federal agencies gain experience in the development of cost information, and as the need for additional standard definitions becomes apparent.

Appendix B: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273.

Statement of Federal Financial Accounting Standards No. 5: Accounting for Liabilities of The Federal Government

Status

Issued	December 20, 1995
Effective Date	for fiscal years beginning after September 30, 1996.
Volume I References	SFFAS No. 1, *Accounting for Selected Assets and Liabilities* (provides information on other liabilities) SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees* (provides information for loan guarantee liabilities) SFFAS No. 6, *Accounting for Property, Plant, and Equipment* (provides information on cleanup cost liabilities) SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation* SFFAS No. 17, *Accounting for Social Insurance*
Volume II References	Leases (L20), Federal Debt (F10), Insurance and Guarantee Programs (I40), Liabilities (L40), Pensions, Other Retirement Benefits and Postemployment Benefits (P20); Clean-up Costs (C40)
Interpretations and Technical Releases	Interpretation No. 2, *Accounting for Treasury Judgment Fund Transactions* Interpretation No. 3, *Measurement Date for Pension and Retirement Health Care Liabilities* Interpretation No. 4, *Accounting for Pension Payments in Excess of Pension Expense* TR 1, *Audit Legal Letter Guidance* TR 2, *Environmental Liabilities Guidance*
Affects	• SFFAS No. 5, pars. 3 and 19 affect SFFAS No. 1, by amending the definition of "liability".
Affected by	• SFFAS No. 7, paragraph 36(b), affects SFFAS No. 5, paragraphs 35-42 (Contingencies), by creating an exception to the general principles for losses on contracts for goods made to order or services produced to order. • SFFAS No. 8, paragraphs 116 & 117 defer consideration of social insurance issues until additional research is conducted; a departure from the intent expressed in SFFAS No. 5, paragraphs 6, 104 and 105. • SFFAS No. 12, affects SFFAS No. 5, paragraphs 33 and 36, by changing the recognition criteria for recognizing liabilities arising from litigation. • SFFAS No. 17 affects SFFAS No. 5, provides accounting guidance for social insurance contrary to statements in SFFAS No. 5, paragraphs 6, 104, and 105. • Interpretation No. 3 affects SFFAS No. 5, paragraphs 56-76, by clarifying that the measurement of pension and health care liabilities in general purpose federal financial reports does not have to be based on a full actuarial valuation as of the end of the reporting period. • Interpretation No. 4 affects SFFAS No. 5, paragraphs 71, 74, and 75, by providing accounting guidance for the expectional circumstance where the employer entity's total payments for FERS and CSRS exceed the related total pension expense. SFFAS No. 5 provides for the normal circumstance where the pension expense is equal to or more than the entity's payment to the administrative entity. • SFFAS No. 25, paragraph 4, affects SFFAS No. 5, paragraph 106, by classifying "risk assumed" information as Required Supplementary Information (RSI) instead of Required Supplementary Stewardship Information (RSSI). Also affects Executive Summary, paragraphs 186 and 190.

Summary

This Statement establishes accounting standards for liabilities of the federal government not covered in Statement of Federal Financial Accounting Standards Number 1, *Accounting for Selected Assets and Liabilities*, and in Statement of Federal Financial Accounting Standards Number 2, *Accounting for Direct Loans and Loan Guarantees*. This Statement defines "liability" as a probable future outflow or other sacrifice of resources as a result of past transactions or events.[1]

This Statement defines the recognition points for liabilities associated with different types of events and transactions (See Figure 1 on page 414).[2]

- A liability arising from reciprocal or "exchange" transactions (i.e., transactions in which each party to the transaction sacrifices value and receives value in return) should be recognized when one party receives goods or services in return for a promise to provide money or other resources in the future (e.g., a federal employee performs services in exchange for compensation).
- A liability arising from nonreciprocal transfers or "nonexchange" transactions (i.e., transactions in which one party to the transaction receives value without directly giving or promising value in return, such as grant and certain entitlement programs) should be recognized for any unpaid amounts due as of the reporting date. The liability includes amounts due from the federal entity to pay for benefits, goods, or services[3] provided under the terms of the program, as of the federal entity's reporting date, whether or not such amounts have been reported to the federal entity (e.g., estimated Medicaid payments due to health providers for service that has been rendered and that will be financed by the federal entity but have not yet been reported to the federal entity).
- Government-related events are nontransaction-based events that involve interaction between federal entities and their environment. The event may be beyond the control of the entity. A liability is recognized for a future outflow of resources that results from a government-related event when the event occurs if the future outflow of resources is probable and measurable (see paragraphs 33 and 34 for the definitions of probable and measurable, respectively) or as soon thereafter as it becomes probable and measurable. Events, such as a federal entity accidentally causing damage to private property, would

[1]Liabilities recognized according to the standards in this Statement include both liabilities covered by budgetary resources and liabilities not covered by budgetary resources. Liabilities covered by budgetary resources are liabilities incurred that will be covered by available budgetary resources encompassing not only new budget authority but also other resources available to cover liabilities for specified purposes in a given year. Liabilities not covered by budgetary resources include liabilities incurred for which revenues or other sources of funds necessary to pay the liabilities have not been made available through congressional appropriations or current earnings of the reporting entity. Notwithstanding an expectation that the appropriations will be made, whether they in fact will be made is completely at the discretion of the Congress. (Adapted from OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements.")

[2]Recognition means reporting a dollar amount on the face of the basic financial statements.

[3]Goods or services may be provided under the terms of the program in the form of, for example, contractors providing a service for the government on the behalf of the disaster relief beneficiaries.

create a liability when the event occurred, to the extent that existing law and policy made it probable that the federal government would pay for the damage and to the extent that the amount of the payment could be estimated reliably. Government-related events also include hazardous waste spills on federal property caused by federal operations or accidents and catastrophes that affect government-owned property.

- Government-acknowledged events are events that are of financial consequence to the federal government because it chooses to respond to the event. A liability is recognized for a future outflow of resources that results from a government-acknowledged event when and to the extent that the federal government formally acknowledges financial responsibility for the event and a nonexchange or exchange transaction has occurred. The liability for a nonexchange transaction should be recognized for any unpaid amounts due as of the reporting date and the liability for the an exchange transaction should be recognized when goods or services have been provided. The liability includes amounts due from the federal entity to pay for benefits, goods, or services provided under the terms of the program, as of the federal entity's reporting date, whether or not such amounts have been reported to the federal entity (Examples of government-acknowledged events include toxic waste damage caused by nonfederal entities and damage from natural disasters).

In addition to discussing the general liability recognition principle, the Statement includes several specific federal liability accounting standards which are summarized below.

- *Contingencies*—A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. Contingent future outflows or other sacrifices of resources as a result of past transactions or events may be recognized, may be disclosed[4], or may not be reported as all, depending on the circumstances.[5] Contingencies should be recognized as a liability when a past transaction or event has occurred, a future outflow or other sacrifice of resources is probable, and the related future outflow or sacrifice of resources is measurable. A contingent liability should be disclosed if any of the conditions for liability recognition are not met and there is a reasonable possibility that a loss or an additional loss may have been incurred. Disclosure should include the nature of the contingency and an estimate of the possible liability, an estimate of the range of the possible liability, or a statement that such an estimate cannot be made.

[4]"Disclosure" in this document refers to information in notes regarded as an integral part of the basic financial statements.

[5]In the case of government-acknowledged events giving rise to nonexchange or exchange transactions, there must be a formal acceptance of financial responsibility by the federal government, as when the Congress has appropriated or authorized (i.e., through authorization legislation) resources. Furthermore, exchange transactions that arise from government-acknowledged events would be recognized as a liability when goods or services are provided. For nonexchange transactions, a liability would then be recognized at the point the unpaid amount is due. Therefore, government-acknowledged events do not meet the criteria necessary to be recognized as a contingent liability.

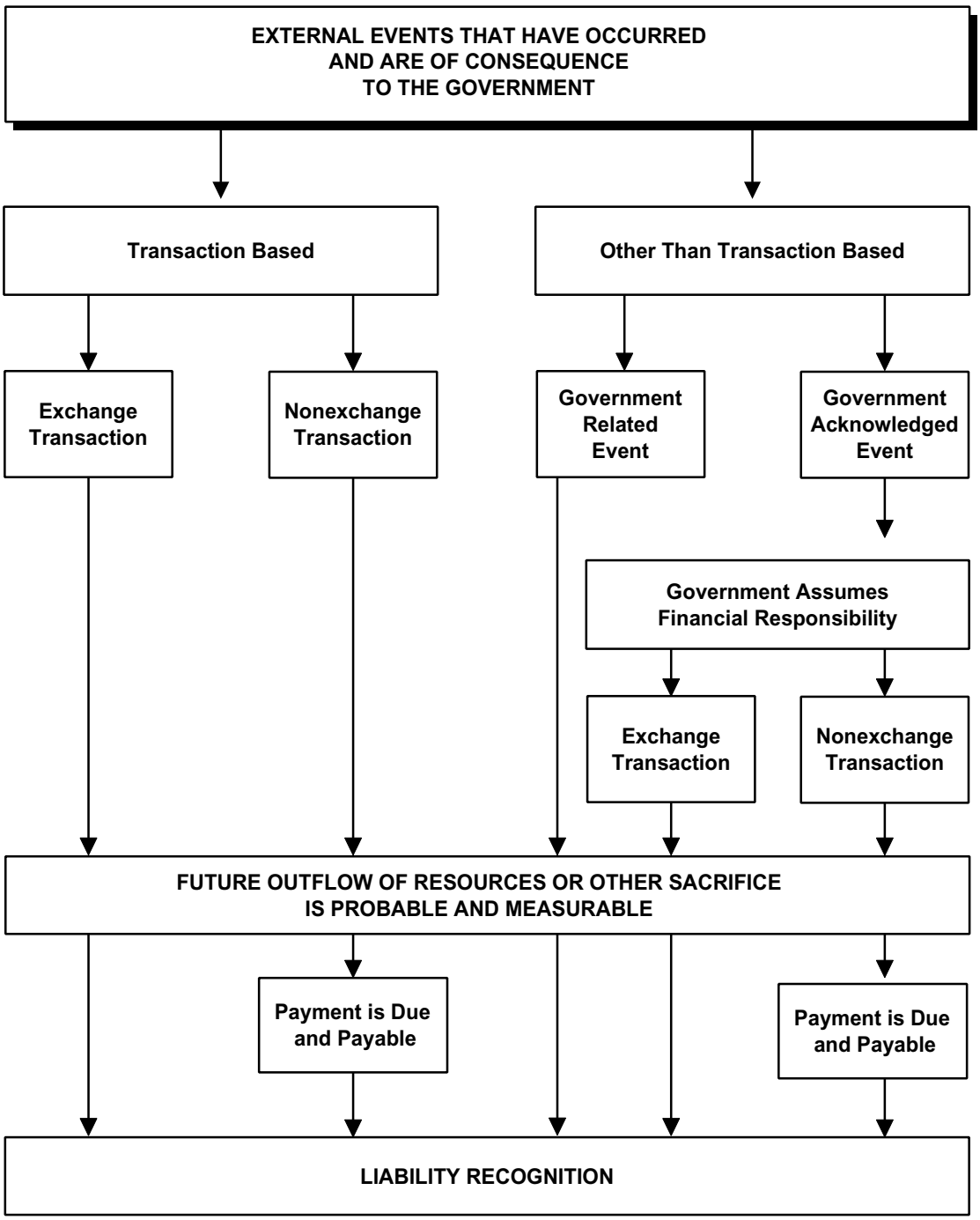
- *Capital leases*—In a lease transaction, the lessee should report a liability when one or more of four specified capital lease criteria are met (see detailed criteria on page 429). The amount to be recorded by the lessee as a liability[6] under a capital lease is the present value of the rental and other minimum lease payments during the lease term, excluding that portion of the payments representing executory cost to be paid by the lessor.
- *Federal debt*—Federal debt transactions are recognized as a liability when there is an exchange between the involved parties. Fixed-value securities are securities that have a known maturity or redemption value at the time of issue. These securities should be valued at their original face (par) values net of any unamortized discount or premium. Amortization of the discount or the premium should normally follow the interest method; in certain cases, the straight line method is permitted (see page 16). Variable-value securities should be originally valued and periodically revalued at their current value on the basis of the regulations or offering language. The related interest cost of the federal debt includes the accrued (prorated) share of the nominal interest incurred during the accounting period, the amortization amounts of discount or premium of each accounting period, and the amount of change in the current value for the accounting period for variable-value securities.
- *Pensions, other retirement benefits, and other postemployment benefits*—The liability and associated expense for pensions and other retirement benefits (included health care) should be recognized at the time the employee's services are rendered. The expense for postemployment benefits should be recognized when a future outflow or other sacrifice of resources is probable and measurable based on events occurring on or before the reporting date. Any part of that cost unpaid at the end of the period is a liability. The aggregate entry age normal actuarial cost method should be used to calculate the expense and the liability for the pension and other retirement benefits for the administrative entity financial statements, as well as the expense for the employer entity financial statements. The employer entity should recognize an expense and a liability for postemployment benefits when a future outflow or other sacrifice of resources in probable and measurable on the basis of events that have occurred as of the reporting date.
- *Insurance and guarantee programs*—All federal insurance and guarantee programs[7] (except social insurance and loan guarantee programs[8]) should recognize a liability for unpaid claims incurred resulting from insured events that have already occurred. Insurance and guarantee programs recognize as an expense all claims incurred during the period, including, when appropriate, those not yet reported. The change in a contingent liability during the reporting period should also be recognized as a component of expense. Life insurance programs should recognize a liability for future policy benefits in addition to the liability for unpaid claims incurred. All federal insurance and guarantee programs (except life insurance and loan guarantee programs) should also report as required supplementary stewardship information (RSSI) the expected losses that are based on risk inherent in the insurance and guarantee coverage in force.

[6]"The cost of general property, plant, and equipment acquired under a capital lease shall be equal to the amount recognized as a liability for the capital lease at its inception." (See SFFAS No. 6, *Property, Plant, and Equipment*.)

[7]Social insurance in considered to be a separate program type not included within insurance and guarantee programs. See social insurance discussion in [SFFAS No. 17, *Accounting for Social Insurance*].

[8]Accounting for federal loan guarantee programs should follow the Statement of Federal Financial Accounting Standards Number 2, *Accounting for Direct Loans and Loan Guarantees* (August 23, 1993).

Figure 1: Liability Recognition Summary



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Purpose

1. The purpose of this Statement is to establish accounting standards to recognize and measure liabilities in general purpose federal financial reports, which are issued for both internal and external users. Appendixes provide background, rationale, and examples of how to apply this standard to liabilities associated with federal programs' transactions and events.

Scope

2. This Statement articulates a general principle that should guide preparers of general purpose federal financial reports. It also provides more detailed guidance regarding liabilities resulting from deferred compensation, insurance and guarantees (except social insurance), certain entitlements, and certain other transactions. The Statement addresses liabilities not covered in Statement of Federal Financial Accounting Standards (SFFAS) Number 1, *Accounting for Selected Assets and Liabilities*, and in Statement of Federal Financial Accounting Standards Number 2, *Accounting for Direct Loans and Loan Guarantees*.

3. The concept of a liability in this document is consistent with those in Statements Number 1 and 2. The definition amends the stated definition of a liability in SFFAS Number 1. This Statement establishes accounting for liabilities not covered in SFFAS No. 1 and 2. Statement Number 1 addresses only those selected liabilities that routinely recur in normal operations and are due within a fiscal year. The liabilities covered in Statement Number 1 are accounts payable, interest payable, and other current liabilities, such as accrued salaries, accrued entitlement benefits payable, and unearned revenue.[9]

[9]Adapted from Statement of Federal Financial Accounting Standards (SFFAS) Number 1, *Accounting for Selected Assets and Liabilities* (March 30, 1993), par. 96.

4. Statement Number 2 addresses liabilities specifically arising from direct loans and loan guarantees. Loan guarantees are "any guarantee, insurance, or other pledge with respect to the payment of all or part of the principal or interest on any debt obligation of a nonfederal borrower to a nonfederal lender, but they do not include the insurance of deposits, shares, or other withdrawable accounts in financial institutions."[10]

5. The general conceptual definition of "liability" underlying this Statement is similar in some respects to that articulated by the Financial Accounting Standards Board (FASB) but the FASAB made certain modifications to the private sector concept to apply it within the federal context. Also, as is explained in the Basis for Conclusions, the specific standards dealing with pensions, other retirement benefits, and postemployment benefits differ from those the FASB has published.

6. This Statement requires certain disclosures about existing liabilities. The Statement, however, does not fully address information about stewardship responsibilities, including social insurance,[11] related to future financial reporting periods. Such information may be reported in a supplementary stewardship report, pursuant to standards now being developed (see FASAB's ED, *Supplementary Stewardship Reporting*). Information about projected future outflows is vital to making informed decisions about public policies, including the level of benefits promised under current law and the level of revenues/premiums required to liquidate the liability (if any).

7. The recognition of social insurance programs[12] presented the Board with significant theoretical and practical problems. The exposure process for the draft liability standard brought forth strongly held positions about social insurance. Upon reconsideration of the issues the Board concluded that, regardless of the technical merits of the

[10]OMB Circular No. A-11 as cited in Statement of Federal Financial Accounting Standards Number 2, *Accounting for Direct Loans and Loan Guarantees* (August 23, 1993), p. 46.

[11]Stewardship responsibilities are further discussed in *Supplementary Stewardship Reporting*.

[12]Social insurance programs are income transfer programs financed by compulsory earmarked taxes and in certain cases also include general revenues of the federal government.

arguments concerning the nature of social insurance programs, it was questionable whether adequate information concerning social insurance could be presented by means of a single, point-in-time number on a Balance Sheet. The Board modified the draft standard so it would require several measures of social insurance to be presented. The Board decided that, given the sensitivity and magnitude of social insurance, the new proposal should receive additional exposure to allow users to review it and comment. The Board felt that the concepts and alternatives had not yet been presented to the user community in sufficient detail. Hence, the discussion of social insurance has been withdrawn from the liability standard and presented in the *Supplementary Stewardship Reporting* Exposure Draft. (For more details see the Basis for Conclusions).

Objectives Of Federal Financial Reporting

8. When developing accounting standards for the federal government, the significant environmental differences between the federal government and the private sector must be kept in mind. Statement of Federal Financial Accounting Concepts Number 1, *Objectives of Federal Financial Reporting*, discusses the federal accounting and financial reporting environment. It notes the following:

> The federal government is unique, when compared with any other entity in the country, because it is the vehicle through which the citizens of the United States exercise their sovereign power. The federal government has the power through law, regulation, and taxation to exercise ultimate control over many facets of the national economy and society. All other entities within the nation, both public and private, operate within the context of laws, oversight, and accountability established by the national government. The federal government is accountable only to its citizens. It is politically accountable to the electorate, but no higher agency has the power to demand an accounting from the government.

9. The objectives of federal financial reporting were designed to guide the Board in developing accounting standards to enhance the financial information reported by the federal government. The four objectives are discussed under the headings (1) budgetary integrity, (2) operating performance, (3) stewardship, and (4) systems and control. These objectives were used as a basis to develop the Liability Statement. The Board believes that the operating performance objective has special relevance to decisions about recognition and measurement of liabilities in general purpose federal financial reports. That objective reads as follows:

Federal financial reporting should assist report users in evaluating the service efforts, cost, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities.[13]

10. At the same time, the Board recognizes that the third objective, dealing with stewardship, is equally important.

Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial conditions have changed and may change in the future.

Federal financial reporting should provide information that helps the reader to determine:

- whether the government's financial position improved or deteriorated over the period;
- whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due; and
- whether government operations have contributed to the nation's current and future well-being.

Examples of information relevant to this objective include:

- the amount of assets, liabilities, and net assets (or net position);
- an analysis of government debt, its growth, and debt service requirements;
- changes in the amount and service potential of capital assets; and
- the amount of contingent liabilities and unrecognized obligations[14] (such as the probable cost of deposit insurance).

Accordingly, information about projected future responsibilities and resources is as important as information about assets, liabilities, revenues, and expenses.

Entity And Display

11. SFFAC Number 2, *Entity and Display*, is a concept statement that provides a framework for defining the meaningful reporting units for general purpose federal financial reports with consideration of the

[13]Statement of Federal Financial Accounting Concepts Number 1, *Objectives of Federal Financial Reporting* (Sept. 2, 1993).

[14]The term "obligation" is used in its everyday or generic sense, not as it is used in federal budgetary accounting.

relationships among the budgetary, organizational, and programmatic units. The Concepts Statement also describes in general terms the nature of general purpose federal financial reports, including their names and formats. Agreement on the concepts of entity and display is necessary to establish standards for presenting general purpose federal financial reports.

12. The Entity and Display and Liability Statements are interrelated in several ways. Decisions on each affected the other. For example, the Entity and Display Concept Statement suggests what reporting units should report liabilities and, in general terms, how these liabilities should be displayed. The provisions of the Concept Statement that contemplate presentation of information about future stewardship responsibilities as well as information about events and transactions that have occurred are related to the selection of events and transactions to be recognized.[15]

Effective Date

13. The accompanying standards presented in this Statement become effective for fiscal periods beginning after September 30, 1996. Earlier implementation is encouraged.

Structure Of This Document

14. This document has three sections, two appendixes, and a glossary. The first section, the executive summary, precedes this section. This introduction constitutes the second section. The remaining section and appendixes are described below.

Liability Standards

15. This section presents a definition and criteria for recognizing a liability and related disclosure requirements. It also provides specific standards for contingencies, capital leases, federal debt, pensions, other postemployment and retirement benefits, and insurance (other than social insurance) and guarantees.

[15] See Statement of Federal Financial Accounting Concepts (SFFAC) Number 2, Entity and Display (April 20, 1995).

Appendix A: Basis for Conclusions

16. This appendix summarizes considerations that members of the Board deemed significant in reaching the conclusions in the Statement.

Appendix B: Liability Recognition and Measurement Matrix

17. The Liability Recognition and Measurement Matrix illustrates the measurement attributes and recognition points for several transactions and events.

Appendix C: Glossary

Glossary [omitted -- see Consolidated Glossary in "Appendix E: Consolidated Glossary" on page 1273]

18. The glossary defines various terms used in this Statement.

Liability Standards

Definition And General Principle For Recognition Of A Liability

19. A liability for federal accounting purposes is a probable future outflow or other sacrifice of resources as a result of past transactions or events. General purpose federal financial reports should recognize[16] probable and measurable future outflows or other sacrifices of resources arising from (1) past exchange transactions, (2) government-related events, (3) government-acknowledged events, or (4) nonexchange transactions that, according to current law and applicable policy, are unpaid amounts due as of the reporting date.[17]

Events And Transactions

20. The existence of a past event (which includes transactions) is essential for liability recognition. An event is a happening of financial consequence to an entity.[18] An event may be an internal event that occurs within an entity, such as transforming raw materials into a product. An event may also be an external event that involves interaction between an entity and its environment, such as a transaction with another entity, an act of nature, a theft, vandalism, an injury caused by negligence, or an accident.

21. As the term is used in this Statement, a **transaction** involves the transfer of something of value . Transactions may be either exchange transactions or nonexchange transactions. The distinction between exchange and nonexchange transactions is important in determining the point of liability recognition in federal accounting.

[16]Recognition means reporting a dollar amount on the face of the basic financial statements .

[17]This document uses the term "nonexchange transaction" in a way similar to FASB's "nonreciprocal transfer." That is, it implies a one-way flow of resources, services, or promises between two parties. "Transaction" in the phrase "nonexchange transaction" does not include reclassification, closing, and similar "internal" entries to the accounting records, though some accountants use the term in that broader sense. "Probable" means more likely than not. "Measurable" means reasonably estimable.

[18] "Consequence" is defined as something of importance or significance.

22. An **exchange transaction** arises when each party to the transaction sacrifices value and receives value in return. There is a two-way flow of resources or of promises to provide resources. In an exchange transaction, a liability is recognized when one party receives goods or services in return for a promise to provide money or other resources in the future.[19]

23. An example of an exchange transaction occurs when a federal employee performs services in exchange for compensation. The compensation includes current salary and future retirement benefits. An exchange transaction occurs because both parties (the employee and the employer) receive and sacrifice value. The expense is recognized in the period that the exchange occurs. The compensation liability includes unpaid salary amounts earned and the cost of future retirement benefits related to current period services.

24. A **nonexchange transaction** arises when one party to a transaction receives value without directly giving or promising value in return. There is a one-way flow of resources or promises. For federal nonexchange transactions, a liability should be recognized for any unpaid amounts due as of the reporting date. This includes amounts due from the federal entity to pay for benefits, goods, or services[20] provided under the terms of the program, as of the federal entity's reporting date, whether or not such amounts have been reported to the federal entity (for example, estimated Medicaid payments due to health providers for service that has been rendered and that will be financed by the federal entity but have not yet been reported to the federal entity) .

25. Many grant and certain entitlement programs are nonexchange transactions. When the federal government creates an entitlement program or gives a grant to state or local governments, the provision of the payments is determined by federal law rather than through an exchange transaction.

[19]Executory contracts where goods and services have not been received are not generally recognized as liabilities in financial accounting, although they are generally recognized as obligations in governmental budgetary accounting.

[20]Goods or services may be provided under the terms of the program in the form of, for example, contractors providing a service for the government on the behalf of the disaster relief beneficiaries.

26. An **event** is defined as a happening of financial consequence to an entity. For federal financial reporting, some events may be other than transaction based and these events may be classified in one of two categories: (1) government-related events or (2) government-acknowledged events.

27. **Government-related events** are nontransaction-based events that involve interaction between the federal government and its environment. The event may be beyond the control of the federal entity. In general, a liability is recognized in connection with government-related events on the same basis as those that arise in exchange transactions. Events, such as a federal entity accidentally causing damage to private property, would create a liability when the event occurred, to the extent that existing law and policy made it probable that the federal government would pay for the damages and to the extent that the amount of the payment could be estimated reliably.[21]

28. Government-related events include:

    (1) cleanup from federal operations resulting in hazardous waste that the federal government is required by statutes and/or regulations, that are in effect as of the Balance Sheet date, to clean up (i.e., remove, contain, or dispose of);[22]

    (2) accidental damage to nonfederal property caused by federal operations; and

[21]The vast majority of claims against the United States Government stemming from tortious government conduct are adjudicated under the Federal Tort Claims Act (FTCA), which provides for both administrative and judicial resolution. Administrative awards under the established threshold are paid from agency appropriations. Administrative awards in excess of the established threshold are paid from the judgment appropriation. Court judgments and compromise settlements by the Department of Justice are paid from the judgment appropriation regardless of amount. This Act means that, for certain types of events it is not necessary for the government to acknowledge financial responsibility separately for each individual event as is the case for events described in paragraph 30.

[22]See SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, for a detailed discussion of cleanup cost.

(3) other damage to federal property caused by such factors as federal operations or natural forces.[23]

29. Government-related events resulting in a liability should be recognized in the period the event occurs if the future outflow or other sacrifice of resources is probable and the liability can be measured, or as soon thereafter as it becomes probable and measurable.

30. **Government-acknowledged events** are those nontransaction-based events that are of financial consequence to the federal government because it chooses to respond to the event. The federal government has broad responsibility to provide for the public's general welfare. The federal government has established programs to fulfill many of the general needs of the public and often assumes responsibilities for which it has no prior legal obligation.

31. Consequently, costs from many events, such as toxic waste damage caused by nonfederal entities and natural disasters, may ultimately become the responsibility of the federal government. But these costs do not meet the definition of a "liability" until, and to the extent that, the government formally acknowledges financial responsibility for the cost from the event and an exchange or nonexchange transaction has occurred. In other words, the federal entity should recognize the liability and expense when both of the following two criteria have been met (1) the Congress has appropriated or authorized (i.e., through authorization legislation) resources and (2) an exchange occurs (e.g., when a contractor performs repairs) or nonexchange amounts are unpaid as of the reporting date (e.g., direct payments to disaster victims), whichever applies.

32. The following example illustrates the liability recognition of government-acknowledged events. A tornado damages a U.S. town and the Congress appropriates funds in response to the disaster. This event is of financial consequence to the federal government because the federal government chooses to provide disaster relief to the town. Transactions resulting from this appropriation, including disaster

[23]The subjects of valuing assets and of measuring asset impairments--thus measuring the loss to be recognized--are beyond the scope of this Statement. See SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, for a discussion on the impairment or loss of federal property.

loans, outright grants to individuals, and work performed by contractors paid by the federal entities, are recognized as exchange or nonexchange transactions. In the case of exchange transactions, amounts payable for goods and services provided to federal entities are recognized when the goods are delivered or the work is done. In the case of nonexchange transactions, a liability should be recognized for any unpaid amounts due as of the reporting date. The liability includes amounts due from the federal entity to pay for benefits, goods, or services provided under the terms of the program, as of the federal entity's reporting date, whether or not such amounts have been reported to the federal entity.

Probable Future Outflow Or Other Sacrifice Of Resources

33. "Probable" refers to that which can reasonably be expected or is believed to be more likely than not on the basis of available evidence or logic. [See SFFAS 12 for addition text and footnote.] The probability of a future outflow or other sacrifice of resources is assessed on the basis of current facts and circumstances. These current facts and circumstances include the law that provides general authority for federal entity operations and specific budget authority to fund programs. If budget authority has not yet been provided, a future outflow or other sacrifice of resources might still meet the probability test if (1) it directly relates to ongoing entity operations and (2) it is the type for which budget authority is routinely provided. Therefore, the definition applies both to liabilities covered by budgetary resources and to liabilities not covered by budgetary resources.[24]

Measurability

34. "Measurability" means that an item has a relevant attribute that can be quantified in monetary units with sufficient reliability to be reasonably estimable. Liabilities reported in the financial report are measured by different attributes specified by various accounting standards. Several different measurement attributes are used for different items in present practice (e.g., fair market value, current cost, present value, expected value, settlement value, and historical cost).

Contingencies

35. A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an

[24]See Statement of Federal Financial Accounting Standards Number 1, *Accounting for Selected Assets and Liabilities*, (March 30, 1993), app. A, par. 95.

entity. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm a gain (i.e., acquisition of an asset or reduction of a liability) or a loss (i.e., loss or impairment of an asset or the incurrence of a liability).[25]

36. This Statement does not deal with gain contingencies or measurement of contingencies that involve impairment of nonfinancial assets. When a loss contingency (i.e., contingent liability) exists, the likelihood that the future event or events will confirm the loss or the incurrence of a liability can range from probable to remote. The probability classifications are as follows:

- Probable: The future confirming event or events are more likely than not to occur.
- Reasonably possible: The chance of the future confirming event or events occurring is more than remote but less than probable.
- Remote: The chance of the future event or events occurring is slight.

37. The following are some examples of loss contingencies:

- collectability of receivables,
- pending or threatened litigation, and
- possible claims and assessments.

[25]Contingencies are different from "subsequent events" as used in the accounting/audit literature. Subsequent events are events or transactions that occur subsequent to the Balance Sheet date, but prior to the issuance of the financial statements and auditor's report, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements.

Criteria For Recognition Of A Contingent Liability

38. A contingent liability should be recognized when all of these three conditions are met:[26]

- A past event or exchange transaction has occurred (e.g., a federal entity has breached a contract with a nonfederal entity).[27]
- A future outflow or other sacrifice of resources is probable (e.g., the nonfederal entity has filed a legal claim against a federal entity for breach of contract and the federal entity's management believes the claim is ... likely ... [*Note that SFFAS 12 changed the definition of "probable" in cases involving litigation from "more likely than not" to "likely." See SFFAS 12 for more explanation. Also note that this parenthetical example would no longer be typical of the "more likely than not" application.*] to be settled in favor of the claimant).
- The future outflow or sacrifice of resources is measurable (e.g., the federal entity's management determines an estimated settlement amount).

39. The estimated liability may be a specific amount or a range of amounts. If some amount within the range is a better estimate than any other amount within the range, that amount is recognized. If no amount within the range is a better estimate than any other amount, the minimum amount in the range is recognized and the range and a description of the nature of the contingency should be disclosed.

[26]The unit of analysis for estimating liabilities can vary according to the reporting entity and the nature of the transaction or event. The liability recognized may be the estimation of an individual transaction or event; or a group of transactions and events. For example, SFFAS Number 2, "applies to direct loans and loan guarantees on a group basis, such as a cohort or a risk category of loans and loan guarantees. Present value accounting does not apply to direct loans or loan guarantees on an individual basis, except for a direct loan or loan guarantee that constitutes a cohort or a risk category." Statement of Federal Financial Accounting Standards Number 2, *Accounting for Direct Loans and Loan Guarantees*. par. 21. See the standard on Insurance and Guarantees in this document for a description of incurred but not reported (IBNR) claims.

[27]In the case of government-acknowledged events giving rise to nonexchange or exchange transactions, there must be a formal acceptance of financial responsibility by the federal government, as when the Congress has appropriated or authorized (i.e., through authorization legislation) resources. Furthermore, exchange transactions that arise from government-acknowledged events would be recognized as a liability when goods or services are provided. For nonexchange transactions, a liability would then be recognized at the point the unpaid amount is due. Therefore, government-acknowledged events do not meet the criteria necessary to be recognized as a contingent liability.

Criteria For Disclosure Of A Contingent Liability

40. A contingent liability should be disclosed if any of the conditions for liability recognition are not met and there is at least a reasonable possibility that a loss or an additional loss may have been incurred. "Disclosure" in this context refers to reporting information in notes regarded as an integral part of the basic financial statements.

41. Disclosure should include the nature of the contingency and an estimate of the possible liability, an estimate of the range of the possible liability, or a statement that such an estimate cannot be made.

42. In some cases, contingencies may be identified but the degree of uncertainty is so great that no reporting (i.e., recognition or disclosure) is necessary in the general purpose federal financial reports. Specifically, contingencies classified as remote need not be reported in general purpose federal financial reports, though law may require such disclosures in special purpose reports. If information about remote contingencies or related to remote contingencies is included in general purpose federal financial reports (e.g., the total face amount of insurance and guarantees in force), it should be labeled in such a way to avoid the misleading inference that there is more than a remote chance of a loss of that amount.

Capital Leases

43. **Capital leases** are leases that transfer substantially all the benefits and risks of ownership to the lessee. If, at its inception, a lease meets one or more of the following four criteria, the lease should be classified as a capital lease by the lessee:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains an option to purchase the leased property at a bargain price.
- The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
- The present value of rental and other minimum lease payments, excluding that portion of the payments representing executory cost, equals or exceeds 90 percent of the fair value of the leased property.

The last two criteria are not applicable when the beginning of the lease term falls within the last 25 percent of the total estimated economic

life of the leased property. If a lease does not meet at least one of the above criteria it should be classified as an operating lease.

44. The amount to be recorded by the lessee as a liability under a capital lease is the present value of the rental and other minimum lease payments during the lease term, excluding that portion of the payments representing executory cost to be paid by the lessor.[28] However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the liability should be the fair value. If the portion of the minimum lease payments representing executory cost is not determinable from the lease provisions, the amount should be estimated.

45. The discount rate to be used in determining the present value of the minimum lease payments ordinarily would be the lessee's incremental borrowing rate unless (1) it is practicable for the lessee to learn the implicit rate computed by the lessor and (2) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both these conditions are met, the lessee shall use the implicit rate. The lessee's incremental borrowing rate shall be the Treasury borrowing rate for securities of similar maturity to the term of the lease.

46. During the lease term, each minimum lease payment should be allocated between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the liability.[29]

[28]"The cost of general property, plant, and equipment acquired under a capital lease shall be equal to the amount recognized as a liability for the capital lease at its inception. See SFFAS No. 6, Accounting for Property, Plant, and Equipment.

[29]OMB Circular No. A-11, "Preparation and Submission of Annual Budget Estimates," explains the measurement of budget authority, outlays, and debt for the budget in the case of lease-purchases and other capital leases. Circular A-94, "Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs," provides the requirements under which a lease-purchase or other capital lease has to be justified and the analytical methods that need to be followed.

Federal Debt And Related Interest Cost

47. This standard applies to all securities or other debt instruments issued by the U.S. Treasury or other federal agencies. It encompasses debt issued to the public and debt issued to federal accounts by other federal accounts.[30]

48. Accounting for the federal debt should identify the amount of the outstanding debt liability of the federal government at any given time and the related interest cost for each accounting period. This entails valuing securities initially at their sales price or proceeds, ultimately at the amount paid to the holder at maturity, and in the intervening period in a way that fairly expresses the federal government's liability.

Accounting For Federal Debt Securities

49. Federal debt securities[31] fall into two major categories for accounting purposes: fixed value securities and variable value securities.

Fixed Value Securities

50. Fixed value securities have a known maturity or redemption value at the time of issue. These securities should be valued at their original face (par) value net of any unamortized discount or premium. Securities sold at face (par) have no discount or premium and should be valued at face (par). Securities sold at a discount will increase in value between sale and maturity; securities sold at a premium will decrease in value. Amortization of the discount or premium may follow the straight line method or the interest method.[32] Either method is acceptable in the cases of

- short-term securities that have a maturity of 1 year or less, and
- longer-term securities for which the amount of amortization under the straight-line method would not be materially different from the amount of amortization under the interest method.

[30]This includes but is not limited to debt issued by the U.S. Treasury to trust funds, agency borrowings from Treasury, and trust fund borrowings from other trust funds.

[31]Figure 2 lists various categories and examples of federal debt securities.

[32]For an explanation and an example of the interest method of amortization, see Appendix B of SFFAS No. 1.

51. In all other cases, the interest method for amortizing any discount or premium should be used.

Variable Value Securities

52. Variable value securities have unknown redemption or maturity values at the time of issue. Values of these securities can vary on the basis of regulation or specific language in the offering. These securities should be originally valued and periodically revalued at their current value, on the basis of the regulations or offering language.

Related Interest Cost

53. The related interest cost of the federal debt include:

- the accrued (prorated) share of the nominal interest incurred during the accounting period,
- the amortization amounts of discount or premium for each accounting period (based on the same amortization method used to account for the related debt liability) for fixed value securities, and
- the amount of change in the current value for the accounting period for variable value securities.

Retirement Prior To Maturity

54. For those securities that are retired prior to the maturity date due to a call feature of the security, or because they are eligible for redemption by the holder on demand, the difference between the reacquisition price and the net carrying value of the extinguished debt should be recognized currently in the period of the extinguishment as losses or gains.

Old Currencies Issued By The Federal Government[33]

55. Pursuant to federal law, old currencies issued by the federal government and not yet redeemed or written off are identified as a federal debt liability at face value and do not bear any interest.

[33]Old currencies include National and Federal Reserve Bank Notes, Old Demand Notes, Old Series currency, and silver certificates classified as public debt pursuant to 31 U.S.C. 5119.

Figure 2: Various Categories And Examples Of Federal Debt Securities[34]

	Federal Debt Instruments			
Debt Category	**Subcategory**	**Term**	**Redeemable**	**Accounting Method**
Marketable Debt	Treasury Bills	Up to 1 yr	At maturity	Liability at face value net of unamortized discount Straight line method of amortization of discount
	Treasury Notes	2 to 10 yrs	At maturity	Liability at face value net of unamortized discount and premium Straight line method of amortization of discount and premium
	Treasury Bonds	10 to 30 yrs	At maturity	Liability at face value net of unamortized discount and premium Straight line method of amortization of discount and premium
Non-Marketable Debt	Government Account Series:			
	Par Values	Various	On demand	Par value, no discount or premium to be amortized
	Market Based	Various	On demand	Liability at face value net of unamortized discount and premium Interest method of amortization of discount and premium
	U.S. Savings Bonds:			
	E/EE bonds	10 to 40 yrs	On demand after 6 months	Current value
	H/HH bonds	10 to 30 yrs	On demand after 6 months	Par value, no discount or premium to be amortized
	State & Local Government Securities	Various	On demand	Par value, no discount or premium to be amortized
	Domestic Series			
	Zero-Coupon bonds	20 to 40 yrs	At maturity	Liability at face value net of unamortized discount Interest method of amortization of discount
	Foreign Series			
	Treasury bills	Up to 1 yr	On demand	Liability at face value net of unamortized discount Straight line method of amortization of discount
	Zero-Coupon bonds	20 to 30 yrs	At maturity (1 bond) On demand (2 bonds)	Liability at face value net of unamortized discount Interest method of amortization of discount Current value.

[34]These tables are intended to illustrate current practice only and are not to be considered authoritative.

Pensions, Other Retirement Benefits, And Other Postemployment Benefits

56. Employee benefits of federal civilian and military personnel and veterans[35] include pensions and postemployment and retirement benefits other than pensions. Pension plans[36] provide benefits upon retirement and may also provide benefits for death, disability, or other termination of employment before retirement. Pension plans may also include benefits to survivors and dependents, and they may contain early retirement or other special features. The actuarially determined liability and expense of the plan, including all its provisions, is part of the pension plan's liability and expense estimate.

57. In addition to or in lieu of pension benefits, a liability for postemployment and other retirement benefits may be incurred outside the pension plan. Postemployment benefits other than pensions (OPEB) include all types of benefits provided to former or inactive (but not retired) employees, their beneficiaries, and covered dependents.[37] Inactive employees are those who are not currently rendering services to their employers and who have not been terminated, but who are not eligible for an immediate annuity, including those temporarily laid off or disabled. OPEB include salary continuation, severance benefits, counseling and training, continuation of health care or other benefits, and unemployment and workers' compensation benefits paid by the employer entity.[38]

[35]Veterans' compensation included in this category is a measurable program benefit that directly relates to a veteran's prior military service and is not the type of benefit included in general fund benefit programs. For example, compensatory income payments for injuries sustained in the line of duty (i.e., VA disability compensation benefits) are employee benefits, while entitlement benefits (i.e., VA pension) are accounted for as general fund benefits. (Also see Appendix A: Basis for Conclusions.)

[36]This standard addresses "defined benefit plans," which define the future benefits that will be paid in terms of such factors as age, years of service, or compensation. The amount of benefit depends on a number of future events incorporated in the plan's benefit formula.

[37]Special termination benefits (such as specially authorized separation incentive programs) are considered other postemployment benefits and should be recognized as such.

[38]The terms "employer entity" and "administrative entity" are used in this document to distinguish between entities that employ federal workers and thereby generate the employee costs, including pension cost, and those that are responsible for managing and/or accounting for the pension or the other employee plan. For example, entities that receive "salaries and expense" appropriations are employer entities, while the Office of Personnel Management is an administrative entity because it administers the civilian retirement benefit plans.

58. Retirement benefits other than pensions (ORB) are all forms of benefits to retirees or their beneficiaries provided outside the pension plan. Examples include health and life insurance. Retirement health care benefits are the primary ORB expense. They present unique measurement problems.

59. Pension benefits, OPEB, and ORB are exchange transactions because the employee performs service in part to receive the deferred compensation provided by the plans (such as future pension and medical care benefits). For pension and other retirement benefits, the expense is recognized at the time the employees' services are rendered. For OPEB, the expense is recognized at the time the accountable event occurs. Any part of that cost unpaid at the end of the period is a liability.

60. This Statement is intended to specify the accounting objectives. With regard to pensions and ORB, if estimates, averages, or such devices can reduce the cost of applying this Statement, their use is appropriate provided the results do not materially differ from a detailed application of the standard.

Pensions

61. Pension benefits include all retirement, disability, and survivor benefits financed through a pension plan, including unfunded pension plans. Federal civilian and military employees are covered primarily under the following three defined benefit retirement plans: Civil Service Retirement System (CSRS), Federal Employees Retirement System (FERS), and Military Retirement System (MRS). To the extent that federal employees are covered by social insurance programs (such as Social Security), the taxes they pay to the program and the benefits they will eventually receive are to be accounted for on the same basis used to account for other program participants. However, the payments to social insurance plans that agencies must make are operating costs. Similarly, to the extent that federal employees are covered by defined contribution plans (i.e., the Thrift Savings Plan, which is like a 401(k) plan), federal payments to the plan are expenses, but the plan itself is not covered under this standard.

62. This Statement establishes standards of accounting for pension expense and related pension liability for federal government employers and administrative agencies.

Accounting for the Pension Plan

63. This section covers federal pension plans. The entity that administers the plan (i.e., the "administrative entity") should account for and report the plan in accordance with this standard.[39] A subsequent section covers federal employer entities.

64. **Attribution Methods**—The "aggregate entry age normal" actuarial cost method should be used to calculate the pension expense, the liability for the administrative entity financial statements, and the expense for the employer entity financial statements. The aggregate entry age normal method is one under which the actuarial present value of projected benefits is allocated on a level basis over the earnings or the service of the group between entry age and assumed exit ages; and it should be applied to pensions on the basis of a level percentage of earnings. The portion of this actuarial present value allocated to a valuation year is called the "normal cost." The portion not provided for at a valuation date by the actuarial present value of future normal cost is called the "actuarial accrued liability."[40] The plan, however, may use other actuarial cost methods if it explains why aggregate entry age normal is not used and if the results are not materially different.

65. **Assumptions**—For financial reports prepared for the three primary federal plans (CSRS, FERS, and MRS), the best available actuarial estimates of assumptions should be used to calculate the pension expense and liability. The selection of all actuarial assumptions should be guided by Actuarial Standards of Practice No. 4, Measuring Pension Obligations, as revised from time to time by the Actuarial Standards Board.[41] Accordingly, actuarial assumptions should be on the basis of the actual experience of the covered group, to the extent that credible

[39]In addition to the requirements of this standard, which deals with general purpose financial reports, federal plans report annually pursuant to P.L. 95-595, which calls for statements of net assets available for benefits, a statement of accumulated benefits, and other statements. The reporting requirements of Public Law 95-595 were rescinded by Public Law 105-362, Federal Reports Elimination Act of 1998.

[40]Adapted from Actuarial Standards of Practice No. 4, *Measuring Pension Obligations* (Jan. 1990), p. 31.

[41]The Actuarial Standards Board is a board within the American Academy of Actuaries that sets professional standards of actuarial practice.

experience data are available, but should emphasize expected long-term future trends rather than give undue weight to recent past experience. Although emphasis should be given to the combined effect of all assumptions, the reasonableness of each actuarial assumption should be considered independently on the basis of its own merits and its consistency with each other assumption.

66. In addition to complying with the guidance in the preceding paragraph, the interest rate assumption should be based on an estimated long-term investment yield for the plan, giving consideration to the nature and the mix of current and expected plan investments and the basis used to determine the actuarial value of assets; or if the plan is not being funded, other long-term assumptions (for example, the long-term federal government borrowing rate). The underlying inflation rate and the other economic assumptions should be consistent. The rate used to discount the pension obligation should be equal to the long-term expected return on plan assets.

67. The administrative entity should disclose the assumptions used. Administrative entities are encouraged to consult with one another to achieve the maximum consistency among assumptions used for financial reports. Smaller federal administrative entities may employ the assumptions used by any of the three primary plans where appropriate or their own assumptions. If they use assumptions that differ from all of the primary plans, a footnote should explain how and why the assumptions differ from one of those plans.

68. **Assets** should be reported separately from the pension liability rather than reporting only a net liability. Assets of federal pension plans should be carried at their acquisition cost, adjusted for amortization, if appropriate. For investments in market-based and marketable securities, the market value of the investment should be disclosed.[42]

69. **Past Service Cost, Prior Service Cost, and Actuarial Gains and Losses**—Past service costs result from retroactive benefits granted when a new plan is initiated. Prior service costs result from retroactive benefits granted in a plan amendment. A plan amendment may also reduce benefits attributed to prior service. This results in a gain to the extent that previously recognized benefits are reduced. As explained

[42]See SFFAS Number 1, *Accounting for Selected Assets and Liabilities*.

in the next paragraph, the accounting for such gains should be consistent with accounting for retroactive benefit increases. Actuarial gains and losses are changes in the balance of the pension liability that result from (1) deviations between actual experience and the actuarial assumptions used or (2) changes in actuarial assumptions.

70. The administrative entity should recognize all past and prior service costs (or gains) immediately, without amortization. Similarly, the administrative entity should recognize all actuarial gains and losses immediately, without amortization.

71. **Accounting by the Administrative Entity**— The administrative entity should account for and report the pension liability in its financial report, using the aggregate entry age normal actuarial method. The liability is the actuarial present value of all future benefits, based on projected salaries and total projected service, less the actuarial present value of future normal cost contributions that would be made for and by the employees under the plan. Projected salaries should reflect an estimate of the future compensation levels of the individual employees involved, including future changes attributed to the general price level, productivity, seniority, promotion, and other factors.

72. The administrative entity should report a pension expense for the net of the following components:

    - normal cost;
    - interest on the pension liability during the period;
    - prior (and past) service cost from plan amendments (or the initiation of a new plan) during the period, if any; and
    - actuarial gains or losses during the period, if any.

    The individual components should be disclosed.

73. The administrative entity should report revenue for the sum of amounts received from the employer entity representing contributions from:

    - the employer entity and

- its employees.[43]

The employer entity's contribution represents intragovernmental revenue.[44]

An illustration of the accounting for the administrative entity (and the employer entity) is explained in the following section entitled "Accounting Illustration."

Employer Entity Accounting

74. The federal employer entity should recognize a pension expense in its financial report that equals the service cost[45] for its employees for the accounting period, less the amount contributed by the employees, if any. The measurement of the service cost should require the use of the plan's actuarial cost method and assumptions, and therefore the factor to be applied by the employer entities must be provided by the plan and/or the administrative entity.

75. The employer entity's pension expense should be balanced by: (a) a decrease to its "fund balance with Treasury" for the amount of its contribution to the pension plan, if any; and if this does not equal the full expense, by (b) an increase to an account representing an intragovernmental imputed financing source entitled, for example, "imputed financing - expenses paid by other agencies." The latter represents the amount being financed directly through the pension plan's administrative entity.

76. In special instances when an employer entity is also the administrative entity, that is, when there is no separate pension plan (e.g., the Coast Guard), the employer entity should report the liability and recognize the pension expense for all components of cost. The liability and the expense should be accounted for as described in the preceding section

[43]The administrative entity may also receive financing from the General Fund to cover prior service or other cost for which contributions from employer entities are not provided.

[44]Intragovernmental revenue should be eliminated for government-wide consolidated financial statements.

[45]"Service cost" is defined as the actuarial present value of benefits attributed by the pension plan's benefit formula to services rendered by employees during an accounting period. The term is synonymous with "normal cost."

for the administrative entity without reference to transactions with external employer entities.

Accounting Illustration

77. Tables 1-4 provide an example in which the employer entity recognizes an "employer's pension expense" in an amount equal to the service cost attributable to its employees during the accounting period, less the employees' own contributions. The expense in this example is more than the contribution that the employer entity is required by law to pay. The difference between the employer's pension expense and the employer's contribution is credited to the employer entity as a financing source ("imputed financing-expenses paid by other entities"). The employer entity transfers its contribution and that of its employees to the administrative entity.

78. The administrative entity recognizes revenue for: (1) contributions from the employer entity, (2) contributions from the employees, and (3) interest on the plan's investments. The administrative entity recognizes expense for the net of the pension cost components.

    Assumptions are as follows:

    - Total normal cost of employees for the accounting period is $160,000.
    - The employer's pension expense is $100,000. The employer entity would calculate its pension expense on the basis of information received from the plan and/or the administrative entity. Its pension expense is equal to its share of the service cost of its employees' pensions.
    - According to current law, the employer entity is authorized in its appropriation to pay $60,000 for employee pensions.
    - The employees contribute $60,000 to the pension fund.
    - No general fund appropriations made directly to the administrative agency are involved in these transactions, as they could be under actual operations.

Entry #1 -- Employer entity's entry to record pension expense:

	Debit	Credit
Employer's Pension Expense	$100,000	
Appropriations Used		$60,000
Imputed Financing - Expenses Paid by Other Entities		$40,000

Table 1

Employer Entity's Other Financing Sources as They Should Appear on Its Statement of Changes in Net Position

FINANCING SOURCES:[46]
Appropriations Used..... $ 60,000
Imputed financing ..... $ 40,000

Note: Imputed financing covers the difference between (1) the employer entity's contribution transferred to the administrative entity pursuant to law (exclusive of the employees' contributions) and (2) the employer's pension expense calculated on the basis of information received from the administrative entity--as shown immediately below.

Employer Entity's Cost as It Should Appear on the Statement of Net Cost

COST :
Employer's pension cost ..... $ 100,000

Note: This is the employer entity's service cost of employee pensions. The employer entity would calculate this amount using factors provided by the plan and/or the administrative entity. Also to be transferred to the administrative entity is the amount withheld from employees' wages, as called for under the terms of the plan. The employees' contribution is not an expense of the employer entity.

Note: The above table and those that follow in the sections on pensions and ORB are presented for illustrative purposes only; the responsibility for defining the form and content of a financial statement prepared pursuant to the Chief Financial Officers Act, as amended, is the responsibility of the Office of Management and Budget.

[46]SFFAC No. 2, *Entity and Display*, presents a change in the way revenue and other financing sources are reported. This illustration reflects the new concepts.

Entry #2 -- Administrative entity's entry to record revenue received from employer entity:

	Debit	Credit
Fund Balance with Treasury	$120,000	
Retirement Program Revenue - Contribution Received from Employer Entity		$60,000
Retirement Program Revenue - Contribution Received from Employees		$60,000

Entry #3 -- Administrative entity's entry to record revenue from interest on investments in Treasury securities:

	Debit	Credit
Fund Balance with Treasury	$XXX,XXX	
Interest Revenue		$XXX,XXX

Table 2

Administrative Entity's Revenue as It Should Appear on the Statement of Net Cost

LESS OTHER EARNED REVENUES:
Contributions received from employer entities .... $ 60,000
Contributions received from employees 60,000
Interest on investments ..... XX,XXX

Total other earned revenues ..... $ XXX,XXX

Note: Contributions are amounts transferred to the administrative entity from the employer entity representing its contribution--and that of its employees--for the employees' pensions.

Entry # 4 -- Administrative entity's entry to record its pension expense:

	Debit	Credit
Pension Expense	$XXX,XXX	
Pension Liability		$XXX,XXX

Table 3

Administrative Entity's Pension Expense

Normal cost	$160,000
Interest on pension liability	XXX
Prior serv. costs (gains) (if any)	XXX
Actuarial gains (losses) (if any)	XXX
Total pension expense	$ XXX,XXX

Note: The $160,000 represents 100 percent of the normal cost—as calculated by plan actuaries—for the one employer entity in this example. According to law, $60,000 of this amount is to be contributed by the employer entity and $60,000 is to be contributed by the employees themselves. The remaining $40,000 is a liability of the pension plan (covered by future financing sources). The pension expense is reported on the Statement of Net Cost in accordance with paragraph 72.

Table 4

Administrative Entity's Pension Liability:

Beginning balance	$ XX,XXX,XXX
Add: additional pension expense incurred (as calculated in table 3)	XXX,XXX
Less: payments made to beneficiaries	XXX,XXX
Ending liability balance	$ XX,XXX,XXX

Note: The liability balance should be reported on the administrative entity's Balance Sheet.

Other Retirement Benefits (ORB)

79. ORB include all retirement benefits other than pension plan benefits.[47] ORB are provided outside the pension plan by an employer to a former employee or the employee's beneficiary upon retirement. The predominant ORB in the federal government is retirement health care benefits, and they are the focus of this section.[48]

80. Future health care benefits present unique measurement problems. They are more uncertain than pensions since they depend on the changing patterns of health care delivery and utilization, on the price trends for medical care, and on the benefits provided by social insurance programs like Medicare (part A). Also, medical plans do not vest like pensions in which, after a fixed number of years of service, an employee has a right to receive payment. To receive ORB benefits the employee must retire with health care benefits provided by the organization.

81. This Statement establishes standards of accounting for ORB expense and related ORB liability for federal government employers and administrative agencies.

[47]See Appendix A: Basis for Conclusions, for a discussion of reporting medical costs for veterans.

[48]Accounting for life insurance is described in a separate section of the liability standard. However, to the extent that premiums paid by covered individuals and employer entities do not fully cover the retirement life insurance cost of employees, the employer entities would account for the additional cost as described in this section.

Accounting for the ORB Plan

82. **Attribution Method**—The aggregate entry age normal actuarial cost method should be used to calculate the ORB expense and liability for the administrative entity's financial statements, and the expense for the employer entity's financial statements. As indicated in the pension section, aggregate entry age normal is a method under which the actuarial present value of projected benefits is allocated on a level basis over the earnings or the service of the group between entry age and assumed exit ages. It should be applied to ORB on the basis of service rendered by each employee. The portion of this actuarial present value allocated to a valuation year is called the normal cost. The portion not provided for at a valuation date by the actuarial present value of future normal cost contributions is called the actuarial accrued liability.[49] Unlike federal pensions, retiree health care benefits do not depend on future salary levels of individual employees but rather are allocable to each employee on a per person basis. Plans may use other actuarial cost methods if they explain why aggregate entry age normal is not used and if the results are not materially different.

83. **Assumptions**—Amounts calculated for financial reports prepared for ORB plans should reflect (1) general actuarial and economic assumptions that are consistent with those used for pensions and (2) a health care cost trend assumption that is consistent with Medicare projections or other authoritative sources appropriate for the population covered by the plan. The rate used to discount projected benefits should be equal to the long-term expected return on plan assets if the plan is being funded or on other long-term assumptions (for example, the long-term federal government borrowing rate) for unfunded plans. The administrative entity should disclose the assumptions used.

84. **The accrual period** should be based on expected retirement age rather than the age when the employee first becomes eligible.

[49]Adapted from Actuarial Standards of Practice No. 4, p. 31. Also see Actuarial Standard of Practice No. 6, *Measuring and Allocating Actuarial Present Values of Retiree Health Care and Death Benefits*, Actuarial Standards Board (1988).

85. **Assets** should be reported separately from the ORB liability rather than merely reporting the net liability. Assets of federal ORB plans should be carried at their acquisition cost, adjusted for amortization, if appropriate.[50] For investments in market-based and marketable securities, the market value of the investment should be disclosed.

86. **Past Service Cost, Prior Service Cost, and Actuarial Gains and Losses**—The standard for ORB is the same as that for pensions. Past service costs result from retroactive benefits granted when a new plan is initiated. Prior service costs result from retroactive benefits granted in a plan amendment. A plan amendment may also reduce benefits attributed to prior service resulting in a gain to the plan to the extent that previously recognized benefits are reduced. The accounting for such gains should be consistent with accounting for retroactive benefit increases. Actuarial gains and losses are changes in the balance of the ORB liability that result from (1) deviations between actual experience and the actuarial assumptions used or (2) changes in actuarial assumptions.

87. The administrative entity should recognize all past and prior service costs (or gains) immediately, without amortization. Similarly, the administrative entity should recognize all actuarial gains and losses immediately, without amortization.

88. **Accounting by the Administrative Entity**—The ORB plan should be accounted for in a way that is very similar to that described above for pensions. The administrative entity should account for and report the ORB liability in its financial report, using the aggregate entry age normal method. The liability is the actuarial present value of all future benefits less the actuarial present value of future normal cost contributions that would be made for and by the employees under the plan. The administrative entity should report an ORB expense for the net of the following components:

- normal cost,
- interest on the ORB liability during the period,
- prior (and past) service costs from plan amendments (or the initiation of a new plan) during the period, if any,

[50]See SFFAS No. 1, *Accounting for Selected Assets and Liabilities*.

- any gains/losses due to a change in the medical inflation rate assumption; and
- other actuarial gains or losses during the period, if any.

The individual components should be disclosed.

89. The administrative entity should report revenue for the sum of amounts received, if any, from the employer entity representing contributions from:

    - the employer entity and
    - its employees.

    The employer entity's contribution represents intragovernmental revenue.[51] An illustration of the accounting for the administrative entity (and employer entity) is provided in the following section entitled "Accounting Illustration".

Employer Entity Accounting

90. The federal employer entity should account for and report the ORB expense in its financial report in a manner similar to that used for pensions. The employer's ORB expense should be recognized in an amount equal to the total service cost[52] for its employees for the accounting period, less the amount contributed by its employees, if any. The measurement of the service cost requires use of the plan's actuarial cost method and assumptions. The cost factor should be provided to the agencies on a per employee basis by the administrative entity and/or the plan.

91. The employer entity's ORB expense should be balanced by (a) a decrease to the employer entity's "fund balance with Treasury" for the amount of its contributions to the ORB plan, if any; and, if this does not equal the full expense, (b) by an increase to an account representing an intragovernmental financing source entitled, for

[51]Intragovernmental revenue should be eliminated for government-wide consolidated financial statements.

[52]"Service cost" is defined as the actuarial present value of benefits attributed to services rendered by employees during an accounting period. The term is synonymous with "normal cost".

example, "imputed financing - expenses paid by other entities." The latter represents the amount being financed directly through the ORB plan.

92. In special instances when an employer entity is also the administrative entity, the employer entity should report the liability and recognize the ORB expense for all components of cost. For example, the entity is paying its retirees' ORB on a pay-as-you-go basis. The liability and the expense should be accounted for as described in the preceding section for the administrative entity accounting without reference to transactions with external employer entities.

Accounting Illustration

93. Tables 5-8 provide an example where the employer entity recognizes an "employer's ORB expense" in an amount equal to the service cost attributable to its employees during the accounting period. In this example, neither the employer entity nor its employees contribute to the plan. The employer's ORB expense is offset by a credit to the employer entity as a financing source ("imputed financing-expenses paid by other entities"). The administrative entity recognizes a revenue and other financing source for contributions from the General Fund. The administrative entity recognizes an expense for the total ORB expense.

Assumptions are as follows:

- Total normal cost of employees for the accounting period is $10,000.[53]
- The employer's ORB expense is $10,000. The employer entity should calculate its expense on the basis of factors received from the plan and/or the administering entity. For example, the plan-supplied factor is $100 per employee (or full-time equivalent); if the employer has 100 employees, the expense would be $10,000. (The employer's ORB expense equals the service cost of its employees' retirement health care.)

[53]This is the amount attributable to the government for its share of future medical care costs for future retirees. Although this simplified illustration does not show contributions other than those from the General Fund, current retirees pay premiums for their health insurance that partially defray the cost of the program. Federal civilian retirees pay approximately 25-30 percent of the total health benefit premium.

- The employer and employees do not make contributions to a fund. The cost of retirement health care is paid for by General Fund appropriations directly to the administrative entity on a pay-as-you-go basis.

Entry #5 -- Employer entity's entry to record ORB expense:

	Debit	Credit
Employer's ORB Expense	$10,000	
Imputed Financing-Expenses Paid by Other Entities		$10,000

Table 5

Employer Entity's Other Financing Sources as They Should Appear on the Statement of Changes in Net Position

FINANCING SOURCES:
Imputed financing Expenses paid by other entities ... $10,000

Note: Imputed financing "Expenses paid by other entities" covers the annual expense for the employer entity's employees as shown immediately below.

Employer Entity's Cost as It Should Appear on the Statement of Net Cost

COST :
Employer's ORB cost .....$ 10,000

Note: This is the annual ORB service cost of the employer entity's employees. The employer entity would calculate this amount using factors provided by the administrative entity.

Table 6

Administrative Entity's Other Financing Sources as It Should Appear on the Statement of Changes in Net Position

FINANCING SOURCES:

Appropriations used..... $ XX,XXX

Note: Since, in this example, contributions are not required from the employer entity or its employees, all benefits must be paid with appropriations from the General Fund.

Entry #6 -- Administrative entity's entry to record its ORB expense.

	Debit	Credit
ORB Expense	$XX,XXX	
ORB Liability		$XX,XXX

Table 7

Administrative Entity's ORB Expense

Normal cost	$ 10,000
Interest on ORB liability	XX,XXX
Prior service costs (gains) (if any)	XX
Actuarial gains (losses) (if any)	XX
Total ORB expense	$ XX,XXX

Note: The $10,000 represents 100% of the service cost attributable to the employer entity in this example, as calculated by plan actuaries. The ORB expense (as calculated above) would be reported on the Statement of Net Cost in accordance with paragraph 88.

Table 8

Administrative Entity's ORB Liability

Beginning balance	$ X,XXX,XXX
Add: additional ORB expense incurred (as calculated in table 7)	XX,XXX
Less: payments made on behalf of beneficiaries	XX,XXX
Ending liability balance	$ X,XXX,XXX

Note: The liability balance should be reported on the administrative entity's Balance Sheet.

Other Postemployment Benefits (OPEB)

94. OPEB are provided to former or inactive employees, their beneficiaries, and covered dependents outside pension or ORB plans. Inactive employees are those who are not currently rendering services to the employer but who have not been terminated, including those temporarily laid off or disabled. Postemployment benefits can include salary continuation, severance benefits, counseling and training,

continuation of health care or other benefits, and unemployment, workers' compensation, and veterans' disability compensation benefits paid by the employer entity.

95. The employer entity should recognize an expense and a liability for OPEB when a future outflow or other sacrifice of resources is probable and measurable on the basis of events occurring on or before the reporting date. For example, a reduction in force may require an employer entity to make severance payments, unemployment reimbursements, or other payments in future periods. Similarly, an injury on the job may require the employer entity to make short- or long-term reimbursements to the federal workers' compensation program. A long-term OPEB liability should be measured at the present value of future payments. This will require the employer entities to estimate the amount and timing of future payments, and to discount the future outflow using the Treasury borrowing rate for securities of similar maturity to the period over which the payments are to be made.

96. Most OPEB liabilities should be short-term because the benefits will be paid in the near future. Some OPEB, however, could be longer term. For example, a liability for workers' compensation or veterans' disability compensation might be long-term for some injuries since federal employer entities might be required to reimburse the program for many years.[54] Also, certain specially authorized separation incentive programs could provide for payments that extend over many future years.

Insurance And Guarantees

Nature Of Federal Insurance And Guarantee Programs[55]

97. Insurance and guarantee programs are federal programs that provide protection to individuals or entities against specified risks. Many of

[54]Both the federal employee unemployment program and the federal workers' compensation program are financed by direct reimbursements from federal employers.

[55]In the federal government, the aspects of insurance and guarantees are frequently commingled within the same program. Therefore, this Statement treats the terms as a single type of activity.

these programs were established to assume risks that private sector entities are unable or unwilling to assume [at least at prices that beneficiaries of the program can afford (in some cases) or want to pay (in other cases)] or to subsidize the provision of insurance to achieve social objectives. Program participants pay fees or premiums for specific services. These funds are commonly held in revolving funds within the federal government; losses sustained by participants are paid from these funds. Many of these programs receive appropriations to pay excess claims and/or have authority to borrow from the Treasury.

98. For accounting purposes, private sector insurance and guarantee contracts are customarily divided into two types. The first type provides insurance protection for a fixed period. The insurer may cancel the coverage or adjust the provisions of coverage at the end of any coverage period, for example, by adjusting the amount of premiums charged or changing the conditions under which coverage is provided. Most property insurance and health insurance offered by private insurers is of this type.

99. The second type of insurance or guarantee contract is one in which the insurer cannot cancel the insurance or the insured is guaranteed the ability to renew it. The insurer must provide coverage for an extended period until the insured event occurs or can no longer occur, or when the insured party allows the policy to lapse. Examples of this type of insurance offered by private insurers include whole and guaranteed renewable term life insurance, annuities, and title insurance.

100. Federal programs provide protection against many types of risk for individuals and entities. These include life insurance; medical insurance; and insurance against damage to property (homes, crops, and airplanes) or other assets (deposits and pension benefits) caused by perils such as flooding and other natural disasters, war-risk, and insolvency.

101. For federal insurance and guarantee programs, there often is no explicit contract. For example, the federal government, acting through the Pension Benefit Guaranty Corporation (PBGC), functions as an insurer of pension benefits, but the "contract" with employers and pension plans is implicit in federal law, not explicit in contracts between PBGC and employers. Moreover, the PBGC itself has no power to set premiums or to change the terms of coverage, though it may recommend changes to the Congress. The Congress has occasionally raised premiums and changed other factors, such as pension plan funding requirements, in an effort to achieve the statutory intent that the program be self-financing without appropriations from general revenue.[56] Companies with defined benefit pension plans must participate, but may (and sometimes do) elect to terminate their defined benefit pension plans.

102. Federal insurance programs also differ from private insurance in that they are not subject to the same market forces (e.g., competition for business and for capital) and regulatory requirements (e.g., for capitalization) that apply to privately owned insurers. In particular, federal insurance, unlike private insurance, is not extended with the intent of earning a profit. Some programs operate deliberately at a loss, as when disabled veterans are offered life insurance at premiums set for healthy participants. Other programs offer insurance covering catastrophic or systemic risks, where large losses can occur all at once, as in war-risk or deposit insurance. At most, federal insurance programs are expected just to meet anticipated costs, leaving them vulnerable to unfavorable surprises.

103. For this reason, the issue in accounting for federal insurance and guarantee programs is when to recognize net expected losses. In this respect, federal insurance programs are similar to federal credit programs. The federal government extends credit on terms and conditions designed to subsidize particular borrowers or encourage particular activities for social policy reasons. As soon as a federal direct loan or loan guarantee is obligated, the federal government is committed to bear whatever loss, through defaults or interest subsidies, is inherent in the terms and the conditions under which the credit is extended. The government is likewise committed when

[56]Further details on PBGC may be found in Controlling Losses of the Pension Benefit Guaranty Corporation, Congressional Budget Office, January 1993.

federal insurance is extended to additional policyholders, either for an additional fixed period, or to cover additional amounts of assets.

Accounting For Liabilities Of Federal Insurance And Guarantee Programs

104. All federal insurance and guarantee programs (except social insurance and loan guarantee programs[57]) should recognize a liability for unpaid claims incurred, resulting from insured events that have occurred as of the reporting date. The standard requires recognition of the liability that is known with certainty plus an accrual for a contingent liability recognized when an existing condition, situation, or set of circumstances involving uncertainty as to possible loss exists and the uncertainty will ultimately be resolved when one or more probable future events occur or fail to occur; a future outflow or other sacrifice of resources is probable; and the future outflow or sacrifice of resources is measurable. Insurance and guarantee programs should recognize as an expense all claims incurred during the period, including, when appropriate, those not yet reported and contingencies that meet the criteria for recognition. Life insurance programs should recognize a liability for future policy benefits (a liability to current policyholders that relates to insured events, such as death or disability) in addition to the liability for unpaid claims incurred. (See Contingencies section for the criteria for disclosure of a contingent liability.)

105. Risk assumed information is important for all federal insurance and guarantee programs (except social insurance, life insurance and loan guarantee programs) and will be considered in the context of the Stewardship reporting. Risk assumed is generally measured by the present value of unpaid expected losses net of associated premiums, based on the risk inherent in the insurance or guarantee coverage in force.

Additional Disclosures For Insurance And Guarantee Programs Administered By Government Corporations

106. When financial information pursuant to FASB's standards on federal insurance and guarantee programs conducted by government corporations is incorporated in general purpose financial reports of a larger federal reporting entity, the entity should report as RSSI what

[57]Social insurance is considered to be a different type of program not included within insurance and guarantee programs. See social insurance discussion in the FASAB ED, *Supplementary Stewardship Reporting*. Accounting for all federal loan guarantee programs should follow the Statement of Federal Financial Accounting Standards Number 2, *Accounting for Direct Loans and Loan Guarantees* (August 23, 1993).

amounts and periodic change in those amounts would be reported under the "risk assumed" approach referred to in this section (see par. 105). In other words, in addition to the liability for unpaid claims from insured events that have already occurred (including any contingent liability that meets criteria for recognition), such reporting entities should also report as RSSI risk assumed information.

Illustrations Of The Application Of The Standard

107. Table 9 illustrates the application of the liability recognition, disclosure, and supplementary reporting standards for six federal insurance and guarantee programs. Two of these, flood and crop insurance, offer fixed period annual insurance. A third, deposit insurance, also can be said to offer fixed period annual insurance, though in practice it is continually renewed at the option of the insurer.[58] A fourth program listed, overseas private investment insurance, offers a fixed period multi-year written contract. The fifth program, life insurance, offers coverage that in practice is noncancelable by the insurer and guaranteed renewable by the insured, continuing until the insured event has occurred or the policy is cancelled by the insured. Finally, the pension benefit guarantee program is included as an example of noncancelable insurance. Pension insurance is characterized here as noncancelable with respect to vested guaranteed benefits earned by covered employees to date, on the assumption that this coverage would remain in effect even if the Congress ended the program.

108. The column numbered (3) in the table shows the point at which the standard requires a liability to be recognized for insurance and guarantee programs except life insurance. Column (3) recognizes all unpaid claims and expected claims resulting from insured events that have already occurred, whether floods, crop damage, overseas investment losses, bank closures and insolvencies, deaths, or pension plan terminations. The liability for unpaid claims is the estimated amount needed to settle claims relating to insured events that have occurred on or before the reporting date. This liability includes a contingent liability recognized when an existing condition, situation, or set of circumstances involving uncertainty as to possible loss exists and the uncertainty will ultimately be resolved when one or more probable future events occur or fail to occur; a future outflow or other

[58]In effect, FDIC's options are to renew the insurance coverage or to assume losses of the institution; only Congress can reduce or eliminate the deposit insurance program.

sacrifice of resources is probable; and the future outflow or sacrifice of resources is measurable.

109. The liability at the end of any period should be the expected unpaid net loss inherent in insured events that have occurred, including any claims --both claims reported and when appropriate, claims incurred but not reported (IBNR)-- and any contingent liabilities that meet the criteria for recognition. When payments and losses extend beyond the current year, net losses should be calculated on a present value basis to reflect the time value of money. The expense for claims incurred in the reporting period should be recognized in that period. Changes in estimates of claim cost resulting from the present value calculations, the continuous review process, and differences between estimates and actual payments for claims should be recognized as charges against operations of the period in which the estimates are changed or payments are made.

110. Liability recognition for life insurance programs spans over columns (3) and (4). The column numbered (4) in the table shows the point at which the standard requires liability recognition for life insurance and supplementary reporting for other insurance and guarantee programs. The supplementary reported amounts represent the present value of unpaid expected losses based on the risk assumed as a result of insurance coverage net of associated premiums.

Table 9 [Note: The below underlined items are recognized liabilities.]

Liability Recognition, Supplementary Information And Disclosure			
(1) Type of insurance	**(2) Example of program**	**(3) Insured event has occurred**	**(4) Risk assumed**
Fixed period, annual	National Flood Insurance	CLAIMS + IBNR FOR FLOODS TO END OF PERIOD	The present value of unpaid expected losses net of associated premiums, based on the risk assumed as a result of insurance or guarantee coverage.
Fixed period, annual	Federal Crop Insurance	CLAIMS + IBNR FOR DAMAGE TO END OF PERIOD	The present value of unpaid expected losses net of associated premiums, based on the risk assumed as a result of insurance or guarantee coverage.
Fixed period, annual	Federal Deposit Insurance	CLAIMS + PV OF COST FOR DEPOSITORIES IN PROCESS OF CLOSURE BY THE END OF THE REPORTING PERIOD; AND THE ESTIMATED LOSS FOR THE PROBABLE COST FOR INSTITUTIONS THAT HAVE NOT YET FAILED BUT THE REGULATORY PROCESS HAS IDENTIFIED AS EITHER EQUITY INSOLVENT OR IN-SUBSTANCE EQUITY INSOLVENT OR LIKELY TO BECOME IN-SUBSTANCE EQUITY INSOLVENT WITHIN THE FORESEEABLE FUTURE.	The present value of unpaid expected losses net of associated premiums, based on the risk assumed as a result of insurance or guarantee coverage.
Fixed period, Multi-year	Overseas Investment Insurance	CLAIMS + IBNR FOR LOSSES TO END OF PERIOD	The present value of unpaid expected losses net of associated premiums, based on the risk assumed as a result of insurance or guarantee coverage.
Noncancelable or renewable	Pension Benefit Guarantee	CLAIMS + IBNR: PV OF UNFUNDED GUARANTEED BENEFITS FOR PLANS TERMINATED OR MORE LIKELY THAN NOT TO BE TERMINATED	The present value of unpaid expected losses net of associated premiums, based on the risk assumed as a result of insurance or guarantee coverage.
Noncancelable or renewable	VA Life Insurance	CLAIMS + IBNR (PLUS RESERVE FOR CURRENT CASH VALUE, IF NECESSARY)	*LIABILITY FOR FUTURE POLICY BENEFITS (NET APV OF POLICIES IN FORCE).* All components of the liability for future policy benefits should be separately disclosed in a footnote with a description of each amount and an explanation of its projected use and any other potential uses (e.g., reducing premiums, determining and declaring dividends available, and/or to reducing federal support in the form of appropriations related to administrative cost or subsidies).

Present Value (PV)

Actuarial Present Value (APV)

Note: Liability recognition includes any contingent liability that meets the criteria for recognition.

This example is intended to illustrate examples of various programs and how the various liabilities would be determined. This table is not to be considered authoritative.

111. Insurance programs are on-going and may be viewed as having long term characteristics. Thus, from a broader, longer term perspective, the liability to be recognized (column 3), and the amount to be reported as supplementary information (column 4) may be conceptually different and materially different from each other. From the broader perspective column (4) could be a longer term measure and a probabilistic estimate of future costs of these programs.

112. For noncancelable or guaranteed renewable insurance also, a difference arises between columns (3) and (4). Thus, for pension guarantees, column (3) shows the net present value of losses arising from plans that have already been terminated or that are more likely than not to be terminated. This is the amount to be recognized as a liability. Column (4) shows the net present value of the expected loss inherent in the risk assumed as a result of coverage on the guaranteed and vested benefit amounts. This number should be reported as supplementary information. It will generally be larger than the liability because it includes a provision for the additional losses that are expected to arise because some plan sponsors currently in good financial condition will in the future face bankruptcy with pension assets too small to cover the vested benefits that were guaranteed.

113. The liability for life insurance includes both the liability for unpaid claims, including IBNR (i.e., column 3), and a liability for net future policy benefit outflows (i.e., column 4). The liability for future policy benefits represents the expected present value of future outflows to be paid to, or on behalf of, existing policyholders, less the expected present value of future net premiums to be collected from those policyholders. The liability is estimated using appropriate financial or actuarial methods that include assumptions, such as estimates of expected investment yield, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made and in accordance with existing law and related policy (see specific whole life insurance standard below). Changes in the liability for future net policy benefit outflows that result from periodic re-estimations would be recognized as expense in the period in which the changes occur. The effects of changes in relevant law or policy would be recognized when those changes occur.

114. The assessments of losses expected based on the risk assumed may be made by appropriate actuarial or financial methods that include information and assumptions applicable to the economic, legal, and

policy environment in force at the time the assessments are made. Since all future events are uncertain, indicators of the range of uncertainty around expected estimates, including indicators of the sensitivity of the estimates to changes in major assumptions, should also be reported.

Whole Life Policies

115. Some VA life insurance programs are whole life policies.[59] These programs operate in a manner similar to private sector mutual life insurance enterprises,[60] except that the regulations and market forces that control the private sector are different for these federal programs. VA life insurance policyholders are issued participating policies, and a portion of the earnings from those policies is returned to policyholders in the form of dividends. The following paragraphs specifically address the accounting required for federal whole life insurance programs.

116. The premiums collected by the insurer are used to pay benefits and other cost, and the balance is usually invested to yield additional income. These assets would be fund balances with Treasury or investments. Encompassed in the liability (also referred to as policy reserves) is cash surrender value and the liability for future policy benefits. The cash surrender value is the portion of premiums paid or other amount recoverable on an insurance policy if immediately canceled. The liability for future policy benefits is the present value of future outflows to be paid to (or in behalf of) policyholders, less the present value of future related premiums. In general, for whole life policies, the liability for future policy benefits should be no less than the cash surrender value that accrues to the benefit of policyholders.

[59]Whole life policies provide insurance over the insured's entire life and the proceeds (face amount) are paid only upon death of the insured. A level premium is usually paid for policies of this type. The premium may be paid annually or more frequently.

[60]A mutual company is an incorporated entity without private ownership interests which operates for the benefit of its policyholders and their beneficiaries. With limited exceptions, mutual companies issue only participating policies. In a mutual company, participating policyholders have the right to vote for members of the company's board of directors or trustees. In some states, the insurance laws provide that upon liquidation of a mutual insurance company, the net assets are distributed among the existing policyholders of the company, and the prior policyholders have no claim against such assets.

Accounting for Liabilities of Federal Whole Life Insurance Programs

117. All federal reporting entities with whole life insurance programs should follow the standards as prescribed in the private sector standards (and as these private sector standards are amended) when reporting the liability for future policy benefits, in addition to the required disclosures described below.[61]

118. A liability for future policy benefits relating to participating life insurance contracts should be equal to the sum of:

    a. the net level premium reserve for death and endowment policy benefits,

    b. the liability for terminal dividends, and

[61]The applicable private sector standards are as follows, FASB SFAS 60 *Accounting and Reporting by Insurance Enterprises*, FASB SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and FASB SFAS 120 *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts* and AICPA Statement of Position (SOP) 95-1 *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*.

For those federal entities with "mutual enterprise-type" whole life insurance programs, FASB SFAS 120 should be followed. SFAS 120 states that mutual life insurance enterprises shall apply SFAS 60 or 97, as appropriate, to participating life insurance contracts unless those contracts meet both of the following conditions:

- The contracts are long-duration participating contracts that are expected to pay dividends to policyholders based on actual experience of the insurer.

- Annual policyholder dividends are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the contribution principle).

If the participating life insurance contracts meet the above conditions SOP 95-1 should be followed.

c. any premium deficiency.[62]

119. An assessment should be made to compare the liability for future policy benefits using actuarial assumptions applicable at the time the contract is made (contract assumptions) with the liability for future policy benefits using assumptions that consider current economic conditions and experience (current conditions). Actual mortality, morbidity, and termination rates should be used when determining experience. For economic conditions, the nature and the mix of current and expected investments should be considered with expected long-term yields.

120. A premium deficiency occurs if the liability for future policy benefits using current conditions exceeds the liability for future policy benefits using contract conditions; the difference should be recognized as a charge to operations in the current period.

Additional Whole Life Insurance Disclosure

121. All components of the liability for future policy benefits (i.e., the net level premium reserve for death and endowment policy and the liability for terminal dividends) should be separately disclosed in a footnote with a description of each amount and an explanation of its projected use and any other potential uses (e.g., reducing premiums, determining and declaring dividends available, and/or reducing federal support in the form of appropriations related to administrative cost or subsidies).

[62]The liability for future policy benefits is consistent with the liability required by SOP 95-1. Net level premium reserve is the excess, if any, of the present value of future guaranteed death endowment benefits over the present value of future net premiums. The net level premium reserve should be calculated based on the dividend fund interest rate, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contracts. The dividend fund interest rate is the interest rate determined at policy issuance used to determine the amount of the dividend fund. It is the rate used to credit interest to the dividend fund, and against which experience is measured to determine the amount of the interest portion of dividends paid to individual policyholders. Terminal dividends are dividends to policyholders calculated and paid upon termination of a contract, such as on death, surrender, or maturity. If the payment of terminal dividends is probable and the amount can be reasonably estimated, the liability should be recognized. [AICPA SOP 95-1, Glossary, p. 33]

Appendix A: Basis For Conclusions

122. This appendix summarizes considerations deemed significant by the Board in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.

123. This Statement addresses recognition and measurement of liabilities in the general purpose financial reports of federal reporting entities. The unique circumstances of the federal government, most notably its role as the vehicle through which citizens express their sovereign power, meant that the Board had to resolve some new issues in order to define exactly how to apply accrual concepts in federal financial reports.

124. The Board's deliberations on liabilities were based on certain ideas about the distinction between exchange and nonexchange transactions, the importance of reporting cost of services provided by the federal government, and the impact of information on decisionmakers. These ideas are explained in the following paragraphs.

125. Many users of federal financial reports are familiar with accounting concepts and standards published by the Financial Accounting Standards Board (FASB) for private sector entities, and the Governmental Accounting Standards Board (GASB) for state and local government entities. Because such users might assume that identical concepts and standards are used by the federal government if differences are not explained clearly, this appendix compares certain concepts underlying the federal standard with concepts that govern recognition and measurement of liabilities in financial reports of private sector entities and state and local governments in the United States. Finally, this appendix also explains the basis for specific conclusions regarding social insurance, contingencies, federal employee pensions, other retirement benefits, other postemployment benefits, and insurance and guarantee programs.

Exchange And Nonexchange Transactions

126. As noted in SFFAC No. 1, *Objectives of Federal Financial Reporting*: "The accounting process begins with recording information about transactions between the government (or one of its component entities) and other entities, that is, inflows and outflows of resources or promises to provide them."[63] In some transactions, consideration of value is exchanged: there is a reciprocal or two-way flow. Other transactions, such as grants and other transfer payments are nonexchange transactions (i.e., there is a nonreciprocal transaction--normally a one-way flow).

127. The federal government is the vehicle through which citizens of the nation exercise their sovereign power. In this role, the federal government is responsible for taking collective action at the national level "to promote the general welfare. "Thus the government undertakes many programs that do not involve reciprocal transfers between the government as an entity and its counterparties. Examples include disaster relief, grants to state and local governments, subsidies, and other transfer programs for individuals. The federal government has a propensity to assume such burdens because it is the agent by which the society, through its elected officials, accomplishes transfers between groups of citizens to enhance their well-being.

128. A taxpayer or a donor may, in fact, receive a benefit of some sort, such as the opportunity to live in a safe, secure environment; to improve one's standard of living; and to receive specific benefits, such as visits to national parks and travel over highways. But it is not ordinarily said that the benefit to the individual taxpayer or donor is of value comparable to that of the consideration given. Therefore, these are classified as nonexchange transactions. For this Statement, the significance of the distinction between exchange and nonexchange transactions arises from the nature of the obligation that is created when one party to a transaction provides a product or service to the other party in return for a promise that something of value will be exchanged for it.

129. Obligations become legally enforceable claims against the federal government in different ways and at different points within transaction cycles that relate to various programs. An important factor

[63]SFFAC No. 1, paragraph (16c).

in distinguishing between various programs is whether an exchange is involved. For example, the federal government may not contract for and receive goods or services and then arbitrarily decide not to honor the contract. Similarly, under existing law, the federal government may be financially responsible for certain damage and injury it causes.

130. In other cases, the obligation may be more a matter of what is perceived as equitable and good public policy than a legally enforceable claim. Although there may be a high probability that a grant, a subsidy, or an income transfer will be made or will continue in future years, the recipients of such grants, subsidies, or transfers do not have a right to receive such payments in the future from the federal government as do those who receive payments in exchange for service they have performed.

131. However, it is possible to make meaningful estimates of the future amounts required to continue present policies regarding such programs. These estimates are relevant to certain decisions and should be disclosed or otherwise reported, as discussed further in *Supplementary Stewardship Reporting*. In the context of the Board's definition, however, estimates of future nonexchange payments should not be recognized as a current period liability. On the other hand, any payments due as a result of past events but unpaid at the end of the period constitute a liability.

132. In the case of federal liabilities, some future outflows of resources are so likely that they should be recognized as accounting liabilities in general purpose federal financial reports before all the other events necessary to create a legally enforceable claim against the government exists.[64] Two important examples of such substantive accounting liabilities are the pensions and retirement health care promised federal workers in return for their service.

133. An exchange can in substance be said to have occurred in such cases, even if the government has not yet made an outlay of cash or other financial resources. Service has been exchanged for a promise of future payment or health care. Such charges are properly assignable to the current period in financial reports. This exchange implies, for

[64]Notwithstanding an expectation that the appropriations will be made, whether they in fact will be made is completely at the discretion of the Congress.

example, that general purpose federal financial reports should recognize the financial effects of the promise to provide health care to retired federal workers as that obligation accrues during their years of service, regardless of whether the budget includes a provision for this item. This is true even though unfunded liabilities of the federal government reported on the financial statements cannot be liquidated without the enactment of an appropriation. Also, as a sovereign entity, the payment of all liabilities other than for contracts can be abrogated by the federal government.

Conclusion On Social Insurance

134. The recognition, measurement and display of obligations for social insurance programs presented the Board with significant theoretical and practical problems. From the theoretical perspective, the Board considered whether social insurance programs resulted in exchange or nonexchange transactions, or whether they contained both exchange and nonexchange features. The Board also considered the problems of articulation between the operating statement and the Balance Sheet, specifically whether the process of reporting a year-to-year change in a Balance Sheet liability might affect the usefulness of an operating statement measure of performance. Finally, the Board considered the difficulty of determining an appropriate measure of the obligation assumed, whether such a measure were to be presented on the face of the Balance Sheet or in the notes.

135. In the exposure draft *Accounting for Liabilities of the Federal Government*, the majority of the Board concluded that social insurance programs were entitlement programs developed to carry out the sovereign responsibilities of the government, financed primarily by compulsory earmarked taxes. The Board favored characterizing social insurance obligations as nonexchange transactions, and limiting recognition of a liability to any unpaid amounts due as of the reporting date. A significant majority of the respondents, however, agreed with an alternative view, which expressed the notion that social insurance programs contained both exchange and nonexchange features, and that there was a need for recognizing a liability at least equal to the present value of future payments due to recipients currently eligible for benefits.

136. Upon reconsideration of the issues, the Board concluded that the most appropriate approach from both the Balance Sheet and Statement of Net Cost perspectives would be: (1) to include a line item entitled

"social insurance obligations" in a separate section of the Balance Sheet following the liability section and before the equity section; (2) to make note disclosure of supplementary data resulting from several approaches for measuring the obligation, and (3) to report the annual financial outflows of current financial resources on the Statement of Net Cost. The Board also decided that, given the sensitivity and magnitude of social insurance, this new position should receive additional exposure, to allow users to review it and comment. The Board felt that the concepts and alternatives had not yet been presented to the user community in sufficient detail. Hence, the discussion of social insurance has been withdrawn from the liability standard and consolidated in Supplementary Stewardship Reporting.

Impact Of Communicating Information In General Purpose Federal Financial Reports

137. FASAB recognizes that extensive information about probable and possible future federal outlays is available now in many special purpose reports on various federal programs. In that sense, the financial reports prepared pursuant to this Statement are not likely to reveal information that is new in an absolute sense. Analysts working for the various executive agencies, congressional committees, private interest groups, "think tanks" and universities are, collectively, aware of this information and much more. Nevertheless, the Board believes that presenting liabilities and stewardship responsibilities in the general purpose federal financial reports can be valuable in several ways. There are at least four reasons for this belief.

138. First, analysts typically know a lot about certain programs, but only those programs. Currently it is difficult, if not impossible, to assemble comprehensive information prepared on a comparable basis for the federal government as a whole. In many cases, this is also true for significant component units. General purpose federal financial reports attempt to provide a way of presenting comprehensive information.

139. Second, much of this information has no impact on individual decisionmakers, such as program managers, unless it is conveyed in a way that facilitates, or even requires, suitable attention to it. For example, information about federal pension plans and retirement benefits conveyed in an actuarial report or in the narrative section of the *Budget of the United States Government* may have an impact on certain congressional decisions, but is unlikely to influence managers' decisions about whether to use federal employees, invest in labor-saving equipment, or contract out to accomplish a given task. If the

information is to have such an impact, it must be reported in a way more directly associated with the activities the manager is responsible for. Associating the expenses and liabilities reported in the general purpose federal financial report with the outputs of responsibility centers is able to accomplish this direct association.

140. Third, the mere requirement to assemble and report these data will, in some cases, affect federal managers, who, like everyone, tend to manage what they measure. Some observers believe, for example, that the prospect of having to comply with FASB's Statement 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, caused corporate managers and others to focus increased attention on the need to manage the cost of promises they had made to provide health care to retirees, even before the statement became effective.

141. Fourth, financial reports prepared and audited pursuant to federal accounting standards may reasonably be expected to possess a certain credibility and to command a certain amount of attention from various users, sufficient to affect decisions about federal government public policy. They will provide a source of information that should complement what is provided by the *Budget of the United States Government*. An important collateral benefit arises from the processes of preparing, auditing, and publishing annual financial statements. Experience demonstrates that these processes improve the reliability of information and of control systems, thereby enhancing both decisionmaking and accountability in general.

Relationship To Liability Recognition Principles Used By Nonfederal Entities

142. FASB defines the basic principles that govern liability recognition by private sector entities in the United States.[65] Government corporations follow those standards in their separately issued financial statements. Probably most readers of this Statement are familiar with these principles. Probably most users of federal financial reports are accustomed to seeing other financial reports prepared according to these principles.

143. FASAB's principle for liability recognition differs from FASB's. The difference can be seen as a modification made necessary by the sovereign nature of the federal government. FASAB contemplates a liability standard within the context of a reporting model that provides much greater emphasis on publicly reporting certain stewardship responsibilities than does the reporting model used by private sector organizations. This kind of reporting model is necessary because of the federal government's responsibility for the general welfare of the nation and its resulting willingness to take on obligations.

Conclusion On Contingencies

144. In the Exposure Draft the Board asked the following question. "When an estimated [contingent] liability is a range of amounts and no amount within the range is a better estimate than any other amount, should either the midpoint or, alternatively, the 'expected value' (as the term is used in statistics) be recognized as a liability instead of the minimum amount?" The majority of respondents preferred the expected value and the second preference was the minimum amount.

145. The Board further considered all of the options. Based on the Board discussions it was noted that it would be difficult to use "expected value" to pinpoint an estimate within a range. The expected value method would assign a probability percentage to each of the numbers

[65]The Governmental Accounting Standards Board (GASB) has not published a concept statement on financial statement elements as FASB has done in Concept Statement Number 6 and has not defined "liability" per se. In the current state and local governmental accounting model, a fund liability is "the amount left unpaid at the end of the reporting period that normally would be liquidated with expendable available financial resources. The remainder of the liability should be reported in the General Long-Term Debt Account Group (GLTDAG)." National Council on Government Accounting Statement (NCGAS) Number 4, par. 17. (See GASB *Codification of Governmental Accounting and Financial Reporting Standards*, section 1500.)

within the range, but these probabilities would usually be difficult to estimate.

146. After much discussion the majority of the Board preferred the minimum amount because of its established use in other accounting standards. The Board decided that liabilities arising from nonexchange transactions would be recognized for any unpaid amounts due as of the reporting date. This includes amounts payable from the federal entity to pay for benefits, goods, or services[66] provided under the terms of the program, as of the federal entity's reporting date, whether or not such amounts have been reported to the federal entity (for example, estimated Medicaid payments due to health providers that will be financed by the federal entity but have not yet been reported to the federal entity).

147. In the case of government-acknowledged events giving rise to nonexchange or exchange transactions, there must be a formal acceptance of financial responsibility by the federal government, as when the Congress has appropriated or authorized (i.e., through authorization legislation) resources. Furthermore, exchange transactions that arise from government-acknowledged events would be recognized as a liability when goods or services are provided. For nonexchange transactions a liability would then be recognized at the point the amount is due. Therefore, government-acknowledged events do not meet the recognition criteria necessary to be recognized as a contingent liability. The government is acting in its sovereign capacity when it assumes financial responsibility and makes income transfer payments or provides other nonexchange benefits. The Board does not believe that accounting recognition should anticipate sovereign actions in advance of occurrence.

[66]Goods or services may be provided under the terms of the program in the form of, for example, contractors providing a service for the government on the behalf of disaster relief beneficiaries.

Conclusion On Pensions, Other Retirement Benefits And Other Postemployment Benefits

Pensions - Projected Salary Levels

148. A primary objective for federal financial reporting is to measure accurately the full cost of employer entity services to the public. The methods used to account for pensions, ORB, and OPEB in general purpose financial reports should accurately measure the full cost of an employer entity's services. Since federal pension benefits are based on final salaries, whatever method is used for the annual cost and accrued liability of federal pensions must include projected future salaries that reflect an estimate of the compensation levels of the individual employees involved (including future changes attributable to the general price level, seniority, promotion, and other factors). They are part of the obligation that the federal government is incurring.

Accounting For The Pension Plan

Attribution Methods

149. The major federal pension plans use an actuarial cost method for funding purposes known as aggregate entry age normal (AEAN). Various actuarial cost methods exist. All the methods regarded as acceptable methods for advance funding of private pension plans recognize the cost of an employee's pension benefits during the employee's years of service, but the different actuarial methods recognize the cost in different patterns over time. The AEAN method is intended to produce a periodic pension cost that is a level percent of payroll.

150. That is, AEAN is a method under which the present value of projected benefits of each employee is allocated on a level basis (such as a constant percentage of salary) over the service of the employee between entry age and assumed exit age. The portion of this present value allocated to each year is called the normal cost. The portion of this present value not provided for at a valuation date by the present value of future normal cost is called the actuarial accrued liability.

151. FASAB considered the method used by the Financial Accounting Standards Board in Statement of Financial Accounting Standards (SFAS) No. 87, *Employer Accounting for Pensions* (the projected unit credit, or PUC), as well as AEAN. FASB concluded that PUC gave a better measure of the employer's obligation for the benefits earned by the employees at a particular point in time. It therefore said that PUC provides a better measure of the value of the benefits that accrue during the year. However, FASAB heard testimony from an OPM actuary that results from these two methods were similar for federal plans. FASAB concluded that AEAN is a sound measure of the accruing expense.

152. FASAB concluded that any method of assigning the value of benefits that are earned over the entire career to particular years of service involves a process of estimation. It is, of course, reasonable to assume that the benefits accrue in some sort of systematic and uniform fashion and not, for example, all at once when the employee becomes eligible. Assuming that the benefits accrue as a uniform percentage of salary each year (as is done with AEAN for pensions) is a reasonable approach. AEAN is particularly useful within an organization when measuring costs over time because it provides that a dollar of salary always equals a fixed percent of pension, regardless of the year involved. Thus, inflation is factored into the calculation automatically.

153. FASAB specified the AEAN for several reasons. First, as stated, AEAN is a reasonable and systematic way of allocating costs evenly over the service lives of employees. Second, the major federal retirement systems [the Military Retirement System (MRS), the Civil Service Retirement System (CSRS), and the Federal Employees Retirement System (FERS)] use AEAN, and in two cases (FERS and MRS) charge "full cost" in the budget under a statutory requirement.[67] Finally, exact comparability with private-sector entities is not relevant. Minor differences in the size of the pension liability and expense calculated

[67]The CSRS statute calls for procedures that are generally construed as entry age normal. "Full cost," of course, depends on the method selected. For example, prior service cost is amortized in FERS over 30 years pursuant to the funding method; it would be recognized over a shorter period (years of expected future service of the group or 15 years) under SFAS 87. It should be recognized in full immediately under the terms of this standard, but only in financial reports of the agency that administers the pension plan and in the consolidated financial statements of the United States, not in the employer agency's financial statements. Thus, "full cost" in this sentence must be read in a generic way, that is, as a statement of the general intent underlying the law.

pursuant to this Statement and SFAS 87 clearly would not have a material impact on investor's assessment of the credit-worthiness of the U. S. government.

154. Since there are several acceptable attribution methods and several small pension plans in addition to the three major plans, FASAB decided that the use of methods other than AEAN was permitted provided the results were not materially different from those of AEAN. A material difference between the expenses and the liabilities for federal plans based solely on the choice of attribution method would destroy the comparability and impair the usefulness of the information for users other than investors.

155. FASAB recognizes also that other attribution methods might be useful for other purposes. For example, a method that calculates the vested benefits accrued by employees to date, at current salary levels, would be useful as a measure of the accumulated amount the plan would owe if it were to terminate. Such calculations would be for special purpose reports not covered by this Statement.

Assumptions

156. There are three objectives for actuarial assumptions. First, FASAB considers it extremely useful to have consistent assumptions among accounting, budgeting, and actuarial statements to the extent it is possible to do so while attaining the objectives of federal financial reporting.

157. Second, assumptions ought to be consistent across federal employee retirement systems. Assumptions need not be identical because the conditions facing each plan may objectively differ, but they should be rationally related (thus, the standard calls for financial reports to be prepared on the basis of the best available estimates for actuarial assumptions). Also, the standard allows the smaller plans to use the assumptions provided by any of the three primary plans or to use their own assumptions if they explain how and why they are different from one of the major plans.

158. Third, assumptions ought to reflect the underlying economic substance of the transaction. They should reflect the entity's past experience and current expectations regarding cost trends. They

should reflect the similarities of and differences between two sets of economic phenomena rather than forcing artificial uniformity.

159. FASAB concluded also that the discount rate should reflect the long-term expected return on plan assets rather than a current market rate on debt of comparable maturity (the discount rate called for by SFAS 87). The long-term expected rate reduces volatility, reflects the actual experience and expectations of the primary federal plans, and is consistent with the assumptions used in the budget. The Governmental Accounting Standards Board uses a similar approach for the discount rate for state and local government pensions for similar reasons.

Prior Service Cost

160. Prior service costs (or gains) are the costs (or gains) of retroactive benefits granted (or reduced) in a plan amendment. Under the current budgetary system, prior service costs are funded in the budget through General Fund appropriations over 30 years. The employer entities under MRS and FERS--which are intended to be fully funded--are not charged in their budgets for prior service cost (nor are they credited for gains), but rather the General Fund is charged for these costs.[68]

161. As stated in the Statement, FASAB believes that prior service costs, interest on the pension (or ORB) liability, and actuarial gains and losses are expenses of the federal government as a whole and are best accounted for by the administrative entity. Some respondents did not agree that employer entities should recognize only the "normal" or "service" cost element. The respondents suggested that the employer entity should recognize all elements of the pension (or ORB) expense: service costs, prior service costs, actuarial gains and losses, and interest on the pension liability. In general, these respondents believe that the full cost of products and services produced by the employer entity includes these elements, and that the full cost thus defined is relevant to various decisions such as comparing the cost of outputs and services with alternative providers.

[68]CSRS also receives General Fund appropriations for this purpose, but the appropriations are based on statutory provisions and are less than they would be under a fully funded approach. Because of this, the CSRS funding approach is not being used as an example of budgetary treatment to be contrasted with the accounting treatment.

162. The Board considered these views, but it continues to believe that employer component entities of the U. S. Government should usually recognize only the service cost element of pension (and ORB) expense in their general purpose financial reports. (Exceptions will arise in cases such as the Coast Guard, where the employer entity is also the administrative entity for the plan). The Board is aware that its approach may appear to differ from the approaches taken by FASB and GASB in this regard. However, neither of those Boards focused, in their standards on pensions and other retirement benefits, on reporting by component entities of a larger reporting entity comparable to the Government of the United States. All elements of pension (and ORB) expense should be recognized in the consolidated financial statements of the United States Government; however, the Board believes that prior service cost and other non-service cost are not useful for most managerial or policy decisions at the program level. They are sunk costs (or sunk gains) attributable to services rendered in prior years, or otherwise are not under the control of program management. FASAB continues to believe that having non-service elements of cost reported by the administrative entity best reflects the federal environment and organizational structure.

163. The Board recognizes that some analysts might, for some purposes, want to consider an alternative measure of compensation cost, e.g., one that includes interest on the part of the pension (or ORB) liability that relates to current workers, or one that recognizes some non-service costs over the workers' years of expected service. Special analyses and reports will always be necessary for special purposes. General purpose financial reports must, by definition, focus on the most common needs of users of those reports.

164. For similar reasons, FASAB also continues to believe that prior service costs (or gains) should be recognized immediately, without amortization, by the administrative entity, and in federal government-wide financial reports. FASAB sees no benefit to delaying recognition of a cost and a liability or to reducing volatility in the general purpose financial report of the administrative entity. FASAB was not persuaded that the benefit (or the cost) derived in future periods from increased (or deceased) pension benefits was sufficiently tangible in the federal context to warrant delayed recognition by means of amortization over future periods. Examples of plausible future benefits or costs would be, increased (decreased) employee productivity or reduced (increased) turnover.

165. FASAB recognizes that, for funding purposes, prior service costs for CSRS, FERS, and MRS are amortized through appropriations over a number of years. Funding decisions, however, should not be determinative for accounting recognition of cost. Deciding when and how to fund an obligation is not an accounting issue.

Actuarial Gains and Losses

166. Actuarial gains and losses result from (1) deviations between actual experience and the actuarial assumptions used and (2) changes in actuarial assumptions. Actuarial assumptions are essentially long-range estimates about future events and necessarily vary from actual experience.

167. Actuarial gains and losses and prior service costs (or gains) have similar characteristics. They are both determined after the accounting period in question has concluded, and both relate to the past (either prior service or prior experience). The difference between actuarial gains and losses and prior service costs (or gains) is that the former are the normal result of actuarial estimation and may occur annually, while prior service costs are incurred only when the plan is amended. Also, actuarial gains and losses may tend to even out over time, unlike prior service costs.

168. FASAB concluded that actuarial gains and losses should receive the same treatment as prior service costs (or gains). They should be charged to the administrative entity. The employer entities should recognize an expense only for the service cost[69] of their employees for the period less the amount contributed by the employees, if any. Like prior service costs, the actuarial losses are sunk costs (or sunk gains) attributable to services rendered in prior years and therefore should be excluded from data used for managerial or policy decisions.

169. For the same reasons as were given for prior service costs, actuarial gains and losses should be recognized immediately by the administrative entity. There is no benefit in delaying recognition or

[69]"Service cost" is defined as the actuarial present value of benefits attributed by the plan's benefits formula to services rendered by employees during an accounting period. The term is synonymous with "normal cost".

reducing volatility in the cost measures and the financial reports of the administrative entity.

Recognition and Measurement

170. The Board's conclusions discussed immediately above are reflected in the accounting treatment of pensions. The employer entity should recognize an annual pension expense as a cost of operations. When the employer entity's contributions are less than its pension expense, the employer entity should recognize an imputed financing source for the expenses paid by other entities. To the extent that it receives contributions from the employer entity, the administrative entity should recognize an intragovernmental revenue.

171. These transactions are intragovernmental. For purposes of federal government-wide consolidated financial reports, the employer's pension expense should be offset against (1) the administrative entity's contributions received from employer entities and (2) the employer entity's imputed financing source, if applicable.

172. The administrative entity should report the pension liability. An increase in the liability during the accounting period is an expense to the administrative entity. The liability is increased by the net total of the pension cost components [normal cost, interest on the pension obligation, prior service costs (gains), and actuarial gains (losses)]. Thus, the administrative entity should be providing information not only about the actuarial liability but also about the relationship between the full cost and the revenue from employees, employer entities, interest, and Treasury contributions.

173. Recognizing the pension cost components in the administrative entity and also the normal cost in the employer entities accomplishes two objectives. First, the full cost and actuarial liability are summarized and presented in one place, i.e., in the administrative entity's operating results and Balance Sheet. Second, each employer entity reports its respective normal cost as a cost of providing service. This is essential to report properly the cost of delivering federal government services. These entries are eliminated during consolidation for federal government-wide financial statements and, thus, no double counting occurs.

Other Retirement Benefits

174. FASAB concluded that ORB are similar to pension benefits and should be accounted for in a similar way unless differences in substance dictate otherwise. The predominant other retirement benefit in the federal government is health care benefits for retirees. These are long-term and require actuarial estimation.

175. FASAB recognizes that future health care benefits present unique measurement problems. They are more uncertain than pensions since they depend on the changing patterns of health care delivery and utilization, on the price trends for medical care, and on the benefits provided by social insurance programs like Medicare.

176. Also, some federal retiree health benefits are provided directly in federal government hospitals and domiciliary facilities. The liability in these cases also depends on the amount that the Congress will appropriate in the future to pay for the benefits, so the expense and liability are more difficult to measure. Notwithstanding the measurement difficulties, because of the importance of approximating the cost of services rendered at the time the service is rendered, FASAB believes that in most cases, the ORB costs and liabilities should be measured for federal programs. However, as noted in the discussion starting with paragraph 182, VA medical care cost would be recognized in the period medical care service is rendered.

Accounting For The Other Retirement Benefits Plan

Attribution Method

177. Unlike the situation regarding federal pension plans, there is no established attribution method for federal retirement medical care. Although there are current proposals to do so, the costs are not currently being funded.

178. For retirement health care, FASAB found no compelling reason to prefer an approach other than the aggregate entry age normal used for pensions. The employer's service cost however, should be calculated differently for health care than for pensions. For the pensions, costs are calculated as a percent of payroll, but retirement health care benefits are paid for each individual retiree regardless of prior salary. Cost, therefore, should be calculated on a per person basis because that accurately represents how the cost is incurred.

Assumptions

179. Although the general assumptions employed for ORB should be the same as those for pensions, the health care cost trend assumption is unique. The standard gives general guidance regarding the use of "Medicare projections or other authoritative sources" for the trend assumption in order to achieve consistency and set broad guidelines for the estimates. The health care cost assumption should reflect these sources adjusted for any factors unique to the organization.

Other Postemployment Benefits

180. OPEB represent operating expenses of the federal employer entity. Some might argue that OPEB, like pensions and ORB, should be accrued as employees perform services, as a cost of operations, because (1) they believe the event is occurring as the employees perform service, (2) future OPEB payments are probable, and (3) they can be measured. FASAB was not persuaded that there was an adequate nexus between these cost and the employee's daily, ongoing service; or that these costs were sufficiently probable at that point to warrant accrual.

181. FASAB believes that an accrual based on the occurrence of an actual event, such as a job-related injury or a decision to reduce the entity's workforce generally, is a reasonable approach. Such an event makes the future outflow of resources probable and measurable, may involve long-term accruals in some cases, and provides an accurate measure of expense in a way that is the least burdensome to the reporting entities.[70]

VA Medical Care Cost

182. Although it might appear that medical benefits provided by the Department of Veterans Affairs should be treated like other retirement or medical benefits, there are significant differences between the two. Most often retiree medical benefits are provided through a health insurance provider, which receives premium payments from the

[70]The federal workers' compensation and unemployment insurance programs are different from the programs applicable to nonfederal workers. The benefits for federal employees under these programs are financed by direct reimbursement from employer entities. Usually the reimbursement period for workers' and unemployment compensation is short-term, but under certain conditions, workers' compensation may extend for many years.

former employer. But, with VA medical benefits, the former employer (the government) provides the medical services through VA facilities to veterans on an "as needed" and an "as available" basis versus payment of health insurance premiums for each veteran.

183. Eligibility for VA hospital care and nursing-home care is divided into mandatory and discretionary categories. VA must provide hospital care to veterans with service-connected disabilities and others in the mandatory category. Hospital care is considered discretionary if the veteran has income above a specified limit and a non-service-connected injury. Veterans in the discretionary category may be required to pay fees to receive VA hospital care. In addition, VA medical care is financed by annual appropriations. The entitlement to receive care does not guarantee any particular level of care. The Congress decides annually how adequately VA medical care will be funded.

184. The Board believes that VA medical benefits, for both mandatory and discretionary programs, are best measured by the annual cost incurred rather than by actuarially determined charges during the veteran's military service. Medical care for veterans does not satisfy the probability or reasonably measurable criteria in this standard at earlier dates, and therefore future medical benefits do not constitute a long-term liability to be recognized in the Balance Sheet. The Board believes VA medical benefit liability and related expenses should be recognized in the period medical care service is rendered. The entity should consider, however, what disclosures would be appropriate for these costs under the contingency standard.

Conclusion On Insurance And Guarantees

185. The Board considered two possible bases for recognizing the liability of federal insurance programs. One would recognize as a liability the unpaid expected present value (PV) cost of insured events that had occurred. The second would recognize as a liability the unpaid expected PV cost of risks that had been assumed (i.e., the unpaid expected PV cost inherent in insurance extended or in force). This second approach would be similar to that taken by the Congress in budgeting for direct loans and loan guarantees and by FASAB in accounting for these transactions. (See Statement of Federal Financial Accounting Standards Number 2, *Accounting for Direct Loans and Loan Guarantees*).

186. Several Board members believe that this second approach has merit from a conceptual standpoint. However, the Board has concerns about the measurability of the risk assumed, particularly in the context of pension guarantees. There may also be some question as to the exact nature or categorization of some assumed risks in the absence of written contracts. The Board concluded that it would continue the traditional practice of recognizing the effect of events that had occurred on the face of the financial statements. However, it also decided to require reporting as RSSI the estimated PV cost of the risk assumed for all programs, except social insurance, life insurance, and loan guarantee programs.

187. Accrual accounting for insurance programs attempts to report the expenses of operations for each period and the unpaid liability at the end of the period. Projections of future claims, including renewed, expanded, and new business, also provide important information for policy decisions about what rates should be charged to cover all expected future losses, what additional insurance should be extended, and similar decisions. Management of reporting entities may wish to include such projections in financial reports as other accompanying information, and may do so on a voluntary basis, but the Board is not presently making any specific recommendations about this, beyond those required by this Statement and those to be further considered in *Supplementary Stewardship Reporting*.

188. During the Exposure Draft stage of the Liability Standard, the Board asked respondents whether the Standard provided sufficient guidance on how the risk assumed amount should be measured. Two of the fifty five respondents asked for additional guidance but did not mention measurement possibilities.

189. At the discussion stages of the final Statement the Board contemplated two possible measurement perspectives for reporting the risk assumed. The Statement requires that all federal insurance programs (except social insurance, life insurance, and loan guarantee programs) report the risk assumed amount as supplementary information. The risk assumed calculation as presented in the Exposure Draft measured the cost of the coverage outstanding during the reporting year. For annual term insurance programs, under this approach the risk assumed amount might not be significantly different from the sum of recognized liabilities and contingent liabilities reported on the Balance Sheet. However, the Board believes that requiring disclosure or

supplementary reporting of a risk assumed number that is similar in concept and amount to the liability recognized could be confusing and would not add informational value.

190. In the second perspective, the risk assumed amount would be a broader and longer term measure of the government's potential cost for on-going insurance programs. Under some measures, this second approach to risk assumed could be regarded as an indicator of the "fair" or "full cost" premium that should be charged if taxpayers are not to subsidize the program. This measure would be a probabilistic estimate of the expected cost under certain assumed economic factors. The Board found merits in this calculation, and believes it can provide important additional information beyond that contained in the accrual. Although they believe the measure to be important, proponents of this approach acknowledge that the measure may be difficult to measure precisely. Accordingly, they would treat it as RSSI. The Board currently has a project at the Exposure Draft stage, *Supplementary Stewardship Reporting*, that will provide further details on the measurement and reporting of "risk assumed" in its final statement.

191. The Board also considered the liability recognition of whole life insurance programs. The federal government has a small number of whole life insurance programs that are administered by federal entities. The most significant programs (mutual enterprise-type whole life insurance) are through the Department of Veteran Affairs (VA).

192. At the time the exposure draft on liabilities was issued, there were no established accounting standards for mutual enterprise-type whole life insurance within the federal government, state and local government, or the private sector. Therefore VA followed the statutory requirements for accounting purposes as well as statutory insurance reporting.

193. In January 1995, the FASB and AICPA issued a standard and a statement of position, respectively, that specified accounting for mutual whole life insurance enterprises. Due to the similarities between the federal programs and the insurance enterprises covered in the FASB and AICPA documents, the Board decided that the private sector standards would be appropriate for the applicable federal programs. Therefore the Board concluded that federal entities with whole life insurance programs would follow the standards as

prescribed in the private sector standards (and as these private sector standards are amended) when reporting the liability for future policy benefits, along with the additional disclosures prescribed by this Statement. The Board further concluded that disclosure of the components of the liability was necessary to adequately inform the financial statement users of the projected use and any other potential uses of the liability components and associated assets.

Appendix B: Liability Recognition And Measurement Matrix

Federal Program Categories		Expense	Liability
General fund benefit programs—financed by general revenues	• Aid to Families with Dependent Children • Medicaid • Food Stamps • Special disabled coal miner benefits • VA pension[71]	Recognize expenses when payments are made or unpaid amounts are due as of the reporting date. This includes amounts due from the federal entity as of the federal entity's reporting date, whether or not such amounts have been reported to the federal entity.	Recognize any unpaid amounts due as of the reporting date. This includes amounts due from the federal entity as of the federal entity's reporting date, whether or not such amounts have been reported to the federal entity.
Employee benefits	• Federal employee pension and ORB benefits • Military pension and ORB benefits	Recognize expense as employee services are performed.	Recognize actuarial accrued liability.
	• VA disability compensation[72] • FECA—workers' compensation • OPEB	Recognize expense when relevant event occurs and program participant is determined eligible for compensation.	Recognize any amount due or the present value of future payments due, which ever is applicable.

[71]This program is an entitlement program that veterans may be eligible for if they have limited income when they have 90 days or more of active military service, at least one day of which was during a period of war. Their discharge from active duty must have been during a period of war. Their discharge from active duty must have been under conditions other than dishonorable. They must be permanently and totally disabled for reasons neither traceable to military service nor to willful misconduct. [Department of Veterans Affairs, *Federal Benefits for Veterans and Dependents*, 1993 Edition].

[72]Disability compensation is paid to veterans who are disabled by injury or disease incurred or aggravated during active military service in the line of duty. The service of the veterans must have been terminated through separation or discharge under conditions that were other than dishonorable. Monetary benefits are related to the residual effects of the injury or disease. [Department of Veterans Affairs, *Federal Benefits for Veterans and Dependents*, 1993 Edition].

Federal Program Categories		Expense	Liability
Insurance and guarantees	Fixed period—annual: • Federal Crop Insurance Corp. • National Flood Insurance Fund • Federal Deposit Insurance Corp. Fixed period—multi-year: • Overseas Investment • Noncancelable or renewable: • Pension Benefit Guaranty Corp.	Recognize an expense for claims of the period, including IBNR, i.e., insured events that occur.	Recognize liability for unpaid claims of the period, including IBNR, i.e., insured events that occur.
	Noncancelable or renewable: • Veterans Life Insurance Trust Fund • Employees' Life Insurance Fund	Recognize expense on the basis of risk assumed.	Recognize liability based on risk assumed (plus cash surrender value if relevant)
Capital leases		Recognize interest expense as lease payments are made.	Recognize a liability (the present value of future lease payments) when there is agreement between the federal government and the lessor.
Federal debt	• Treasury debt to federal agencies • Federal agency debt to the Treasury • Federal debt to the public	Recognize accrued (prorated) share of the nominal interest incurred during the accounting period, amortized discount or premium, and the amount of any change in current value for the accounting period for variable-value securities.	Recognize a liability at the par value of the security net of any unamortized discount or premium.

Appendix C: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273.

Statement of Federal Financial Accounting Standards No. 6: Accounting for Property, Plant, and Equipment

Status

Issued	November 30, 1995
Effective Date	for fiscal years beginning after September 30, 1997.
Volume I References	• SFFAS No. 5, *Accounting for Liabilities of the Federal Government* (for definition of a liability and capital lease accounting) • SFFAS No. 7, *Accounting for Revenue and Other Financing Sources* (for guidance on transactions involving asset sales, transfers, exchanges and donations and for revalution of capitalized assets) • SFFAS No. 8, *Supplementary Stewardship Reporting* (for reporting requirements on [National Defense PP&E], heritage assets, and stewardship land) • SFFAS No. 10, *Accounting for Internal Use Software* • SFFAS No. 14, *Amendments to Deferred Maintenance Reporting* (to change the status of deferred maintenance information) • SFFAS No. 16, *Amendments to Accounting for Property, Plant, and Equipment—Measurement and Reporting for Multi-Use Heritage Assets* • SFFAS No. 23, *Eliminating the Category National Defense Property, Plant, and Equipment*
Volume II References	Cleanup Cost (C40), Deferred Maintenance (D20), General Property, Plant, & Equipment (G20), Heritage Assets (H20), Land (L10), Leases (L20), Prior Period Adjustments (P40), Seized and Forfeited Property (S30), Stewardship Land (S60)
Interpretations and Technical Releases	TR 2, *Environmental Liabilities Guidance*
Affects	No other statements.
Affected by	• SFFAS No. 10, paragraph 7, rescinds SFFAS No. 6, paragraphs 27 and 28, and SFFAS No. 10, paragraphs 8-36 provide a comprehensive standard for accounting for internal use software. • SFFAS No. 14, paragraphs 5-9, affect SFFAS No. 6, paragraphs 79-80, and 83-84 by changing certain section headings, deleting paragraph 79, and adding phrases to paragraphs 83-84. • SFFAS No. 16, paragraphs 6 and 8-12 replace SFFAS No. 6 paragraphs 59 and 60-62, respectively; SFFAS No. 16, paragraph 14, replaces SFFAS No. 6, paragraph 63; SFFAS No. 16, paragraph 15, provides additional implementation guidance. • SFFAS No. 23, affects SFFAS No. 6, paragraph 23, by rescinding the category name "Federal mission property, plant, and equipment"; SFFAS No. 23 rescinds SFFAS No. 6, paragraphs 46 through 56 and the accompanying heading "Federal mission property, plant, and equipment", which precedes these paragraphs, SFFAS No. 23 affects SFFAS No. 6, paragraph 35, by adding the following sentence as a separate bulleted line item: "A composite or group depreciation methodology, whereby the costs of PP&E are allocated using the same allocation rate, is permissible."

Summary

a This statement contains accounting standards for Federally owned property, plant, and equipment (PP&E); deferred maintenance on PP&E; and cleanup costs. Each standard is summarized below.

Property, Plant, And Equipment

b The Federal Government's investment in PP&E exceeds $1 trillion[1] and includes many types of PP&E used for many different purposes. "PP&E" is defined as follows:

> Tangible assets that (1) have an estimated useful life of 2 or more years, (2) are not intended for sale in the ordinary course of business, and (3) are intended to be used or available for use by the entity.

c The diversity among Federal PP&E creates a need for meaningful categories of PP&E with different accounting standards for each category. The Board identifies four categories of PP&E. The categories are:

- general PP&E are PP&E used to provide general government services or goods;
- Federal mission PP&E are PP&E exhibiting specific characteristics set by the Board;
- heritage assets are those assets possessing significant educational, cultural, or natural characteristics; and
- stewardship land[2] (i.e., land other than that included in general PP&E).

d Complete accounting standards for *general PP&E* are included in this document.

e *Federal mission PP&E*, *heritage assets*, and *stewardship land* are the subject of a project on "Supplementary Stewardship Reporting." An exposure draft (ED) on this topic was issued in August 1995. The Supplementary Stewardship Reporting ED proposes accounting standards for these assets after their acquisition. The accounting standards in this document address (1) classification of PP&E in the categories, (2) accounting for the acquisition cost of PP&E falling into one of these three categories, and (3) implementation of these standards where it affects the basic financial statements. Because Federal mission PP&E, heritage assets, and stewardship land would be subject to supplementary stewardship reporting, they are referred to collectively as stewardship PP&E. This term is used for convenience only since each category has its own definition.

[1]Department of the Treasury, Financial Management Service, *Consolidated Financial Statements of the United States Government*, prototype 1993, p. 23. The prototype statements provide gross historical cost investment amounts for all PP&E recorded by government entities. These amounts have not been audited.

[2]Land acquired for or in connection with *general PP&E* would be included in that category. Land not associated with general PP&E would be subject to supplementary stewardship reporting and is referred to throughout this document as stewardship land.

General PP&E

f The general PP&E category consists of items that:

- could be used for alternative purposes (e.g., by other Federal programs, state or local governments, or non-governmental entities) but are used by the Federal entity to produce goods or services, or to support the mission of the entity; or
- are used in business-type activities;[3] or
- are used by entities in activities whose costs can be compared to other entities (e.g., Federal hospitals compared with other hospitals).

g General PP&E includes land acquired for or in connection with other general PP&E.[4]

h General PP&E shall be reported in the basic financial statements: the balance sheet,[5] and the statement of net cost.[6] The acquisition cost of general PP&E shall be recognized[7] as an asset. Subsequently, except for land which is a nondepreciable asset, that acquisition cost shall be charged to expense through depreciation.[8] The depreciation expense shall be accumulated in a contra asset account—accumulated depreciation.

[3]Business-type activity is defined as a significantly self-sustaining activity which finances its continuing cycle of operations through collection of exchange revenue as defined in the Board's exposure draft on *Revenue and Other Financing Sources*.

[4]"Acquired for or in connection with other general PP&E" is defined as land acquired with the intent to construct general PP&E and land acquired in combination with general PP&E, including not only land used as the foundation, but also adjacent land considered to be the general PP&E's common grounds.

[5]"Balance sheet" refers to the statement that reports on assets, liabilities, and net position of the entity at the end of the reporting period. This statement is referred to in OMB Bulletin 94-01, Form and Content of Agency Financial Statements, as the Statement of Financial Position.

[6]"Statement of Net Cost" refers to the statement providing information on the entity's flows of exchange revenues, expenses, gains, and losses. The Board presented this new statement in its Statement of Recommended Accounting Concepts No. 2, *Entity and Display*. In addition, the Board has exposed for comment a standard for reporting net costs and has provided an illustrative statement which might give effect to this standard in the ED on *Revenue and Other Financing Sources*, July, 1995.

[7]"Recognize" means to record an amount in entity accounts and to report a dollar amount on the face of the Statement of Net Costs or the Balance Sheet either individually or so that the amounts are aggregated with related amounts.

[8]"Depreciation" is the systematic and rational allocation of the acquisition cost of an asset, less its estimated salvage or residual value, over its estimated useful life.

i The standards provide that certain costs of internally-developed software[9] can be capitalized and amortized over a period not to exceed five years. The costs to be capitalized are limited to direct costs incurred after technological feasibility has been established.

j In addition, the standard addresses donations, transfers, and retirements of general PP&E as well as disclosure[10] requirements.

Stewardship PP&E

k The following paragraphs describe Federal mission PP&E, heritage assets, and stewardship land, the categories for which supplementary stewardship reporting is being proposed. These standards are limited to accounting requirements for the basic financial statements—they do not address the information to be reported through supplementary stewardship reporting. The accounting standards provide guidance on:

- identifying stewardship PP&E, and
- elements associated with stewardship PP&E that are to be recognized on the basic financial statements (e.g., information shown on the statement of net costs).

Federal Mission PP&E

l *Federal mission PP&E* are specific types of PP&E identified by the Board (i.e., weapons systems and space exploration equipment) or exhibiting the characteristics established by the Board.[11] The Board specifically identified weapons systems and space exploration equipment as Federal mission PP&E because it does not believe applying depreciation accounting would contribute to measuring the cost of outputs produced, or to assessing operating performance, in any given accounting period. The Board believes that these assets are developed, used, and retired in a manner that does not lend itself to a "systematic and rational" assignment of costs to accounting periods (i.e., depreciation accounting) and, ultimately, to outputs.

[9]"Internally-developed software" means software developed by personnel employed by the reporting entity. This includes modifications made by entity personnel to purchased or contractor-developed software. Standards for internally-developed software are not to be applied to purchased or contractor developed software. The Board recognizes that contractor-developed software is conceptually similar to internally-developed software and that standards for each should be similar. The Board intends to address the inconsistent treatment of these items at a later date.

[10]"Disclosure" refers to reporting information in notes regarded as an integral part of the basic financial statements.

[11]The term "federal mission" refers to activities that are typically Federal—such as national defense. In addition, Federal mission PP&E is limited to PP&E that would not typically be used by non-Federal entities. Clearly, any functions performed by a "Federal" entity could be labeled "Federal mission." The definition of this category clarifies the characteristics of PP&E appropriately includable in this category—a much narrower group than inferred by the category's title.

m The Board did not find any other categories of PP&E that it believed should be explicitly included in the Federal mission category at this time. However, there are other types of PP&E, or PP&E may be developed in the future, that are similar to these two items, so the Board has articulated characteristics of Federal mission PP&E. PP&E other than weapons systems and space exploration equipment clearly exhibiting these characteristics should be categorized as Federal mission PP&E. For example, based on comments from respondents and information provided by the Department of Energy, nuclear weapons production facilities do exhibit these characteristics and should be categorized as Federal mission PP&E.

n There are two types of characteristics. The first relates to the use of the PP&E. The second relates to expectations about, and risks associated with, its useful life. To be categorized as Federal mission PP&E, an item should have at least one characteristic from each of the two types of characteristics discussed below.

o Characteristics related to the use of Federal mission PP&E are that the PP&E:

- has no expected nongovernmental alternative uses; or
- is held for use in the event of emergency, war, or natural disaster; or
- is specifically designed for use in a program for which there is no other program or entity (Federal or non-Federal, governmental or nongovernmental) using similar PP&E with which to compare costs.

p Characteristics related to the useful life are that the PP&E:

- has an indeterminate or unpredictable useful life[12] due to the manner in which it is used, improved, retired, modified, or maintained; or
- is at a very high risk of being destroyed during use or of premature obsolescence.

q Annual expenditures to acquire, replace or improve Federal mission PP&E shall be shown as a cost in the period incurred. Separating these costs from other period expenses would facilitate analysis of the operating expense and prevent distortion due to large infrequent expenditures.

Heritage Assets

r Heritage assets include PP&E that have historical or natural significance; cultural, educational, or artistic importance; or significant architectural characteristics. Expenditures to acquire, construct, reconstruct, or improve heritage assets shall be reported as a cost in the period incurred. Separating these costs from other period expenses would facilitate analysis of the operating expense and prevent distortion due to large infrequent expenditures.

[12]This may be evidenced by the ability (1) to retire the PP&E and later return it to service or (2) to continually upgrade the PP&E to maintain its usefulness.

Multi-use Heritage Assets

s Not all heritage assets are used solely for heritage purposes—some serve two purposes by providing reminders of our heritage and by being used in day-to-day government operations unrelated to the assets themselves. For example, the government has constructed "monumental" style office space, such as the Old Executive Office Building and the Pentagon. Such assets contribute to the day-to-day operations of programs but the cost of these assets can not be easily assigned to heritage and operating purposes.

t The cost of renovating, improving, or reconstructing operating components of heritage assets used in government operations shall be included in general PP&E. Following initial construction, any renovation, improvement or reconstruction costs to facilitate government operations (e.g., installation of communications wiring or redesign of office space) would be capitalized and depreciated over its expected useful life. The cost should not be depreciated over an unrealistically long life.

u Costs of renovating or reconstructing the heritage asset that can not be directly associated with operations shall be considered heritage asset costs. For example, installing a new roof should be considered a heritage asset cost.

Stewardship Land

v The Federal Government has vast holdings of land and puts land to various uses. If land is acquired for or in connection with an item of general PP&E, it shall be categorized as general PP&E. Other land (e.g., land in the public domain and national park or national forest land) shall be excluded from general PP&E and referred to as stewardship land.

w The acquisition cost of stewardship land shall be reported as a cost in the period incurred. Separating the cost of land acquisitions from other period expenses would facilitate analysis of the operating expense and prevent distortion due to large infrequent purchases.

Deferred Maintenance

x The deferred maintenance standard requires disclosures related to the condition and the estimated cost to remedy deferred maintenance of PP&E. These disclosures are made as a note to a line item on the statement of net costs—no dollar amount shall be recognized on the statement.

y The standards recognize that there are many variables in estimating deferred maintenance amounts. The standards acknowledge that condition rating is a management function since different conditions might be considered acceptable by different entities as well as for different items of PP&E held by the same entity. In addition, management may use condition assessment surveys or life cycle cost plans to estimate the amount of deferred maintenance.

z The deferred maintenance standard applies to all PP&E whether reported on the balance sheet or through supplementary stewardship reporting.

Cleanup Costs

aa Cleanup costs are the costs associated with hazardous waste removal, containment, or disposal. In some instances, the Federal Government incurs liabilities[13] for cleaning up hazardous waste at sites or facilities it operates or has operated. Generally, cleanup cannot be, or is not, done until permanent or temporary closure or shutdown of sites or facilities. The Board has completed recommended accounting standards for liabilities which address liabilities for environmental cleanup resulting from an accident, natural disaster, or other one-time occurrence. Those liability standards do not address inter-period cost allocation when cleanup relates to operations that span many periods.

ab Therefore, the Board chose to provide additional guidance relative to cleanup costs in this standard. The additional standards in this statement provide for the timing of recognition of the liability and related operating expense.

ac For cleanup costs associated with general PP&E, probable[14] and measurable cleanup costs shall be allocated to operating periods benefiting from operations of the general PP&E. This allocation shall be based on a systematic and rational method. For example, the estimated cost could be allocated to operating periods based on the expected physical capacity of the PP&E and the amount of capacity used each period. In addition, disclosure of the total estimated cost is required.

ad For cleanup costs associated with stewardship PP&E, probable and measurable liabilities shall be recognized when the stewardship PP&E is placed in service. Simultaneous to recognizing the liability, the related expense for cleanup cost shall be recognized.

[13]FASAB's Statement of Recommended Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government*, recommends the following definition for liability: a probable future outflow or other sacrifice of resources as a result of past transactions or events. The standards require recognition, in general purpose Federal financial reports, of probable and measurable liabilities arising from past exchange transactions; government-related injuries or damage; or non-exchange amounts that, according to current law and applicable policy, are due and payable to the ultimate recipient. The standards also provide guidance for disclosures related to liabilities that are not both probable and measurable at the balance sheet date.

[14]The term "probable" means that which can reasonably be expected or believed to be more likely than not on the basis of available evidence or logic but which is neither certain nor proven. For example, cleanup costs would be probable if (1) laws and regulations that have been approved as of the balance sheet date, regardless of the effective date of those laws and regulations, require cleanup or (2) compliance agreements (e.g., agreements with state or local authorities relating to the extent and the timing of remedial action) had been entered into by a Federal entity.

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Chapter 1: Introduction

Purpose

1. The purpose of this statement is to provide accounting standards for Federally owned property, plant, and equipment (PP&E); deferred maintenance; and cleanup costs. This introduction provides information on:

   - the scope of the standards,
   - consideration of reporting objectives,
   - applicability of the standards,
   - capitalization threshold,
   - materiality, and
   - effective date.

2. Chapters 2, 3, and 4 present the accounting standards for PP&E, deferred maintenance, and cleanup costs, respectively.

3. Appendix A presents the Basis for Conclusions. This appendix provides the Board's rationale for the decisions made and responds to the major issues raised in comment letters.

4. Appendix B presents illustrations to aid in categorizing PP&E.

5. Appendix C provides an example of a deferred maintenance disclosure.

6. Appendix D illustrates cleanup cost accounting.

7. Appendix E is a glossary of terms used in this statement [Omitted. See Consolidated Glossary in "Appendix E: Consolidated Glossary" on page 1273.]

Scope

8. This statement identifies and defines categories of PP&E and addresses recognition and measurement of, and disclosure requirements associated with property, plant, and equipment (as well as land), including accounting for deferred maintenance and cleanup costs. This statement does not address natural resources. However,

the Board is undertaking a project to address accounting for natural resources.

Reporting Objectives

9. In drafting accounting standards for PP&E, the Board relied on the Statement of Federal Financial Accounting Concepts Number 1, Objectives of Federal Financial Reporting. Ultimately, all accounting standards taken as a whole will help meet the four reporting objectives expressed in the Objectives statement: budgetary integrity, operating performance, stewardship, and systems and controls. The focus of these standards is on the two reporting objectives most relevant to PP&E—operating performance and stewardship. These objectives and how they could be met through PP&E accounting are discussed under the headings (1) operating performance, and (2) stewardship.

Operating Performance

10. The Board believes that it can contribute to meeting the operating performance objective[15] by measuring the cost associated with using property, plant, and equipment and including that cost in entity operating results. The Board first sought to identify PP&E costs that would be appropriate to include in operating expense. Then, from consideration of cost information required, the Board determined what balance sheet information would have to be reported.

11. To meet the operating performance objective, the Board seeks to provide accounting standards that will result in:

    - relevant and reliable cost information for decision-making by internal users (e.g., program managers, budget examiners and officials),

[15]Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities. Federal financial reporting should provide information that helps the reader to determine:

a. the costs of providing specific programs and activities and the composition of, and changes in, these costs.
b. the efforts and accomplishments associated with Federal programs and the changes over time and in relation to costs.
c. the efficiency and effectiveness of the government's management of its assets and liabilities.

- comprehensive, comparable cost information for decision-making and program evaluation by Congress and the public, and
- information to help assess the efficiency and effectiveness of asset management (e.g., condition of assets including deferred maintenance).

Stewardship

12. The Board believes that Federal financial reporting can fulfill the stewardship objective[16] if the Board provides standards that will result in reporting information on:

- asset condition;
- changes in the amount and service potential of property, plant, and equipment;
- cost of property, plant, and equipment where applicable; and
- spending for acquisition of property, plant, and equipment versus non-capital spending.

Capitalization Thresholds

13. The Board believes that capitalization thresholds should be established by Federal entities rather than centrally by the Board. Because Federal entities are diverse in size and in uses of PP&E, entities must consider their own financial and operational conditions in establishing an appropriate capitalization threshold or thresholds. Once established, this threshold(s) should be consistently followed and disclosed in the financial reports.

Applicability

14. For guidance on the general applicability of this standard and all other Federal financial accounting standards please refer to Statement of Federal Financial Accounting Concepts No. 2, *Entity and Display.*

[16]Federal financial reporting should assist users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nations's financial condition have changed and may change in the future. Federal financial reporting should provide information that helps the reader to determine:

a. whether the government's financial position improved or deteriorated over the period.
b. whether the future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due.
c. whether government operations have contributed to the nation's current and future well-being.

Materiality

15. The provisions of this statement need not be applied to immaterial items.

Effective Date

16. The Board recommends that the accounting standards presented in this proposed statement become effective for periods beginning after September 30, 1997. Earlier implementation is encouraged. In addition, under early implementation individual provisions of the accounting standards may be implemented before other provisions. For example, provisions for stewardship PP&E may be implemented before provisions for general PP&E.

Chapter 2: Property, Plant, And Equipment

Definitions

17. Property, plant, and equipment consists of tangible assets, including land, that meet the following criteria:

    - they have estimated useful lives[17] of 2 years or more;
    - they are not intended for sale in the ordinary course of operations; and
    - they have been acquired or constructed with the intention of being used, or being available for use by the entity.

18. Property, plant, and equipment also includes:

    - assets acquired through capital leases (See paragraph 20), including leasehold improvements;
    - property owned by the reporting entity in the hands of others (e.g., state and local governments, colleges and universities, or Federal contractors); and

[17]Useful life is the normal operating life in terms of utility to the owner.

- land rights.[18]

19. Property, plant, and equipment excludes items (1) held in anticipation of physical consumption such as operating materials and supplies[19] and (2) the Federal entity has a reversionary interest in.[20]

20. Capital leases are leases that transfer substantially all the benefits and risks of ownership to the lessee. If, at its inception, a lease meets one or more of the following four criteria,[21] the lease should be classified as a capital lease by the lessee. Otherwise, it should be classified as an operating lease.[22]

    - The lease transfers ownership of the property to the lessee by the end of the lease term.
    - The lease contains an option to purchase the leased property at a bargain price.
    - The lease term is equal to or greater than 75 percent of the estimated economic life[23] of the leased property.

[18]"Land rights" are interests and privileges held by the entity in land owned by others, such as leaseholds, easements, water and water power rights, diversion rights, submersion rights, rights-of-way, and other like interests in land.

[19]Accounting for operating materials and supplies is addressed in Statement of Federal Financial Accounting Standards No. 3 *Accounting for Inventory and Related Property.*

[20]The Federal Government sometimes retains an interest in PP&E acquired with grant money. In the event that the grant recipient no longer uses the PP&E in the activity for which the grant was originally provided the PP&E reverts to the Federal Government.

[21]Note that the criteria for identifying capital leases for financial reporting purposes differ from OMB criteria for budget scoring of leases. OMB Circular No. A-11, *Preparation and Submission of Budget Estimates*, includes criteria for identifying operating leases in Appendix B. OMB provides four additional criteria which relate to the level of private sector risk involved in a lease-purchase agreement. This is necessary because, for budget purposes, there is a distinction between lease-purchases with more or less risk. This distinction is not made in the financial reports and, therefore, FASAB does not include the four criteria related to risk levels.

[22]"Operating leases" of PP&E are leases in which the Federal entity does not assume the risks of ownership of the PP&E. Multi-year service contracts and multi-year purchase contracts for expendable commodities are not capital leases.

[23]"Estimated economic life of leased property" is the estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term.

- The present value of rental and other minimum lease payments, excluding that portion of the payments representing executory cost, equals or exceeds 90 percent of the fair value[24]24 of the leased property.

The last two criteria are not applicable when the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property.

Standards And Categories

21. The following paragraphs provide recognition and measurement principles, and disclosure requirements for each category of PP&E. The categories identified are:

    - general PP&E (including land acquired for or in connection with other general PP&E),
    - ... [SFFAS 11 changed "Federal mission PP&E" to "National Defense PP&E"],
    - heritage assets, and
    - stewardship land (i.e., land not included in general PP&E).

22. In determining which category PP&E should be placed in, it will be necessary to identify the "base unit"[25] of PP&E against which the category definitions will be applied. For example, units as large as entire facilities or as small as computers could be categorized. In determining the level at which categorization takes place, an entity should consider the cost of maintaining different accounting methods for property and the usefulness of the information, the diversity in the PP&E to be categorized (e.g., useful lives, value, alternative uses), the

[24]"Fair value" is the price for which an asset could be bought or sold in an arm's-length transaction between unrelated parties (e.g., between a willing buyer and a willing seller).

[25]"Base unit" refers to the level of detail considered in categorizing PP&E. Generally, the base unit is the smallest or least expensive item of property to be categorized. The term "base unit" may be used by others to have a different meaning—the meaning intended in this standard is limited to that specified above.

programs being served by the PP&E, and future disposition of the PP&E (e.g., transferred to other entities or scrapped).[26]

General Property, Plant, and Equipment

23. General property, plant, and equipment is any property, plant, and equipment used in providing goods or services. General PP&E typically has one or more of the following characteristics:

    - it could be used for alternative purposes (e.g., by other Federal programs, state or local governments, or non-governmental entities) but is used to produce goods or services, or to support the mission of the entity, or
    - it is used in business-type activities,[27] or
    - it is used by entities in activities whose costs can be compared[28] to those of other entities performing similar activities (e.g., Federal hospital services in comparison to other hospitals).

24. For entities operating as business-type activities, all PP&E shall be categorized as general PP&E whether or not it meets the definition of any other PP&E categories.

25. Land and land rights acquired for or in connection with other general PP&E[29] shall be included in general PP&E. In some instance, general PP&E may be built on existing Federal lands. In this case, the land cost would often not be identifiable. In these instances, general PP&E shall

[26]The concept described here is intended for PP&E categorization purposes only. However, for the purpose of record keeping, greater detail may be necessary to maintain accountability for PP&E so that assets can be safeguarded against loss, theft, misappropriation, etc. Categorizing PP&E with less detail considered does not necessarily mean that (1) accounting systems or (2) property records must follow the same level of detail.

[27]Business-type activity is defined as a significantly self-sustaining activity which finances its continuing cycle of operations through collection of exchange revenue as defined in the Board's exposure draft on *Revenue and Other Financing Sources*.

[28]The Board is not making a recommendation that cost comparisons actually be made. Nor is it suggesting that costs can be easily compared for a Federal and non-Federal entity. If the activities are somewhat comparable then one should presume that a cost comparison **could** be made.

[29]"Acquired for or in connection with other general PP&E" is defined as land acquired with the intent to construct general PP&E and land acquired in combination with general PP&E, including not only land used as the foundation, but also adjacent land considered to be the general PP&E's common grounds.

include only land and land rights with an identifiable cost that was specifically acquired for or in connection with construction of general PP&E.

Asset Recognition

26. **All general PP&E** shall be recorded at cost. Cost shall include all costs incurred to bring the PP&E to a form and location suitable for its intended use. For example, the cost of acquiring property, plant, and equipment may include:

- amounts paid to vendors;
- transportation charges to the point of initial use;
- handling and storage costs;
- labor and other direct or indirect production costs (for assets produced or constructed);
- engineering, architectural, and other outside services for designs, plans, specifications, and surveys;
- acquisition and preparation costs of buildings and other facilities;
- an appropriate share of the cost of the equipment and facilities used in construction work;
- fixed equipment and related installation costs required for activities in a building or facility;
- direct costs of inspection, supervision, and administration of construction contracts and construction work;
- legal and recording fees and damage claims;
- fair value of facilities and equipment donated to the government; and
- material amounts of interest costs paid.[30]

27. ... [See SFFAS 10 for standard regarding internally-developed software][31, 32, 33]

[30]"Interest costs" refers to any interest paid by the reporting entity directly to providers of goods or services related to the acquisition or construction of PP&E.

[31][See SFFAS 10 for standard regarding internally developed software]

[32][See SFFAS 10 for standard regarding internally developed software]

[33][See SFFAS 10 for standard regarding internally developed software]

28. ... [See SFFAS 10 for standard regarding internally-developed software][34]

29. The cost of general PP&E acquired under a **capital lease** shall be equal to the amount recognized as a liability for the capital lease at its inception (i.e., the net present value of the lease payments calculated as specified in the liability standard[35] unless the net present value exceeds the fair value of the asset).

30. The cost of general PP&E acquired through donation, devise,[36] or **judicial process** excluding forfeiture (See paragraph 33) shall be estimated fair value at the time acquired by the government.

31. The cost of general PP&E **transferred from other Federal entities** shall be the cost recorded by the transferring entity for the PP&E net of accumulated depreciation or amortization. If the receiving entity cannot reasonably ascertain those amounts, the cost of the PP&E shall be its fair value at the time transferred.

32. The cost of general PP&E acquired through **exchange**[37] shall be the fair value of the PP&E surrendered at the time of exchange.[38] If the fair value of the PP&E acquired is more readily determinable than that of the PP&E surrendered, the cost shall be the fair value of PP&E acquired. If neither fair value is determinable the cost of the PP&E acquired shall be the cost recorded for the PP&E surrendered net of any accumulated depreciation or amortization. Any difference between the net recorded amount of the PP&E surrendered and the cost of the PP&E acquired shall be recognized as a gain or loss. In the

[34][See SFFAS 10 for standard regarding internally developed software]

[35]See Statement of Recommended Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government.*

[36]A will or clause of a will disposing of property.

[37]This paragraph applies only to exchanges between a Federal entity and a non-Federal entity. Exchanges between Federal entities shall be accounted for as transfers (See paragraph 31).

[38]If entity enters into an exchange in which the fair value of the PP&E acquired is less than that of the PP&E surrendered, the PP&E acquired shall be recognized at its cost as described in paragraph 32 and subsequently reduced to its fair value. A loss shall be recognized in an amount equal to the difference between the cost of the PP&E acquired and its fair value.

event that cash consideration is included in the exchange, the cost of general PP&E acquired shall be increased by the amount of cash consideration surrendered or decreased by the amount of cash consideration received.

33. The cost of general PP&E acquired through **forfeiture** shall be determined in accordance with Statement of Federal Financial Accounting Standards No. 3, **Accounting for Inventory and Related Property** (SFFAS 3).[39] Amounts recorded for forfeited assets based on SFFAS 3 shall be recognized as the cost of general PP&E when placed into official use.

34. PP&E shall be recognized when title passes to the acquiring entity or when the PP&E is delivered to the entity or to an agent of the entity.[40] In the case of constructed PP&E, the PP&E shall be recorded as construction work in process until it is placed in service, at which time the balance shall be transferred to general PP&E.

Expense Recognition

35. Depreciation expense is calculated through the systematic and rational allocation of the cost of general PP&E, less its estimated salvage/residual value, over the estimated useful life of the general PP&E. Depreciation expense shall be recognized on all general PP&E[41], except land and land rights of unlimited duration.[42]

[39]SFFAS 3 requires that forfeited real and personal property be valued at market value less an allowance for any liens or claims from a third party.

[40]Delivery or constructive delivery shall be based on the terms of the contract regarding shipping and/or delivery. For PP&E acquired by a contractor on behalf of the entity (e.g., the entity will ultimately hold title to the PP&E), PP&E shall also be recognized upon delivery or constructive delivery whether to the contractor for use in performing contract services or to the entity.

[41]Software and land [See SFFAS 10 for standard regarding internally developed software] rights, while associated with tangible assets, may be classified as intangible assets by some entities. In this event, they would be subject to amortization rather than depreciation. "Amortization" is applied to intangible assets in the same manner that depreciation is applied to general PP&E—tangible assets.

[42]Land rights that are for a specified period of time shall be depreciated or amortized over that time period.

- Estimates of useful life of general PP&E must consider factors such as physical wear and tear and technological change (e.g., obsolescence).
- Various methods can be used to compute periodic depreciation expense so long as the method is systematic, rational, and best reflects the use of the PP&E.
- Any changes in estimated useful life or salvage/residual value shall be treated prospectively. The change shall be accounted for in the period of the change and future periods. No adjustments shall be made to previously recorded depreciation or amortization.

36. Depreciation expense shall be accumulated in a contra asset[43] account—accumulated depreciation. Amortization expense shall be accumulated in a contra asset account—accumulated amortization.

37. Costs which either extend the useful life of existing general PP&E, or enlarge or improve its capacity shall be capitalized and depreciated/amortized over the remaining useful life of the associated general PP&E.

38. In the period of disposal, retirement, or removal from service, general PP&E shall be removed from the asset accounts along with associated accumulated depreciation/amortization. Any difference between the book value of the PP&E and amounts realized[44] shall be recognized as a gain or a loss in the period that the general PP&E is disposed of, retired, or removed from service.

39. General PP&E shall be removed from general PP&E accounts along with associated accumulated depreciation/amortization, if prior to disposal, retirement or removal from service, it no longer provides service in the operations of the entity. This could be either because it has suffered damage, becomes obsolete in advance of expectations, or is identified as excess. It shall be recorded in an appropriate asset account at its expected net realizable value. Any difference in the book value of the PP&E and its expected net realizable value shall be

[43]A contra asset account is an account which partially or wholly offsets an asset account. On financial statements they may be either merged or appear together.

[44]For example, amounts realized may include cash received for scrap materials or fair value of items received in exchange for PP&E removed from service.

recognized as a gain or a loss in the period of adjustment. The expected net realizable value shall be adjusted at the end of each accounting period and any further adjustments in value recognized as a gain or a loss. However, no additional depreciation/amortization shall be taken once such assets are removed from general PP&E in anticipation of disposal, retirement, or removal from service.

Implementation Guidance

40. For existing general PP&E, if historical cost information necessary to comply with the above recognition and measurement provisions has not been maintained, estimates are required. Estimates shall be based on:

    - cost of similar assets at the time of acquisition, or
    - current cost of similar assets discounted for inflation since the time of acquisition (i.e., deflating current costs to costs at the time of acquisition by general price index).

41. Accumulated depreciation/amortization shall be recorded based on the estimated cost and the number of years the PP&E has been in use relative to its estimated useful life. Alternatively, the PP&E may be recorded at its estimated net remaining cost[45] and depreciation/amortization charged over the remaining life based on that net remaining cost.

42. For general PP&E that would be substantially depreciated/amortized had it been recorded upon acquisition based on these standards, materiality and cost-benefit should be weighed heavily in determining estimates. Consideration should be given to:

    - recording only improvements made during the period beyond the initial expected useful life of general PP&E, and
    - making an aggregate entry for whole classes of PP&E (e.g., entire facilities rather than a building by building estimate).

43. In recording existing general PP&E, the difference in amounts added to asset and contra asset accounts shall be credited (or charged) to Net Position of the entity. The amount of the adjustment shall be

[45] *Net remaining cost* is the original cost of the asset less any accumulated depreciation/amortization to date.

shown as a "prior period adjustment" in the statement of changes in net position. For published financial statements presenting prior year information, no prior year amounts shall be restated.

44. In the period that these standards are implemented, disclosure of the adjustments, by major class[46] of PP&E, made to general PP&E and accumulated depreciation/amortization is required.

Disclosure Requirements

45. The following are minimum general PP&E disclosure requirements:

- the cost, associated accumulated depreciation, and book value by major class;
- the estimated useful lives for each major class;
- the method(s) of depreciation for each major class;
- capitalization threshold(s) including any changes in threshold(s) during the period; and
- restrictions on the use or convertability of general PP&E.

... [SFFAS 11 changed from "Federal Mission" to National Defense Property, Plant, and Equipment]

46. ... [See SFFAS 11 for explanation of deletions] [47]

47. ... [See SFFAS 11 for explanation of deletions]

48. ... [See SFFAS 11 for explanation of deletions][48]

49. ... [See SFFAS 11 for explanation of deletions]

50. ... [See SFFAS 11 for explanation of deletions][49, 50]

51. ... [See SFFAS 11 for explanation of deletions]

[46]"Major classes" of general PP&E shall be determined by the entity. Examples of major classes include buildings and structures, furniture and fixtures, equipment, vehicles, and land.

[47][See SFFAS 11 for explanation of deletion]

[48][See SFFAS 11 for explanation of deletion]

[49][See SFFAS 11 for explanation of deletion]

[50][See SFFAS 11 for explanation of deletion]

52. ... [See SFFAS 11 for explanation of deletions]

Recognition and Measurement

53. The periodic cost of acquiring, constructing, improving, reconstructing, or renovating [National Defense] PP&E shall be recognized as a cost on the statement of net cost when incurred. The cost shall be disclosed[51] as "cost of ... [National Defense] PP&E." The cost shall include all costs incurred to bring the PP&E to its current condition and location (See paragraph 26 for examples of the costs to be considered). [See SFFAS 11]

54. Additional reporting requirements for stewardship reporting will be developed in a separate standard.

Implementation Guidance

55. ... [National Defense] PP&E previously recognized as assets and contra-assets for balance sheet reporting shall be removed. The amounts removed shall be charged to Net Position of the entity. The amount of the adjustment shall be shown as a "prior period adjustment" in the statement of changes in net position. The amounts removed from the balance sheet shall be disclosed in a footnote. [See SFFAS 11]

56. For published financial statements presenting prior year information, no prior year amounts shall be restated.

Heritage Assets

57. Heritage assets are property, plant, and equipment that are unique for one or more of the following reasons:

- historical or natural significance;
- cultural, educational or artistic (e.g., aesthetic) importance; or
- significant architectural characteristics.

58. Heritage assets are generally expected to be preserved indefinitely. One example of evidence that a particular asset is heritage in nature is that it is listed on the National Register of Historic Places.

[51]Disclosure shall be either on the face of the statement of net cost or in footnotes depending on the materiality of the amounts and the need to distinguish such amounts from other costs relating to measures of outputs or outcomes of the reporting entity.

59. ... [See SFFAS 16 for explanation of deletion]

60. ... [See SFFAS 16 for explanation of deletion]

61. ... [See SFFAS 16 for explanation of deletion][52, 53, 54]

62. ... [See SFFAS 16 for explanation of deletion]

Implementation Guidance

63. ... [See SFFAS 6, paragraph 63, was replaced by SFFAS 16, paragraph 14]

64. If records are not available to determine which costs are associated with heritage assets and which are general PP&E, the entity may estimate the cost of heritage assets by classes of PP&E (e.g., entire facilities rather than a building by building estimate).

65. For published financial statements presenting prior year information, no prior year amounts shall be restated.

Stewardship Land

66. Land is defined as the solid part of the surface of the earth.

67. Excluded from the definition of land are materials beneath the surface (i.e., depletable resources such as mineral deposits and petroleum), the space above the surface (i.e., renewable resources such as timber), and the outer-continental shelf resources. The materials excluded from the definition of land will be addressed in a separate accounting and reporting standard related to them.

68. Land and land rights owned by the Federal Government and not acquired for or in connection with other general PP&E[55] will be

[52]... [See SFFAS 16 for explanation of deletion]

[53]... [See SFFAS 16 for explanation of deletion]

[54]... [See SFFAS 16 for explanation of deletion]

[55]"Acquired for or in connection with other general PP&E" is defined as land acquired with the intent to construct general PP&E and land acquired in combination with general PP&E, including not only land used as the foundation, but also adjacent land considered to be the general PP&E's common grounds.

referred to as stewardship land and will not be reported on the balance sheet. Examples of land not associated with other items of general PP&E include land used as forests and parks and land used for wildlife and grazing. General PP&E may be built on existing Federal lands. In this case, the cost of the land would often not be identifiable. In these instances, general PP&E shall include only land or land rights with an identifiable cost that was specifically acquired for or in connection with construction of general PP&E.

Recognition and Measurement

69. The acquisition cost of stewardship land shall be recognized as a cost in the period incurred. The cost shall be disclosed[56] as "cost of stewardship land." The cost shall include all costs incurred to bring the PP&E to its current condition and location (See paragraph 26 for examples of the costs to be considered).

70. In some cases, land may be acquired along with existing structures. The following treatments may apply:

- if the structure is significant in and of itself, the entity shall use its judgment as to whether the acquisition cost shall be treated as the cost of stewardship land, heritage asset, or both;
- if the structure is to be used in operations (e.g., as general PP&E) but (1) the value of the structure is insignificant as compared to the value of the land, (2) it has little or no inherent value, and/or (3) it is merely a byproduct of the acquisition of the land, the cost shall be treated as an acquisition of stewardship land in its entirety; or
- only significant structures which have a significant operating use (e.g., a recently constructed hotel or employee housing block) shall be treated as general PP&E by identifying the cost attributable general PP&E and segregating it from the cost of the stewardship land acquired.

[56]Disclosure shall be either on the face of the statement of net cost or in footnotes depending on the materiality of the amounts and the need to distinguish such amounts from other costs relating to measures of outputs or outcomes of the reporting entity.

71. However, no amounts for stewardship land acquired through donation or devise[57] shall be recognized as a cost on the statement of net cost. Its fair value, if known and material, shall be disclosed in notes to the statement of net cost. If fair value is not estimable, information related to the type and quantity of assets received shall be disclosed in the year received.

72. Land may be transferred between Federal entities. In some cases, land included in general PP&E may be transferred to an entity for use as stewardship land. In this instance, the cost of stewardship land transferred from another Federal entity shall be the book value of the land recorded on the transferring entity's books. If the receiving entity does not know the book value, the transfer shall be disclosed in notes if material. In other cases, stewardship land may be transferred between Federal entities. Transfers of stewardship land shall be disclosed in the notes if material.

73. Any costs to prepare stewardship land for its intended use (e.g., razing a building) shall be expensed as a part of the cost of stewardship land.

74. Additional reporting requirements will be developed for stewardship report items in a separate standard.

Implementation Guidance

75. Land previously recognized as assets for balance sheet reporting shall be removed. The amounts removed shall be charged to Net Position of the entity. The amount of the adjustment shall be shown as a "prior period adjustment" in the statement of changes in net position. The amounts removed from the balance sheet shall be disclosed in a footnote.

76. For published financial statements presenting prior year information, no prior year amounts shall be restated.

The provisions of this statement need not be applied to immaterial items.

[57]A will or clause of a will disposing of property.

Chapter 3: Deferred Maintenance

[SFFAS No. 14, presents the standards amending SFFAS 6. Changes are provided herein based on the specific amendments included in SFFAS 14.]

Definition

77. "Deferred maintenance" is maintenance that was not performed when it should have been or was scheduled to be and which, therefore, is put off or delayed for a future period.

78. For purposes of this standard, maintenance is described as the act of keeping fixed assets in acceptable condition. It includes preventive maintenance, normal repairs, replacement of parts and structural components, and other activities needed to preserve the asset so that it continues to provide acceptable services and achieves its expected life.[58] Maintenance excludes activities aimed at expanding the capacity of an asset or otherwise upgrading it to serve needs different from, or significantly greater than, those originally intended.

79. ... [See SFFAS 14 for the explanation of deletion.][59, 60]

Measurement

80. Amounts ... [See SFFAS 14 for the explanation for deletion] [reported] for deferred maintenance may be measured using:

    a. condition assessment surveys, or

    b. life-cycle cost forecasts.[61]

81. *Condition assessment* surveys are periodic inspections of PP&E to determine their current condition and estimated cost to correct any

[58]Acceptable services and condition may vary both between entities and among sites within the same entity. Management shall determine what level of service and condition is acceptable.

[59]... [See SFFAS for explanation of deletion]

[60]... [See SFFAS for explanation of deletion]

[61]Other methods may be used which are similar or identical to condition assessment survey or life-cycle costing. These methods would also be acceptable sources of information on deferred maintenance.

deficiencies. It is desirable that condition assessment surveys be based on generally accepted methods and standards consistently applied.[62]

82. *Life-cycle costing* is an acquisition or procurement technique which considers operating, maintenance, and other costs in addition to the acquisition cost of assets. Since it results in a forecast of maintenance expense, these forecasts may serve as a basis against which to compare actual maintenance expense and estimate deferred maintenance.

Disclosures

83. At a minimum, the following information shall be presented for all PP&E (each of the four categories established in the PP&E standard should be included).

- Identification of each major class[63] of asset for which maintenance has been deferred.
- Method of measuring deferred maintenance for each major class of PP&E.
- If the **condition assessment survey** method of measuring deferred maintenance is used, the following should be presented for each major class of PP&E:
  - description of requirements or standards for acceptable operating condition,
  - any changes in the condition requirements or standards, and
  - asset condition[64] and a range estimate of the dollar amount of maintenance needed to return it to its acceptable operating condition.
- If the **total life-cycle cost method** is used the following should be presented for each major class of PP&E:

[62]Management shall determine what methods and standards to apply. Once determined, it is desirable but not required that methods and standards be applied consistently from period to period.

[63]"Major classes" of general PP&E shall be determined by the entity. Examples of major class include, among others, buildings and structures, furniture and fixtures, equipment, vehicles, and land.

[64]Examples of condition information include, among others, (1) averages of standardized condition rating codes, (2) percentage of assets above, at or below acceptable condition, or (3) narrative information.

- the original date of the maintenance forecast and an explanation for any changes to the forecast,
- prior year balance of the cumulative deferred maintenance amount,
- the dollar amount of maintenance that was defined by the professionals who designed, built or manage the PP&E as required maintenance for the reporting period,
- the dollar amount of maintenance actually performed during the period,
- the difference between the forecast and actual maintenance,
- any adjustments to the scheduled amounts deemed necessary by the managers of the PP&E,[65] and
- the ending cumulative balance for the reporting period for each major class of asset experiencing deferred maintenance.

Optional ... [See SFFAS 14 [Information]]

84. Stratification between critical and noncritical amounts of maintenance needed to return each major class of asset to its acceptable operating condition. If management elects to ... [report] critical and noncritical amounts, the ... [information] shall include management's definition of these categories. [See SFFAS 14.]

The provisions of this statement need not be applied to immaterial items.

Chapter 4: Cleanup Costs

Definition

85. Cleanup costs are the costs of removing, containing, and/or disposing of (1) hazardous waste (see paragraph 86) from property, or (2) material and/or property that consists of hazardous waste at permanent or temporary closure or shutdown of associated PP&E.

[65]Adjustments may be necessary because the cost of maintenance foregone may not be cumulative. For example, if periodic painting is skipped twice it is not necessarily true that the cost would be double the scheduled amount.

86. Hazardous waste is a solid, liquid, or gaseous waste, or combination of these wastes, which because of its quantity, concentration, or physical, chemical, or infectious characteristics may cause or significantly contribute to an increase in mortality or an increase in serious irreversible, or incapacitating reversible, illness or pose a substantial present or potential hazard to human health or the environment when improperly treated, stored, transported, disposed of, or otherwise managed.

87. Cleanup may include, but is not limited to, decontamination, decommissioning, site restoration, site monitoring, closure, and postclosure costs.

Scope

88. This standard applies only to cleanup costs from Federal operations known to result in hazardous waste which the Federal Government is required by Federal, state and/or local statutes and/or regulations that have been approved as of the balance sheet date, regardless of the effective date, to cleanup (i.e., remove, contain or dispose of).[66] These cleanup costs meet the definition of liability provided in Statement of Recommended Accounting Standards no. 5, *Accounting for Liabilities of the Federal Government* (SRAS no. 5).

89. However, due to the nature of the liability and the timing associated with cleanup costs, additional guidance is provided in this standard on the recognition of cleanup costs over the life of the related PP&E. Guidance is required since cleanup can not occur until the end of the useful life of the PP&E or at regular intervals during that life.

90. This standard is intended to supplement the accounting requirements for liabilities in SRAS no. 5. SRAS no. 5 defines liabilities as a "probable future outflow or other sacrifice of resources as a result of past transactions or events." Further, SRAS no. 5 requires recognition of liabilities that are probable and measurable. Measurable means that an item has a relevant attribute that can be quantified in monetary units with sufficient reliability to be reasonably estimable.

[66]Accounting for environmental liabilities such as cleanup costs is currently undergoing change—due to both improved measurement techniques and increased attention from the accounting community. The Board will monitor these changes and revisit these standards as needed.

91. The recognition and measurement standards provided in this standard are subject to the criteria for recognition of liabilities included in SRAS no. 5. That is, liabilities shall be recognized when three conditions are met:

- a past transaction or event has occurred,
- a future outflow or other sacrifice of resources is probable,[67] and
- the future outflow or sacrifice of resources is measurable.[68]

92. SRAS no. 5 also provides for disclosure of liabilities that do not meet all of the above criteria; these standards apply to cleanup costs as well.

93. Other cleanup costs, such as those resulting from accidents or where cleanup is an ongoing part of operations, are to be accounted for in accordance with liability standards and are not subject to the recognition guidance provided in this standard. This guidance does not apply to these other types of cleanup since the cleanup effort is not deferred until operation of associated PP&E ceases either permanently or temporarily.[69]

Recognition And Measurement

Estimation Methods

94. Cleanup costs, as defined above, shall be estimated when the associated PP&E is placed in service . The estimate shall be referred to as the "estimated total cleanup cost." There are two approaches to recognizing this total—one applies to general PP&E and another to stewardship PP&E.

95. The estimate shall contemplate:

[67]Probable means that the future confirming event or events is more likely than not to occur.

[68]The unit of analysis for estimating liabilities can vary based on the reporting entity and the nature of the transaction or event. The liability recognized may be the estimation of an individual transaction or event; or a group of transactions and events. For example, an estimate of the cleanup costs could be made on a facility by facility basis, or an entity by entity basis.

[69]Cleanup may be deferred for other reasons, such as availability of resources. However, this type of deferral does not affect the recognition of the liability.

- the cleanup plan, including
  - level of restoration to be performed,
  - current legal or regulatory requirements,[70] and
  - current technology; and
- current cost which is the amount that would be paid if all equipment, facilities, and services included in the estimate were acquired during the current period.

96. Estimates shall be revised periodically to account for material changes due to inflation or deflation and changes in regulations, plans and/or technology. New cost estimates should be provided if there is evidence that material changes have occurred; otherwise estimates may be revised through indexing.

Cleanup Cost for General PP&E

97. A portion of estimated total cleanup costs shall be recognized as expense during each period that general PP&E is in operation. This shall be accomplished in a systematic and rational manner based on use of the physical capacity of the associated PP&E (e.g., expected usable landfill area) whenever possible. If physical capacity is not applicable or estimable, the estimated useful life of the associated PP&E may serve as the basis for systematic and rational recognition of expense and accumulation of the liability.

98. Recognition of the expense and accumulation of the liability shall begin on the date that the PP&E is placed into service, continue in each period that operation continues, and be completed when the PP&E ceases operation.

99. As reestimates (see paragraph 96) are made, the cumulative effect of changes in total estimated cleanup costs related to current and past operations shall be recognized as expense and the liability adjusted in the period of the change in estimate.

100. As cleanup costs are paid, payments shall be recognized as a reduction in the liability for cleanup costs. These include the cost of PP&E or other assets acquired for use in cleanup activities.

[70] Laws and regulations approved as of the balance sheet date, regardless of the effective date of those laws and regulations, shall be considered.

Cleanup Cost for Stewardship PP&E

101. Consistent with the treatment of the acquisition cost of stewardship PP&E (i.e., expensing in the period placed in service), the total estimated cleanup cost shall be recognized as expense in the period that the stewardship asset is placed in service and a liability established.

102. The liability shall be adjusted when the estimated total cleanup costs are reestimated as described in paragraph 96. Adjustments to the liability shall be recognized in expense as "changes in estimated cleanup costs from prior periods."

103. As cleanup costs are paid, payments shall be recognized as a reduction in the liability for cleanup costs. These include the cost of PP&E or other assets acquired for use in cleanup activities.

Implementation Guidance

104. Two implementation approaches have been provided for liabilities related to general PP&E in service at the effective date of this standard:

- A liability shall be recognized for the portion of the estimated total cleanup cost that is attributable to that portion of the physical capacity used or that portion of the estimated useful life that has passed since the PP&E was placed in service. The remaining cost shall be allocated as provided in paragraphs 97 through 99.
- If costs are not intended to be recovered primarily through user charges, management may elect to recognize the estimated total cleanup cost as a liability upon implementation. In addition, in periods following the implementation period, any changes in the estimated total cleanup cost shall be expensed when reestimates occur and the liability balance adjusted. The provisions for cost allocation provided in paragraphs 97 through 99 shall not apply under this implementation method.

105. The offsetting charge for any liability recognized upon implementation shall be made to Net Position of the entity. The amount of the adjustment shall be shown as a "prior period adjustment" in any statement of changes in net position that may be required. No amounts shall be recognized as expense in the period of implementation. The amounts involved shall be disclosed and to the extent possible the amount associated with current and prior periods should be noted.

106. For stewardship PP&E that are in service at the effective date of this standard, the liability for cleanup costs shall be recognized and an adjustment made to the Net Position of the entity. The amount of the adjustment shall be shown as a "prior period adjustment" in any statement of changes in net position that may be required. The amounts involved shall be disclosed.

Disclosure Requirements

107. The sources (applicable laws and regulations) of cleanup requirements.

108. The method for assigning estimated total cleanup costs to current operating periods (e.g., physical capacity versus passage of time).

109. For cleanup cost associated with general PP&E, the unrecognized portion of estimated total cleanup costs (e.g., the estimated total cleanup costs less the cumulative amounts charged to expense at the balance sheet date).

110. Material changes in total estimated cleanup costs due to changes in laws, technology, or plans shall be disclosed. In addition, the portion of the change in estimate that relates to prior period operations shall be disclosed.

111. The nature of estimates and the disclosure of information regarding possible changes due to inflation, deflation, technology, or applicable laws and regulations.

The provisions of this statement need not be applied to immaterial items.

Appendix A: Basis For Conclusions

112. This appendix summarizes significant considerations by the Board in reaching the conclusions in this statement. In the following paragraphs, the Board's considerations in developing these standards as well as positions on specific issues raised in alternative views, comment letters, and during public hearings are explained. The Board relied extensively on input from a task force on Capital Expenditures as well as a small working subgroup on Physical Property. These paragraphs include reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.

113. This appendix addresses each of the three standards in sequence.

Property, Plant, And Equipment

Background

114. Before addressing specific issues resolved following issuance of the exposure draft, this section provides a broad basis for the main provisions of the standard on investments in PP&E. The Federal Government makes many expenditures that can be characterized as investments or investment-type expenditures. These include expenditures for Federally owned PP&E.

115. Accounting for expenditures for PP&E as well as for the existing stock of PP&E is a significant undertaking because the Federal Government owns substantial amounts of diverse PP&E. Federal PP&E includes approximately 650 million acres of land, buildings containing over 1.5 billion square feet of floor space, many different forms of equipment, and military hardware.

116. These are used for a wide range of purposes; including, among others, operating, defense, conservation, and heritage purposes. Some of these purposes relate to the Federal Government's responsibility to provide for the Nation's common defense and general welfare. Specific types of PP&E are used by the Federal Government to meet this responsibility. Other types of PP&E are held and used for operating purposes that are not unlike those of non-federal entities.

117. Some Federal operations are similar to profit-seeking enterprises and can be described as business-type activities. However, these business-

type activities account for a small portion of the investment in PP&E. The majority of the investment in PP&E is used to provide government services and goods where user charges are not the primary source of revenues.

118. The Board found that a single accounting method for such diverse Federal PP&E would not meet the objectives established in its *Objectives of Federal Financial Reporting*. Therefore, the Board identified categories of PP&E and set different accounting methods for each category.

Categories Required

119. The PP&E standards incorporate the following categories:

- general PP&E are PP&E used to provide general government services;
- Federal mission PP&E are PP&E that are an integral part of the output of certain unique Federal Government missions;
- heritage assets are those assets possessing significant educational, cultural, or natural characteristics; and
- stewardship land[71] is land other than that included in general PP&E.

120. The latter three categories of assets are referred to as stewardship PP&E. The term "stewardship PP&E" is used simply to refer to those categories of PP&E to be reported on a stewardship report.

General PP&E

121. General PP&E are items used to provide general government services; including PP&E that:

- could be used for alternative purposes (e.g., by other Federal programs, state or local governments, or non-governmental entities) but is used to produce goods or services, or to support the mission of the entity, or

[71]Note that land acquired for or in connection with general PP&E would be included in that category. All other land would be subject to stewardship reporting and is referred to throughout this document as stewardship land.

- is used in business-type activities, or
- is used by entities whose costs can be compared to other entities (e.g., Federal hospital services in comparison to other hospitals).

122. Allocation of the cost of general PP&E, excluding land, among accounting periods is essential to assessing operating performance. The Board's concepts statement, *Objectives of Federal Financial Reporting*, focuses on relating cost to accomplishments in reporting an entity's operating performance. Cost information is of fundamental importance both to program managers in operating their activities efficiently and effectively and to executive and congressional decision makers in deciding on resource allocation. General PP&E will be capitalized and depreciated to provide this information.

Stewardship PP&E

123. For stewardship PP&E,[72] the predominant reporting objective is stewardship. This is in contrast to general PP&E, for which the Board is concerned with providing information to assess operating performance and, therefore, provided for depreciation accounting. The most relevant information is about the existence of stewardship PP&E and that information can be provided through a new type of reporting—supplementary stewardship reporting.

124. For stewardship PP&E, the Board believes that allocation of historical cost to operating expense for each period would not contribute to the measurement of entity operating performance. Prior to issuing its *Objectives* statement, the Board conducted a user needs study and met with representatives of a wide variety of user groups. Most users specifically indicated that depreciating stewardship PP&E such as weapons systems would not provide meaningful information for assessing the entity's operating performance. The Board believes that its standards should address the needs of users and the Board has found that users do not need information which includes depreciation expense on this category of PP&E.

125. The Board noted in its *Objectives* statement that the government's responsibility for the nation's common defense and general welfare is

[72]The term "stewardship PP&E" is used to refer collectively to federal mission PP&E, heritage assets, and stewardship land.

unique and that, in some cases, the most relevant measures of performance are nonfinancial.[73] Despite the preference for nonfinancial performance measures for stewardship PP&E, the government must demonstrate that it is being an appropriate "steward" for these assets. To meet the stewardship objective, the government must be able to answer basic questions such as:

- What and where are the important assets?
- Is the government effectively managing and safeguarding its assets?

126. Answers to these questions can be provided through supplementary stewardship reporting. The stewardship information provided would not necessarily have the same measurement basis as information shown on the balance sheet. Information could include value, quantity, and capacity depending on the category being reported on. These types of information are not typically found in balance sheet reporting. (Also, see discussion of deferred maintenance in paragraph 171 through 181 regarding other information that users consider relevant.)

127. The Board is addressing supplementary stewardship reporting in another standard. The information to be provided for stewardship PP&E is proposed in detail in that standard. Each of the stewardship PP&E categories are discussed further in the following paragraphs.

Federal Mission PP&E

128. Federal mission PP&E are specific PP&E acquired to provide a unique good or service for which there is not necessarily a periodic output against which to match costs. For example, the existence of and readiness of weapons systems supports national defense regardless of their actual combat use on a period by period basis. Also, space exploration equipment is used in long-term research efforts which may or may not produce an output each period but which nevertheless benefits the nation in the long run.

129. The standard specifically identifies weapons systems and space exploration equipment as Federal mission PP&E as well as providing a list of characteristics of Federal mission PP&E. The Board articulated

[73] *Objectives*, paragraph 54.

characteristics of Federal mission PP&E because it recognizes that there are other types of PP&E, or PP&E may be developed in the future, that are similar to these two items. To be categorized as Federal mission PP&E an item shall meet at least one characteristic from each of the following two types of characteristics.

130. Characteristics related to the use of Federal mission PP&E are that it:

- has no expected nongovernmental alternative uses; or
- is held for use in the event of emergency, war or natural disaster; or
- is specifically designed for use in a program for which there is no other program or entity (Federal or non-Federal) using similar PP&E with which to compare costs.

131. Characteristics related to the useful life are that it:

- has an indeterminate or unpredictable useful life[74] due to the manner in which it is used, improved, retired, modified, or maintained; or
- is at a very high risk of being destroyed during use or of premature obsolescence.

132. The cost of Federal mission PP&E acquired during the period be shown on the operating statement.

Heritage assets

133. Heritage assets are held for their cultural, architectural, or aesthetic characteristics. Users have identified nonfinancial information as being relevant for these assets. For assessing operating performance, the Board believes that relevant cost information is provided through reporting of periodic maintenance cost since heritage assets are intended to be preserved as national treasures. It is anticipated that they will be maintained in reasonable repair and that there will be no diminution in their usefulness over time.

[74]This may be evidenced by the ability (1) to retire the PP&E and later return it to service, or (2) to continually upgrade the PP&E to maintain its usefulness. In addition, PP&E that is held for "one-time" use, such as a warhead, has an indeterminate life.

134. In addition to assets held purely for heritage purposes (e.g., the Washington Monument), the Federal Government uses heritage assets in its day-to-day operations. For example, many Federal office buildings, such as the Old Executive Office Building, have monumental characteristics. The Board considered whether these multi-use heritage assets would be more appropriately categorized as general PP&E.

135. Despite their heritage characteristics, these assets serve a function that could otherwise be served by assets that do not possess heritage characteristics. Therefore, the standards provide that costs of reconstruction, renovation, or improvements that are directly associated with supporting operations be treated in a manner consistent with general PP&E. The Board based this decision on the need to measure cost for operations and to compare cost between entities.

Stewardship Land

136. The Federal Government owns vast amounts of land and its use of land is diverse. In some instances Federal land is integral to the ownership of general PP&E. For example, the cost of land upon which an office building is sited is integral to the cost of that building. Land acquired for or in connection with general PP&E will be recognized on the balance sheet to provide a more comprehensive measure of the assets devoted to general government operations. However, since land is not a depreciating asset, depreciation expense will not be recognized on land included in general PP&E.

137. Most Federal land is not directly related to general PP&E. For example, the national parks and forests are not used to support general PP&E. The Board concluded that land other than that acquired for or in connection with other general PP&E should not be reported on the balance sheet. This is consistent with the Board's treatment of heritage assets in that much of the government's land is held for the general welfare of the nation and is intended to be preserved and protected.

Issues

138. Following issuance of the ED, the Board specifically considered several issues related to the PP&E standard. These issues are addressed in the sequence that they appear in the standard.

Definitions

139. The Board asked respondents to comment on the appropriateness of the definitions of PP&E, general PP&E, Federal mission PP&E, heritage assets, and stewardship land. Respondents raised issues on the overall definition of PP&E including (1) internally-developed software, (2) land rights, (3) capitalization threshold, and (4) reversionary interests in property. These four issues are discussed below. An issue raised regarding the Federal mission PP&E definition is also addressed below.

Internally-developed Software

140. The ED proposed that internally-developed software be excluded from PP&E—in effect, that it be expensed when incurred. In making this proposal, the Board pointed to concerns affecting the objectivity/accuracy of any capitalized cost for internally-developed software in general PP&E.[75] The Board was concerned that costs could be overcapitalized thus understating expense for the period and that it would be difficult to provide for the removal or write-off of costs related to unsuccessful projects and/or cost overruns. Given these practical concerns and the expectation that costs for software development efforts would not fluctuate dramatically since they related to continuous agency efforts, the Board proposed that these costs be expensed.[76]

141. Many respondents supported the Board's view. They noted that, among other problems, it would be difficult to distinguish new development efforts from ongoing system maintenance. In fact, some respondents commented that software undergoes continuous improvement and updating.

142. On the other hand, the majority of respondents objected to the exclusion of these costs from PP&E. Many argued that internally-developed software met the overall definition of PP&E and that accounting could accommodate the problems of cost overruns and

[75]Internally-developed software may be a component of general PP&E or stewardship PP&E.

[76]In fact, the majority of private-sector entities do not capitalize the cost of internally-developed software. The Financial Accounting Standards Board has not developed guidance on this issue.

unsuccessful efforts. Many suggested that costs be held in a work-in-process account and any unsuccessful efforts subsequently written off in the period deemed unsuccessful. In addition, many believed that cost overruns were appropriate to include in the cost of the asset.

143. Ultimately, the Board made two changes to the PP&E definitions—they removed the statement excluding internally-developed software from PP&E and they added a provision for recognition of internally-developed software as a component of general PP&E under certain circumstances. Since the Board's concern was with the potential for overcapitalization of these costs, they found that it was not necessary to exclude the costs from the PP&E categories for which costs would not be capitalized. Therefore, any internally-developed software costs appropriately classified as an item of stewardship PP&E may be included in those categories.

144. For internally-developed software costs that would be categorized as general PP&E, the Board placed several restrictions on the capitalization of costs. To be capitalized, it must be intended that the costs be recovered through charges to users. In addition, only certain costs may be capitalized after it has been established that the software project is likely to be successful. Once capitalized, the costs can not be amortized over a period longer than five years.

145. In addition to internally-developed software, the Board discussed accounting for contractor-developed software. In principle, the Board's consensus was that the same accounting should be provided for contractor-developed software as for internally-developed software. However, the Board believed that this proposal should be exposed for comment prior to establishing a standard to that effect. Therefore, the standards do not provide specific provisions restricting the capitalization of contractor-developed software.

Land Rights

146. The Board received a request to address restrictive easements acquired by a Federal agency. This agency acquires restrictive easements limiting the use of land adjoining the agency's own property. The Board considers these easements a "land right." Land rights are interests and privileges held by an entity in land owned by others.

147. The Board provided for the recognition of land rights as part of PP&E since they are generally associated with other items of PP&E actually owned by the entity. In addition, where land rights are for a limited period of time and are includable in the general PP&E category, the Board provided for depreciation of the cost.

Capitalization Threshold

148. Many respondents requested that the Board provide a capitalization threshold as an element of the PP&E definition. The Board addressed this issue in developing the ED. At that time, the Board carefully considered whether to take a prescriptive approach by setting a threshold or to permit entities the latitude to establish a threshold suited to their particular operating environment. The Board believes that Federal entities are sufficiently diverse that one threshold would not be suitable for all entities. For example, Title 2's $5,000 threshold would be immaterial for defense department operations but perhaps not for a smaller entity such as the Small Business Administration.

149. Instead of setting a specific threshold, the Board has adopted a materiality approach—just as is done in private sector accounting. Each entity would establish its own threshold as well as guidance on applying the threshold to bulk purchases. The Board believes that permitting management discretion in establishing capitalization policies will lead to a more cost-effective application of the accounting standards.

Reversionary Interests in PP&E

150. The Board also received a request to address reversionary interests in PP&E. In some instances, the Federal Government provides grants to state and local governments for the acquisition of PP&E. If the state or local government eventually decides that it no longer needs to use the PP&E for the purpose specified in the original grant there is often a provision that the PP&E must revert to Federal ownership. In these cases, the Federal Government maintains a reversionary interest in PP&E. In essence, these are contingent assets and should not be recognized on the balance sheet. The Board elected to specifically exclude these items from PP&E.

Federal Mission PP&E

151. Some respondents indicated that the term "Federal mission PP&E" had broader implications than intended by its definition. It was suggested that some may assume any PP&E used to meet an agency's mission would fit this category (e.g., essentially all Federally owned PP&E).

152. The Board agreed that it was possible that a mere reading of the term "Federal mission PP&E" could lead to broader application of the category than permitted under the standard. However, the Board found that there was no brief term that would effectively communicate the nature of the PP&E properly includable in this category. The Board believes that the characteristics provided as well as the illustrations included in Appendix B of this document will clearly establish the appropriate use of this category. In addition, the Board has incorporated in the standard a cautionary footnote regarding loose interpretations drawn from the term "Federal mission PP&E."

Depreciation

153. The exposure draft posed several questions related to depreciation accounting for general PP&E. Briefly, the questions addressed:

- usefulness of depreciation expense for the assessment of operating performance,
- an alternative view suggesting that depreciation accounting be limited to business-type activities,
- usefulness of the allocation of depreciation expense to responsibility segments, and
- cost/benefit of allocating depreciation expense to programs

154. Overall, the respondents supported the Board's proposal to require depreciation accounting on all general PP&E. Many indicated that depreciation accounting would improve performance measurement by producing comprehensive, comparable cost information. In addition, operating expenses would not be overstated in periods that assets were purchased and understated in other periods.

155. A few respondents supported the alternative view that would limit depreciation accounting to business-type activities. They argued that depreciation was only necessary where expenses were to be matched

to revenues. This view is contrary to the operating performance objective and would not support development of cost information to associate with performance measures.

156. The Board did not make any changes to its requirements to apply depreciation accounting to general PP&E.

Multi-use Heritage Assets

157. The ED addressed renovation, reconstruction, improvement, and rebuilding costs for multi-use heritage assets (e.g., monumental style office buildings). Under the ED's proposal, any costs not directly associated with the heritage nature of the asset would be capitalized and depreciated as general PP&E. The ED also provided that abnormally high costs due to the heritage features of the assets (e.g., replacement of a specialized roofing material versus a modern day equivalent) be treated as heritage asset costs.

158. Respondents indicated that it would be very difficult to apply the proposed standards. Difficulties would include segregating the cost associated with preserving the heritage assets and supporting operations as well as identifying abnormal costs. In response to these concerns, the Board modified the treatment of multi-use heritage assets. The standard now provides that only renovation, reconstruction, and improvement costs directly attributable to operations be capitalized as general PP&E.

Current Value

159. The ED included an alternative view espousing the use of current value accounting for Federal Government PP&E. This view was not supported by the respondents. The majority of respondents believed that current values would be difficult and costly to obtain, and subject to manipulation. Many indicated that current values were often useful to decision makers and should be provided on an as needed basis rather than incorporated in the basic financial statements.

Federal Mission PP&E

160. Overall, the reaction to the Federal mission PP&E category was favorable. Respondents indicated that they would not have difficulty applying the category descriptions. However, the Board received the

following specific requests for major revisions in the Federal mission PP&E category:

- to retain the definition but include Federal mission PP&E on the balance sheet and apply depreciation accounting to these assets, and
- to make use of the category optional (e.g., managers would be free to use the general PP&E category for PP&E that would otherwise qualify as Federal mission PP&E).

Depreciate Federal Mission PP&E

161. The Board did not adopt the first proposal—to apply depreciation accounting to Federal mission PP&E. While there may be management uses of this information, no persuasive examples of management uses have been identified. The Board remains convinced that depreciation accounting for these unusual items of PP&E would not provide meaningful information—a view that is supported by the Board's 1992 user needs study. Further, the Board wishes to note that nothing precludes management from developing depreciation information through cost finding means if it desires to do so for particular management purposes.

Make the Federal Mission PP&E Category Permissive

162. It was proposed that classification of PP&E as Federal mission be permissive rather than mandatory. Two reasons were given for this proposal:

- some PP&E is used as both Federal mission and general PP&E (for example, office facilities located at nuclear weapons production plants), and
- entity management should be free to decide that depreciation information on Federal mission PP&E is useful.

163. It was suggested that adopting this proposal would allow agencies to classify property as best suits their needs. The Board discussed this proposal at length. Some Board members were favorably inclined to permit entity managers to exercise judgment regarding the accounting treatment of Federal mission PP&E. However, the majority of the Board members believed that making the category optional would be inappropriate.

164. These members argued that (1) the user needs study supported their belief that historical cost depreciation on these types of items was not useful, (2) it would not be appropriate to give entities the latitude to use different accounting methods for similar assets, and (3) it would not be cost-beneficial to permit entities to make item by item judgments on appropriate accounting treatment. The members noted that, in connection with the proposal to require depreciation accounting for Federal mission PP&E (See paragraph 161), they had not been able to identify any management uses of depreciation information on Federal mission PP&E. The Board was concerned that entities may make unsupported, and costly, decisions regarding the election to categorize items as general or Federal mission PP&E. While entities can use cost finding to determine depreciation expense for internal purposes if they so desire, the Board does not believe that depreciation of Federal mission PP&E would be useful for general purpose financial reports.

165. The Board decided that use of the Federal mission PP&E category would remain mandatory for PP&E exhibiting the designated characteristics. The Board did add guidance in the standard regarding the selection of the base unit to be used in categorizing PP&E (See paragraph). One respondent had proposed that this guidance be added and stated that it would aid entities in establishing the level of detail necessary to properly categorize PP&E. For example, should PP&E be categorized on a site by site basis or by a smaller unit such as building by building. As with the capitalization threshold, the Board has indicated the factors that should enter into the selection of a base unit but has ultimately left the actual selection up to management.

Other PP&E Meeting the Characteristics

166. The Board posed a question in the ED regarding the classification of **nuclear weapons production facilities** and **military base facilities** as Federal mission PP&E.[77] This question was posed because of a discussion among the Board members as to whether these items would or would not meet the Federal mission PP&E definition.

[77]FASAB Exposure Draft, *Accounting for Property, Plant, and Equipment*, February 28, 1995, page 19, paragraph 71, Item IC.

167. The majority of the respondents indicated that nuclear weapons production facilities meet the current characteristics of Federal mission PP&E—confirming the initial reaction of the Board members. One respondent did indicate that these facilities could be converted to other uses—as had munitions plants following World War II—however, the Board believes that the cost of such a conversion would be so great as to make it improbable in the near term. The Board has not elected to add this as another specifically identified item that qualifies as Federal mission PP&E because it is a good illustration of the purpose and application of the characteristics developed. In addition, the Board prefers not to engage in an exercise of listing all items that qualify since the absence of certain items may lead practitioners to assume that an item was specifically excluded.

168. The majority of respondents indicated that military base facilities would not as a group meet the definition of Federal mission PP&E and that the category should not be expanded to accommodate these assets. Many respondents pointed out that military base facilities have alternative uses and are currently being reviewed for just that purpose. The Board agrees with these views and has not modified the definition to permit inclusion of military base facilities in the category.

Audit of Federal Mission PP&E

169. Several respondents expressed concern regarding the level of audit coverage applicable to Federal mission PP&E. Although the ED did not specifically address supplementary stewardship reporting for those categories of PP&E removed from the balance sheet, there was concern that removing these categories would lessen the audit coverage. Respondents noted that military weapons systems and space exploration equipment represented a substantial investment. They were concerned that the changes could lead to poor tracking systems for these items as well as weak internal controls over them. Other respondents pointed out that the key information is the existence and condition of these assets rather than the historical cost of the items. In addition, they suggested that devoting audit resources to verifying historical cost dollar amounts would detract from auditing more important existence and condition information.

170. The Board responded with the following points:

- auditing standards are beyond the scope of the Board's responsibilities,
- Board members representing the General Accounting Office (GAO) and the Office of Management and Budget (OMB) indicated that the audit coverage would be appropriately addressed in their work on Federal audit requirements,
- accounting standards should be established based on information needs not audit concerns, and
- the ED on supplementary stewardship reporting will include a statement to the effect that the Board expects that the responsible parties will produce audit requirements to satisfy concerns of the respondents.

Deferred Maintenance

171. The deferred maintenance standard was well received by the majority of respondents. The Board addressed the issue in part due to the many state and local governments as well as national groups that concerned over the deteriorating condition of government owned PP&E. A report of the U.S. Advisory Commission on Intergovernmental Relations (ACIR), High Performance Public Works,[78] notes that maintenance competes for funding with other government programs and is often underfunded. Contributing to this underfunding is the fact that the consequences of underfunding maintenance are often not immediately reported. The consequences include increased safety hazards, poor service to the public, higher costs in the future, and inefficient operations.

172. The ACIR recommended that entities disclose information on:

- the condition of assets,
- the cost of unfunded maintenance,
- the consequences of unfunded maintenance, and
- the uncertainty in estimates of unfunded maintenance.

173. The Capital Expenditures task force also recognized that deferred maintenance was an issue for Federal PP&E and requested that the Board address it. The policies and initiatives related to deferred

[78]U.S. Advisory Commission on Intergovernmental Relations, High Performance Public Works: A New Federal Infrastructure Investment Strategy for America, November 1993.

maintenance at three Federal agencies[79] were reviewed and it was found that Federal agencies are developing systems to report on deferred maintenance. Although the systems are different, the goals of the systems are consistent—to provide reliable information on the condition of PP&E and to estimate the cost of correcting deficiencies.

174. Under these accounting standards, deferred maintenance information will be incorporated in the financial reports despite the differences in measurement among the agencies. The Board believes that deferred maintenance is a cost—a cost that management, at whatever level, has elected not to fund. However, the Board found that deferred maintenance is not sufficiently measurable to be recognized in the accounting systems.

175. However, to highlight the reality that the cost remains despite being unfunded, the standards provide that deferred maintenance be disclosed by placing a line item on the statement of net cost with a note reference in lieu of a dollar amount on the financial statements. This recommendation is consistent with the findings of the Board's user needs study; that information on the cost of deferred maintenance is important to users. In addition, due to the measurement differences between entities, the disclosure requirements are flexible.

176. The standards provide two alternatives for estimating amounts to be disclosed—condition assessment surveys and life cycle cost analyses. Condition assessment surveys would provide disclosure of the estimated cost to return the PP&E to its desired condition. Life cycle cost analyses would highlight differences between planned maintenance and actual maintenance.

177. Both of these methods will be under the control of entity program managers since deferred maintenance is dependent on the purpose for which PP&E is held and on judgment regarding what condition PP&E should be in to meet that purpose. Entities are permitted flexibility in (1) setting standards for maintenance requirements and (2) establishing cost beneficial methods to estimate the cost of deferred maintenance.

[79]These agencies are the Department of Energy, the Department of the Navy, and the National Aeronautics and Space Administration.

178. The proposed standards require disclosure of information on the condition of PP&E, estimates of the cost of deferred maintenance, and methods used to assess deferred maintenance. The standards apply to both PP&E reported on the balance sheet and the stewardship report.

179. In response to the ED, two opposing suggestions were raised—(1) recognize the amounts as a liability, and (2) remove the information from the notes.

Recognition

180. A few respondents, including two appearing at the public hearing, suggested that the Board provide for recognition of the liability associated with deferred maintenance. The Board does not believe that deferred maintenance can or should be recognized as a liability because it is not sufficiently measurable to be recognized. Deferred maintenance reporting is in an evolutionary phase with Federal agencies currently developing a variety of systems to assess deferred maintenance. Measurement can not be described at this time as consistent or comparable. The deferred maintenance standard will remain as drafted. However, if and when government maintenance standards (e.g., minimum acceptable condition and standard repair costs) are set, the Board will revisit the accounting and consider requiring recognition of the liability and the cost.

Remove From Notes

181. A few respondents requested that the Board provide for deferred maintenance information through required supplemental information to lessen the audit burden associated with the information. The Board—as was the case with Federal mission PP&E—does not believe that audit coverage should govern the placement of information in the annual reports. Deferred maintenance information is considered important because it ensures that readers are informed of the condition of Federally owned PP&E. If there is a need to reduce the audit coverage, the Board believes that GAO and OMB can best address this need.

Cleanup Cost

182. The Board elected to address cleanup costs from long-term Federal operations as one of the costs associated with PP&E. For example, the Federal Government operates nuclear facilities and is required by law to cleanup any hazardous materials upon closing the facilities. This

obligation meets the Board's definition of liability.[80] However, because the cleanup of these types of facilities would not occur until operations cease, additional guidance is needed to determine when and how to recognize these costs and liabilities.

183. The guidance in this standard builds on the accounting standards developed for liabilities. These standards were published in the Board's statement entitled *Accounting for Liabilities of the Federal Government* (liabilities standard). The liabilities standard includes:

- the liability definition,
- recognition criteria, and
- disclosure requirements.

184. The liabilities standard is applicable to cleanup costs. For example, if cleanup costs are not both probable and measurable the disclosure requirements in the liabilities standard would apply. The standards in this statement address cleanup cost accounting including:

- allocating cleanup costs to operating periods,
- estimating cleanup costs to be paid far in the future (e.g., using a current cost approach), and
- recognizing changes in estimates prior to actual cleanup.

185. Because of the differences in accounting for the costs of general PP&E and stewardship PP&E, the Board developed different methods for allocating cleanup costs to operating periods depending on the category of the related PP&E.

Cleanup of General PP&E

186. The Board concluded that the liability for cleanup costs related to the operation of general PP&E would be recognized in a systematic and rational manner over the periods that the associated general PP&E is in use. This approach is consistent with the requirement to depreciate general PP&E. In addition, the Board requires disclosure of the estimate of total cleanup costs.

[80]FASAB, Recommended Accounting Standard No. 5, *Accounting for Liabilities*, September 1995.

Cleanup Of Stewardship PP&E

187. For cleanup costs related to stewardship PP&E, the Board concluded that the total estimated liability for cleanup cost would be recognized at the time that the stewardship PP&E is placed in service. This is consistent with the treatment of the acquisition cost of the stewardship PP&E which is recognized as a cost of operations in the period that the PP&E is placed in service.

Estimating Cleanup Costs

188. With regard to estimating cleanup cost, the Board concluded that the estimate would be based on the current cost to perform the cleanup. Current cost should be based on existing laws, technology and management plans. An alternative to current cost would have been to estimate costs in the future, factoring in expected inflation, and discounting this amount to current dollars. The Board did not believe that this approach offered any greater degree of accuracy in return for the additional effort involved in making the estimate.

189. As with all estimates, the estimates of cleanup costs will change over time. These changes will be due to inflation as well as to changes in laws and technology.

190. For cleanup costs associated with general PP&E, changes in estimates related to current and prior period operations be recognized as an expense in the period of the change. For example, if a facility with a capacity to produce 100 tons of material has produced 60 tons of material, then 60% of the change in estimate should be recognized as expense in the year that the estimate changes.

191. For cleanup costs associated with stewardship PP&E, the total change in estimate be recognized in the period of the change.

Cleanup Cost Issues

192. Respondents to the ED were supportive of the Board's efforts to address cleanup costs. However, several suggested that the Board's treatment of the liability associated with general PP&E—recognizing it incrementally over the life of the PP&E—was inconsistent with its definition of a liability. In some cases, respondents argued, the cleanup liability is incurred at the time the PP&E is placed in service. These respondents suggested that the Board provide for full recognition of the liability if an amount is reasonably measurable at that time.

193. The Board did not adopt this suggestion. While the Board recognizes that in fact the liability may be incurred at the date that general PP&E is put in service, the actual recognition of the liability is problematic in

a double entry accounting system. Generally, the recognition of a liability, a credit account, generates a concurrent recognition of either an expense (e.g., accounts payable for fuel bills is offset by fuel expense) or an asset (e.g., a capital lease liability is offset by an asset—PP&E), both typically debit accounts. In this case, the cleanup cost is not appropriately includable in operating expense of the period that the PP&E is placed in service. This would create a need for a balance sheet debit to offset the liability.

194. The Board does not believe that it would be appropriate to recognize an asset to offset the cleanup liability. Although some argue cleanup cost is a deferred cost of associated PP&E, the Board does not believe that these costs meet the asset definition and finds that recognition of cleanup cost as a component of PP&E would significantly overstate assets.

195. Other respondents expressed the opposite position, suggesting that it is not appropriate to recognize cleanup costs until they are budgeted for. This approach is not only inconsistent with the definition of a liability but would keep users of the financial statements in the dark as to the magnitude of Federal commitments for environmental cleanup.

196. The Board believes that the standards it has developed will contribute to meeting the operating performance and stewardship reporting objectives of Federal financial reporting. The cleanup cost standards have not been modified for either of these recommendations.

197. One modification that was made relates to implementation of the standard. Implementation is a significant issue given the magnitude of the Government's existing facilities and its obligations for cleanup of those facilities. One Board member requested that the implementation guidance related to cleanup of general PP&E provide an alternative method. It was suggested that provision of a second method would lower the cost of implementing the standard in situations where the related PP&E had been in service for a substantial portion of its estimated useful life.

198. The second method would be to recognize the entire estimated total cleanup cost as a liability upon implementation. In periods following implementation, entities electing this method would recognize any changes in the estimated total cleanup cost as expense for that period in lieu of the pro-rata amount of the estimated total cleanup cost. This

method could be applied only by entities not seeking to recover their costs through user charges.

199. The Board adopted this recommendation in light of the large number of Federal facilities that will be affected by this standard and the cost of implementing the standard.

Appendix B: Illustrations Of Categories

200. In developing categories for Federal mission PP&E, Heritage Assets and Stewardship Land (See paragraphs 46, 57, and 66), the Board sought input from Federal agencies, the Standard General Ledger Issues Resolution Committee (SGLIRC), and other subgroup members. The Board found that there were many cases where similar assets could fit more than one category.

201. For example, aircraft and ships are used by law enforcement agencies as well as by the Department of Defense. Under the proposed categories, only those used by the Department of Defense would meet the criteria for Federal mission PP&E. The illustrations provided are intended to clarify the application of the categories to actual assets.

Illustration 1: Federal Mission Property, Plant, And Equipment

202-212 ... [See SFFAS 11 for the explanation of the deletion][81]

Illustration 2: Heritage Assets

214. Many assets are clearly heritage assets. For example, the National Park Service manages the Washington Monument, the Lincoln Memorial and the Mall. However, other assets, particularly Federal office buildings, have historical, cultural or architectural significance as well as being used for general operations.

215. The Board has found that these multi-use heritage assets should still be categorized as heritage assets. Any costs to maintain the assets themselves should be treated as heritage assets. However, any costs that are operational in nature (e.g., reconfiguring of office space or modernized communications wiring) should be classified as general PP&E. Costs of these types of improvements or renovations would then be capitalized and depreciated—providing useful information for performance measurement.

216. For assets that are used solely for heritage purposes (e.g., the Washington Monument), the Board believes that the cost of operation, maintenance, and other periodic expenses combined with deferred

[81]... [See SFFAS 11 for the explanation of he deletions]

maintenance disclosures, are sufficient to assess operating performance. Allocating the cost of heritage assets to accounting periods through depreciation would not enhance the information available for performance assessment.

217. Following are examples of general PP&E that exhibit characteristics of heritage assets.

Illustration 2A: Major Office Building

218. A Federal agency constructed a central office building in 1950 to house its headquarters personnel. The building was subsequently placed on the historical registry but continued to serve as headquarters' office space.

219. Public tours are available and educational exhibits are provided in the hallways. However, public access is restricted to guided tours. The majority of floor space is devoted to offices, meeting rooms, cafeterias, and storage.

220. The building is currently undergoing major renovations. The cost of these renovations should be capitalized and depreciated over their expected useful lives only to the extent that the work is tied to operations rather than to preserving the building. Additional information on the heritage nature of the asset would be provided through stewardship reporting.

Illustration 2B: New Office Building

221. A Federal facility previously used for industrial purposes (e.g., production of equipment parts) is being renovated and remodeled to serve as office space. The brick facade is being preserved because of its historic significance. Office space is being constructed inside of the brick facade.

222. The building can be viewed by visitors to the Federal facility, however, access to the office space will be restricted.

223. The original cost of the brick facade should not be included in the cost of the new office building. The cost of new construction should be capitalized and depreciated as part of general PP&E and none should be treated as a heritage asset. Additional information on the heritage nature of the existing brick facade, if material, would be provided through stewardship reporting.

Illustration 2C: Library Of Congress

224. The Library of Congress is undergoing restoration and renovation. This includes:

- restoring artwork and architectural features,
- installing wiring for workstations, and
- building office space.

225. Expenditures for restoration of heritage aspects of the buildings should be treated as a period cost for heritage assets. However, expenditures for operational aspects of the renovation should be categorized as general PP&E. Additional information on the heritage nature of the asset would be provided through stewardship reporting.

Illustration 3: Land

226. The proposed standard provides that land acquired for or in connection with other general PP&E be included in that category. For example, the cost of land on which facilities are located would be included in general PP&E. Other land would be subject to stewardship reporting.

227. The following illustrations cover two potential issues associated with land. First, identifying land associated with general PP&E. Second, identifying land improvements as general PP&E or PP&E subject to stewardship reporting.

Illustration 3A: Military Uses Of Land

228. In general, land used for military bases would be considered general PP&E. However, in some cases, land is used by the military as a site for missile silos, testing grounds or firing ranges. Land used for these purposes meets the definition of stewardship land. The Board believes that period-by-period cost information related to holding land for defense purposes is not relevant to assessing operating performance.

Illustration 3B: Roads On Public Lands

229. Public lands have various types of roads to provide access. These types include:

- rough dirt roads created from years of use,
- dirt roads created by non-Federal land users (e.g., oil & gas exploration crews) and then abandoned, and
- roads created by Federal entities to provide access (e.g., gravel & paved roads).

230. Some of these roads are maintained while others merely exist until natural conditions overtake them.

231. Under private sector accounting, permanent improvements to land are included in the cost of land on the balance sheet. Typically, the cost of clearing and establishing the road bed is considered a permanent improvement because, with routine maintenance, it will remain indefinitely. Any pavement or gravel that must be replaced periodically would be considered depreciable PP&E. For a Federal entity, if the road could be categorized as general PP&E this practice would be appropriate since the period-by-period cost of assets is relevant for assessing operating performance.

232. For land subject to stewardship reporting, the cost of establishing the roadbed would be expensed in the year incurred since the land improved by the roadbed is not capitalized on the balance sheet. On the other hand, the paved and gravel roads are general PP&E because they are operational and the period-by-period cost is essential for assessing operating performance. The cost of pavement or gravel would be capitalized and depreciated. Decisions about the quality of the road conditions (e.g., how often roads are repaved) are an element of operating performance and of the cost of providing government services.

Appendix C: Deferred Maintenance Illustration

233. This appendix illustrates ... [See SFFAS 14 for the explanation of deletion] paragraphs -77-83. The example shown here is for illustrative purposes only. Different entities may developed different asset categories, condition codes and descriptive terminology. The Board intends that this standard provide flexibility while providing relevant information on the condition of Federal assets. The following illustration presents text from a footnote meeting the requirements of the standard.

XYZ Hospital Facility

... [See SFFAS 14 for the explanation of deletion] Deferred Maintenance

XYZ operates a hospital facility at one of its remote sites. During the period maintenance expense is recognized as incurred. However, maintenance was insufficient over the past several years and resulted in deferred maintenance.

Information on deferred maintenance is based on an annual inspection of facilities. Standards are provided for evaluating facility condition. These standards include:

- minimum and desirable condition descriptions for
- suggested maintenance schedules
- standard costs for maintenance actions
- standardized condition codes

There have not been material changes in the standards in recent years.

The following chart presents information on deferred maintenance on major categories of PP&E experiencing material amounts of deferred maintenance:

Category	Method	Asset Condition (See Note 1)	Cost To Return To Acceptable Condition (See Note 2)	Critical	Non-critical
Buildings	Condition Assessment Survey	4	$100,000-125,000	$75,000-	$15-50,000
Communication Eqp/Systems	Condition Assessment Survey	4.5	$10,000-15,000	$2,000	8-13,000
Laboratory Eqp	Condition Assessment Survey	5	$500,000-550,000	$300,000	200-250,000
Heating & Air Cond. Eqp.	Condition Assessment Survey	5	$40,000-42,000	$5,000	35-37,000

Note 1: Condition Rating Scale:

Excellent	1
Good	2
Fair	3
Poor	4
Very Poor	5

Note 2: Acceptable condition is “fair” or “3.”

Appendix D: Illustration Of Cleanup Cost

234. This appendix illustrates one method of complying with the standards proposed for cleanup costs. The examples shown in this appendix are for illustrative purposes only. There are many types of cleanup that may be accounted for under this proposed standard (e.g., nuclear facilities, landfills, or laboratories). Applying this proposed standard may require consideration of estimated cost components other than those shown here.

235. The computations are based on a formula allocating the estimated total cleanup costs (i.e., the total amount to be spent in the future to accomplish cleanup) to accounting periods. In identifying the amount to be expensed for the period, the formula considers the cumulative amounts:

- of capacity used at the end of the accounting period; and
- recognized as expense in prior accounting periods.

236. The components of the formula are defined below:

a = total cleanup cost estimated as of end of period
b = cumulative capacity used at end of period[82]
c = total estimated capacity[83]
d = amount previously recognized as expense-beginning of period
e = cleanup expense recognized in the current period

237. To calculate the appropriate expense amount, the following formula is used:

$$(a \times b/c) - d = e$$

238. Simply put, the end of period estimated total cleanup cost (a) is multiplied by the percentage of capacity used up at the end of that period (b/c) to arrive at the portion of cleanup cost that has been generated by operations through the end of the period. Theoretically,

[82]If recognition of the costs is based on the passage of time rather than physical capacity, the cumulative amount of time passed since the associated PP&E began operating shall be substituted.

[83]If recognition is based on the passage of time, the estimated useful life of the associated asset shall be substituted.

that amount of expense has been incurred and should be recognized. Amounts recognized as expense in prior periods (d) should be deducted to arrive at the current period expense amount (e). If this is the first period, the deduction for expense recognized in prior periods (d) is zero.

Illustration 1: Hazardous Waste Disposal Site

Operating Assumptions

239. The hazardous waste disposal site will begin accepting waste in 1995. The following assumptions apply:

- the site capacity is 100,000 cubic yards of waste
- it is estimated that the site will accept waste for ten years at an average rate of 10,000 cubic yards per year
- after the site is closed the following cleanup efforts are required by state, local and Federal laws:
  - site closure & sealing
  - thirty year monitoring
  - remediation
- 1995 cost estimates are based on current cost for 1995
- 1996 cost estimates are based on 1996 costs adjusted for inflation at a rate of 1.0%
- 1997 cost estimates are based on current costs for 1997 and include new technology and changes in monitoring requirements

RECOGNITION OF EXPENSE AND LIABILITY AMOUNTS FOR 1995
(Dollars in thousands)

Estimated Total Cleanup Cost[84] based on Current Cost in 1995

1. Site Closure and Sealing Cost:

Facilities for monitoring operations	$100
Sealing site	750
Erosion and control facilities	500

[84]This estimate includes any costs of any cleanup efforts required during the thirty year cleanup period. While these activities will not occur until the associated PP&E is closed, the costs are estimated at the current cost to conduct similar efforts.

2. Monitoring Cost (for a period of 30 years):

Inspection	3,000
Sampling & Testing	2,250
Maintenance of facilities	300

3. Remediation Cost:

Projected remediation based on statistical studies	500
TOTAL ESTIMATED CLEANUP COST	$7,400

Calculation of Annual Expense and Accrued Liability Amounts

This proposed standard would require that a portion of the estimated total cleanup costs be recognized as an expense and as a liability each period that the site operates. During 1995, the site accepts 15,000 cubic yards of waste. The following calculations show the amounts required to be recognized:

(a x b/c) - d = e
($7,400 x 15,000/100,000) - 0 = e
$7,400 x .15 = e
$1,110 = e

where:

a = total cleanup cost estimated as of end of period
b = cumulative capacity used at end of period[85]
c = total estimated capacity[86]
d = amount previously recognized as expense-beginning of period
e = cleanup expense recognized in the current period

[85]If recognition of the costs is based on the passage of time rather than physical capacity, the cumulative amount of time passed since the associated PP&E began operating shall be substituted.

[86]If recognition is based on the passage of time, the estimated useful life of the associated asset shall be substituted.

The following journal entry would be required:

Dr. Cleanup expense	$1,110	
Cr. Cleanup liability		$1,110

To recognize estimated cleanup costs.

RECOGNITION OF EXPENSE AND LIABILITY AMOUNTS FOR 1996
(Dollars in thousands)

Estimated Total Cleanup Cost based on Current Cost in 1996

1.	Site Closure and Sealing Cost:	
	Facilities for monitoring operations	$ 101
	Sealing site	758
	Erosion and control facilities	505
2.	Monitoring Cost (for a period of 30 years):	
	Inspection	3,030
	Sampling & Testing	2,273
	Maintenance of facilities	303
3.	Remediation Cost:	
	Projected remediation based on statistical studies	505
	TOTAL ESTIMATED CLEANUP COST	$7,475

Calculation of Annual Expense and Accrued Liability Amounts

During 1996, the estimated total cleanup costs were adjusted for inflation of 1.0% and site accepted 10,000 cubic yards of waste. The following calculations show the amounts required to be recognized:

(a x b/c) - d = e
($7,475 x 25,000/100,000) - $1,110 = e
$7,475 x .25 - $1,110 = e
$759 = e

where:

a = total cleanup cost estimated as of end of period
b = cumulative capacity used at end of period[87]
c = total estimated capacity[88]
d = amount previously recognized as expense-beginning of period
e = cleanup expense recognized in the current period

The following journal entry would be required:

Dr. Cleanup expense	$759
Cr. Cleanup liability	$759

To recognize estimated cleanup costs.

In addition, the proposed standard would require that any material changes in the estimate due to changes in laws, technology, or cleanup plans be disclosed. However, there is no indication that material changes occurred.

[87]If recognition of the costs is based on the passage of time rather than physical capacity, the cumulative amount of time passed since the associated PP&E began operating shall be substituted.

[88]If recognition is based on the passage of time, the estimated useful life of the associated asset shall be substituted.

RECOGNITION OF EXPENSE AND LIABILITY AMOUNTS FOR 1997
(Dollars in thousands)

Estimated Total Cleanup Cost Based on Current Cost in 1997

1. Site Closure and Sealing Cost:

Facilities for monitoring operations	$ 115
Sealing site	740
Erosion and control facilities	500

2. Monitoring Cost (for 30 years):

Inspection	2,250
Sampling & Testing	1,300
Maintenance of facilities	300

3. Remediation Cost:

Projected remediation based on statistical studies	400
TOTAL ESTIMATED CLEANUP COST	$5,605

Calculation of Annual Expense and Accrued Liability Amounts

During 1997, a new estimate of total cleanup costs was prepared and the site accepted 10,000 cubic yards of waste. The following calculations show the amounts required to be recognized:

(a x b/c) - d =e
($5,605 x 35,000/100,000) - ($1,110 + 759)= e
$5,605 x .35 - $1,869 = e
$1,962 - $1,869 = e
$ 93 = e

where:

a = total cleanup cost estimated as of end of period
b = cumulative capacity used at end of period[89]
c = total estimated capacity[90]
d = amount previously recognized as expense-beginning of period
e = cleanup expense recognized in the current period

The following journal entry would be required:

Dr. Cleanup expense	$93
Cr. Cleanup liability	$93

To recognize estimated cleanup costs.

In addition, the proposed standard would require that material changes in estimated cleanup costs be disclosed and that amounts attributable to prior period operations be disclosed. One means of calculating this amount is to segregate the amount recognized as cleanup expense for the current period between "changes in estimated cleanup cost from prior periods" and "current period cleanup cost." These two amounts would be disclosed.

Changes in estimated cleanup costs from prior periods are:

f = (a x b1/c) - d
f = ($5,605 x 25,000/100,000) - ($1,110 + 759)
f = $5,605 x .25 - $1,869
f = $1,401 - $1,869
f = $(468)

[89]If recognition of the costs is based on the passage of time rather than physical capacity, the cumulative amount of time passed since the associated PP&E began operating shall be substituted.

[90]If recognition is based on the passage of time, the estimated useful life of the associated asset shall be substituted.

where:

a = total cleanup cost estimated as of end of period
b1 = cumulative capacity used at beginning of period[91]
c = total estimated capacity[92]
d = amount previously recognized as expense at beginning of period
f = changes in estimated cleanup cost from prior periods

Current period cleanup costs are:

g = e - f
g = $ 93 - $(468)
g = $ 561

where:

e = cleanup cost recognized in the current period
f = changes in estimated cleanup cost from prior periods
g = current period cleanup costs

SUMMARY:

FINANCIAL STMT.	1995	1996	1997
Operating expense	$1,110	$ 759	$ 93
Liability	$1,110	$1,869	$1,962

Illustration 2: Nuclear Facility Qualifying As General PP&E

Operating Assumptions

240 A nuclear facility was placed in operation in 1981. No recognition of cleanup cost was made under past accounting policy. At the end of 1995, the entity adopts the accounting policies presented in this proposed standard.

[91]If recognition of the costs is based on the passage of time rather than physical capacity, the cumulative amount of time passed since the associated PP&E began operating shall be substituted.

[92]If recognition is based on the passage of time, the estimated useful life of the associated asset shall be substituted.

The following assumptions apply:

- the entity has an expected useful life of thirty years
- after the site is closed the following cleanup efforts are required by state, local and Federal laws:
  - site closure & sealing
  - thirty year monitoring
  - remediation
- 1995 cost estimates are based on current cost for 1995

RECOGNITION OF LIABILITY AMOUNTS FOR 1995 (Dollars in thousands)

Estimated Total Cleanup Cost Based on Current Cost in 1995

1. Site Closure and Sealing Cost:

Facilities for monitoring operations	$1,000
Sealing site	3,000

2. Monitoring Cost (for 30 years):

Inspection	6,000
Sampling & Testing	3,000
Maintenance of facilities	600

3. Remediation Cost:

Projected remediation based on statistical studies	2,000
TOTAL ESTIMATED CLEANUP COST	$15,600

Calculation of Liability Amount To be Recognized Upon Implementation

At the end of 1995, the estimated total cleanup costs was $15,600,000. The following calculations show the amounts that should have been recognized as of the end of 1995 if the proposed standard had been in effect since the facility began operating on October 1, 1980:

(a x b/c) - d = l
($15,600 x 15/30) - $0 = l
$15,600 x .5 - $0 = l
$7,800 = l

where:

a = total cleanup cost estimated as of end of period
b = number of years of operation
c = estimated useful life
d = amount previously recognized as expense-beginning of period
l = liability to be recognized at the end of 1995

Dr.	Net Position	$7,800
Cr.	Cleanup liability	$7,800

To recognize estimated cleanup liability.

No expense is recognized in the year of implementation.

SUMMARY:

FINANCIAL STMT.	1995
Prior Period Adjustment	$7,800
Liability	$7,800

Appendix E: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273

Statement of Federal Financial Accounting Standards No. 7: Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting

Status

Issued	May 10, 1996
Effective Date	for fiscal years beginning after September 30, 1997. Paragraph 65.2 provisions are effective for fiscal years beginning after September 30, 2000. (see para. 4 of SFFAS 13 amending the effective date)
Volume I References	SFFAC No. 2, *Entity and Display* (for discussion of statements) SFFAS No. 1, *Accounting for Selected Assets and Liabilities* (for allowance for uncollectible amounts, recognition of accounts receivable) SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees* (for transactions involving direct loans and loan guarantees) SFFAS No. 3, *Accounting for Inventory and Related Property* (for seized and forfeited property, and foreclosed property) SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government* (for full cost and inter-entity transactions) SFFAS No. 5, *Accounting for Liabilities of the Federal Government* (for pensions, other retirement benefits and for retirement of debt) SFFAS No. 6, *Accounting for Property, Plant, and Equipment* (see sales and transfers of assets, revaluations) SFFAS No. 13, *Deferral of Paragraph 65.2—Material Revenue Related Transactions Disclosures*
Volume II References	Revenue (R40), Prior Period Adjustments (P40), Seized and Forfeited Property (S30)
Interpretations and Technical Releases	Interpretation No. 1, *Reporting on Indian Trust Funds in General Purpose Financial Reports of the Department of the Interior and in the Consolidated Financial Statements of the U.S. Government* Interpretation No. 5, *Recognition by Recipient Entities of Receivable Nonexchange Revenue*
Affects	• SFFAS No. 7, paragraph 36(b), affects SFFAS No. 5, paragraphs 35-42 (Contingencies) by providing an exception to the general principle for accruing losses that are "more likely than not" on contracts for goods made to order or services provided to order. • SFFAS No. 7, paragraph 53, affects SFFAS No. 1, paragraph 41, by providing additional guidance regarding accruing accounts receivable. • SFFAS No. 7, the designated material in paragraphs 90-102, adds a "statement of financing" to the group of reports discussed in SFFAC No. 2. • SFFAS No. 7, paragraphs 264-269, affect SFFAS No. 3, paragraph 76 by providing additional guidance regarding account receivable recognition. • SFFAS No. 7, paragraph 74-75, affect Techincal Bullentin 2003-1, paragraphs 12-14, by providing guidance on accounting for transfers.
Affected by	• SFFAS No. 13 defers the effective date of paragraph 65.2 of SFFAS No. 7. • TB 2002-2 affects paragraphs 79(g) by explaining what disclosures are required when an entity issues financial statements before the budget with "actual" numbers for the same year is published. • SFFAS No. 20 rescinded paragraph 65.2 and amended paragraph 107 and 187.1. • SFFAS No. 21 amends paragraph 76. • SFFAS No. 22 affects paragraphs 80 and 97.

Summary

This Statement contains two separate parts. The first, on revenue and other financing sources, is composed of the introduction, accounting standards, and appendices. The second part of this document amends Statement of Federal Financial Accounting Concepts No. 2, Entity and Display, by adding a new concept to satisfy users' needs for information that reconciles budgetary and financial accounting. Statements of Federal Financial Accounting Concepts articulate the framework within which the Board considers and recommends accounting standards.

Classification, Recognition, and Measurement of Revenue and Other Financing Sources

Revenue is an inflow of resources that the Government demands, earns, or receives by donation. Revenue comes from two sources: exchange transactions and nonexchange transactions. Exchange revenues arise when a Government entity provides goods and services to the public or to another Government entity for a price. Another term for "exchange revenue" is "earned revenue." Nonexchange revenues arise primarily from exercise of the Government's power to demand payments from the public (e.g., taxes, duties, fines, and penalties) but also include donations. The term "revenue" does not encompass all financing sources of Government reporting entities, such as most of the appropriations they receive. These other sources of financing do, however, provide resource inflows to Government reporting entities, so this Statement includes accounting standards for them.

These accounting standards recognize exchange revenue at the time that a Government entity provides goods or services to the public or to another Government entity. The revenue is measured at the price likely to be received. Thus, with some differences that are explained in the standard, the accounting for earned revenue is comparable to the private sector's accrual accounting for earned revenue. Exchange revenue includes most user charges other than taxes.

Nonexchange revenues include income taxes, excise taxes, employment taxes, duties, fines, penalties, and other inflows of resources arising from the Government's power to demand payments, as well as voluntary donations. Nonexchange revenue is recognized when a reporting entity establishes a specifically identifiable, legally enforceable claim to cash or other assets. It is recognized to the extent that the collection is probable (i.e., more likely than not) and the amount is measurable (i.e., reasonably estimable).[1]

[1]As explained in para. 44 of SFFAS Number 1, Accounting for Selected Assets and Liabilities, "more likely than not" means more than a 50 percent chance. "Not probable" means the converse, i.e., 50 percent or less.

In the case of taxes and duties, inherent and practical limitations on the assessment process serve to delay the time when the power to demand payment becomes a legally enforceable claim to cash or other assets. For this reason, the method of accounting for taxes and duties can best be characterized as a modified cash basis of accounting, rather than an accrual basis. This basis of accounting amends the standard for the recognition of accounts receivable for taxes and duties.

Budgetary resources are recognized from two perspectives: the proprietary accounting perspective and the budgetary perspective. From the proprietary perspective, appropriations are accounted for as a financing source when used. Appropriations are used when an entity acquires goods and services or provides benefits and grants that are authorized to be paid by an appropriation. The remaining amount of appropriations enacted into law, but not yet recognized as "appropriations used," is treated as capital, i.e., "unexplained appropriations." This treatment parallels the recognition of expended appropriations during budgetary execution.

To the extent that other standards require that costs not on the entity's books be imputed to the entity, the standards for other financing sources require recognition of the corresponding imputed financing.

Financial statements have not previously presented budget execution information needed by users of those reports. The standards presented in this document require the presentation and, consequently, the audit of information about budgetary resources, the status of those resources, and outlays. The standards also require a reconciliation of proprietary and budgetary information in a way that helps users relate the two.

Disclosures, Supplementary Information, and Other Information

The different types of revenue, and the complexity of accounting for revenue and other financing sources, increase the importance of certain disclosures and other information. Briefly, the standards provide for:

- Extensive disclosures and other information about taxes and duties;
- Certain disclosures about exchange transactions where the full cost of goods and services sold is not recovered;
- Limited disclosure concerning accountability for dedicated collections;
- Disclosures and supplementary information from trust funds and the entities that make the collections for these trust funds where trust funds may be over- or under-funded in terms of applicable law; and
- Disclosures about the use of borrowing authority and the status of budgetary resources that may affect future spending by the entity.

Concepts for Reconciling Budgetary and Financial Accounting

This statement amends Statement of Federal Financial Accounting Concepts No. 2, Entity and Display, by adding a category of financial information to further satisfy users' needs and the objectives of financial reporting. More specifically, the amendment is designed to meet users' need to understand "how information on the use of budgetary resources relates to information on the cost of program operations . . ." (sub-objective 1C). The objective of this new category of information is to provide an explanation of the differences between budgetary and financial (proprietary) accounting. This is accomplished by means of a reconciliation of budgetary obligations and nonbudgetary resources available to the reporting entity with its net cost of operations.

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Executive Summary

Scope

1. This Statement presents standards to account for inflows of resources from revenue and other financing sources. It provides standards for classifying, recognizing, and measuring resource inflows. These financial (proprietary) accounting standards differ from those used for budgetary accounting only to the extent essential to meet the Objectives of Federal Financial Reporting.

Classification, Recognition, And Measurement

2. Revenue is an inflow of resources that the Government demands, earns, or receives by donation. Revenue comes from two sources: exchange transactions and nonexchange transactions. Exchange revenues arise when a Government entity provides goods and services to the public or to another Government entity for a price. Another term for "exchange revenue" is "earned revenue." Nonexchange revenues arise primarily from exercise of the Government's power to demand payments from the public (e.g., taxes, duties, fines, and penalties) but also include donations. The term "revenue" does not encompass all financing sources of Government reporting entities, such as most of the appropriations they receive. These other sources of financing do, however, provide resource inflows to Government reporting entities, so this Statement includes accounting standards for them.

3. These accounting standards recognize exchange revenue at the time that a Government entity provides goods or services to the public or to another Government entity. The revenue is measured at the price likely to be received. Thus, with some differences that are explained in the standard, the accounting for earned revenue is comparable to the private sector's accrual accounting for earned revenue. Exchange revenue includes most user charges other than taxes. Such user charges include regulatory user charges, in which the exchange is not wholly voluntary but the revenue is generally, but not always, related to the cost of providing service to identifiable groups. One example is the revenue derived from the Securities and Exchange Commission's registration fees. Exchange transactions also include those intragovernmental transactions where the price serves as a full or partial reimbursement for the costs incurred.

4. Distinguishing exchange revenue from nonexchange revenue and other financing sources enables the entity to report the net cost of operations of its programs (and the cost of the entity to the taxpayer) and provides the accounting foundation to report unit cost of output measures for performance evaluations. Requiring that exchange revenue be matched with the cost of outputs of goods and services sold to the public enables the entity to report the cost to the taxpayer of not charging the full cost of those goods and services.

5. Nonexchange revenues include income taxes, excise taxes, duties, fines, penalties, and other inflows of resources arising from the Government's power to demand payments, as well as voluntary donations. Nonexchange revenue is recognized when a reporting entity establishes a specifically identifiable, legally enforceable claim to cash or other assets. It is recognized to the extent that the collection is probable (i.e., more likely than not) and the amount is measurable (i.e., reasonably estimable).[1]

6. In the case of taxes and duties, inherent and practical limitations on the assessment process serve to delay the time when the power to demand payment becomes a legally enforceable claim to cash or other assets. For this reason, the method of accounting for taxes and duties can best be characterized as a modified cash basis of accounting, rather than an accrual basis. This basis of accounting amends the standard for the recognition of accounts receivable for taxes and duties. Cash basis tax revenue will continue to be accounted for as well, because of the fiscal importance of the information. The accrual accounting required will provide more accurate and complete information about receivables and refunds legally receivable and payable and about the components of the Government's revenue stream. The Board may review the standard for the accrual of taxes and duties after several years. The Board has provided that in the interim the IRS and Customs may on their own initiative modify this standard so that it reflects a fuller application of the accrual concept.

7. Budgetary resources are recognized from two perspectives: the proprietary accounting perspective and the budgetary perspective.

[1]As explained in para. 44 of SFFAS Number 1, Accounting for Selected Assets and Liabilities, "more likely than not" means more than a 50 percent chance. "Not probable" means the converse, i.e., less than a 50 percent chance.

From the proprietary perspective, appropriations are accounted for as a financing source when used. Appropriations are used when an entity has acquired goods and services or has provided benefits and grants that are authorized to be paid by an appropriation. The remaining amount of appropriations enacted into law, but not yet recognized as "appropriations used," is treated as capital, i.e., "unexpended appropriations." This treatment parallels the recognition of expended appropriations during budgetary execution.

8. To the extent that other standards require that costs not on the entity's books be imputed to the entity, the standards for other financing sources require recognition of the corresponding imputed financing.

9. Financial statements have not previously presented budget execution information needed by users of those reports. Furthermore, concerns have been expressed about whether the budget is being properly executed in all cases. The standards presented in this document require the presentation and, consequently, the audit of information about budgetary resources, the status of those resources, and outlays. The standards also require a reconciliation of proprietary and budgetary information in a way that helps users relate the two.

Disclosures, Supplementary Information, And Other Information

10. The different types of revenue, and the complexity of accounting for revenue and other financing sources, increases the importance of certain disclosures and other information.

11. Extensive disclosures and other information about taxes and duties compensate to some extent for the limited accruals under the modified cash basis of accounting. Such disclosures and other information also provide a better basis for estimating future cash flows, overseeing the custodial responsibilities given to the tax collecting entities, and understanding how the tax burden is shared.

12. Certain disclosures are required about exchange transactions where the full cost of goods and services sold is not recovered.

13. Limited disclosure concerning accountability for dedicated collections is required of reporting entities responsible for administering such funds. Supplementary information is required from those entities and the entities that make the collections in cases where trust funds may be over- or under-funded in terms of applicable law.

14. Disclosures are required about the use of borrowing authority and the status of budgetary resources that may affect future spending by the entity.

Concepts For Reconciling Budgetary And Financial Accounting

15. This statement amends Statement of Federal Financial Accounting Concepts No. 2, Entity and Display, by adding a category of financial information to further satisfy users' needs and the objectives of financial reporting. More specifically, the amendment is designed to meet users' need to understand "how information on the use of budgetary resources relates to information on the cost of program operations ..." (sub-objective 1C). The objective of this new category of information is to provide an explanation of the differences between budgetary and financial (proprietary) accounting. This is accomplished by means of a reconciliation of budgetary obligations and nonbudgetary resources available to the reporting entity with its net cost of operations.

Part I: Accounting For Revenue And Other Financing Sources

Introduction

Background

16. The essential differences among exchange revenues, nonexchange revenues, and other financing sources affect the way they are recognized and measured under the accrual method of accounting. Properly classifying these inflows according to their nature, therefore, provides the basis for applying different accrual accounting principles. In addition, proper classification is essential to constructing financial statements that meet the federal financial reporting objectives,[2] as

[2]Statement of Federal Financial Accounting Concepts No. 1, Objectives of Federal Financial Reporting.

they have been described in Statement of Federal Financial Accounting Concepts No. 2, Entity and Display.

17. To help meet those objectives, classifications were developed to determine what specific kinds of revenue should be deducted from the cost of providing goods and services by the reporting entities. Only revenue classified as exchange revenue should be matched with costs. Nonexchange revenue and other financing sources are not matched with costs because they are not earned in the operations process. Because they are inflows that finance operations, nonexchange revenues and other financing sources should be classified in accordance with other rules and should be recognized only in determining the overall financial results of operations for the period. This differs from the focus used in the private sector, where the focus is on net income for business organizations, and on changes in net assets for not-for-profit organizations. It is also a different focus from that used previously in reporting on U.S. Government operations. Under the old federal accounting standards, the focus was on matching all of an entity's financing with incurred expenses to report "net results of operations" which generally was not useful in evaluating performance. The new focus is on costs —both gross and net—which are useful in evaluating performance on many levels.

18. The concept of matching costs and revenue has little relevance in government except where there is an exchange transaction. An exchange transaction occurs when one party sacrifices value and receives a valuable good or service in return. The operations of an entity engaged in exchange transactions produce the revenue earned as well as the associated cost incurred. Therefore, financial accounting should relate the revenue to the cost for these transactions. The net effect—the gross cost minus the revenue, or the net cost—generally determines the extent to which taxpayers bear the cost of the operations.[3]

19. Information about the net cost of exchange transactions serves other purposes as well. Net cost gives one indication of the extent to which

[3]The only major exception is for intragovernmental sales of goods and services. The extent to which taxpayers bear the costs of these goods and services depends on whether the goods and services are sold to entities that in turn sell goods and services to the public, or to entities that are financed by taxes. The net cost of operations may also be financed by other nonexchange revenue such as fines, forfeitures, and donations.

people are willing to make voluntary payments to acquire goods or services of the kinds that are sold. It thus can give an indication of the extent to which people judge the products to have value. Net cost also can be used in evaluating an entity's pricing policy.

20. Most importantly of all, both net cost and gross cost can be compared with outputs and outcomes in assessing the effectiveness and efficiency with which resources are used to achieve results. Such comparisons can be used by agency management, the President, and the Congress in making decisions about allocating resources. These standards, together with those in SFFAS No. 4, Managerial Cost Accounting Concepts and Standards, provide information essential to effective implementation of the Government Management Reform Act, which requires agencies to report performance measures such as unit cost. These standards, when applied in the context of applicable entity and display concepts, will make federal financial reporting more meaningful to those concerned with performance measurement.

21. Nonexchange revenue transactions do not require a Government entity to give value directly in exchange for the inflow of resources. The Government does not "earn" the nonexchange revenue. The cost that nonexchange revenue finances falls on those who pay the taxes and make the other nonexchange payments to the Government. The different character of nonexchange revenues requires that they be distinguished from exchange revenues. They should, therefore, be shown in a way that does not obscure the entity's net cost of operations.

22. Although Board Members have differing views on whether social insurance programs result in exchange or nonexchange transactions, they agree that social insurance tax revenues should be shown in the same way as other tax revenues for the purposes of financial reporting.[4] Social insurance taxes, like other taxes, are determined by the Government's power to compel payment. Individuals and businesses that pay social insurance taxes are subject to them as a byproduct of their decision to enter covered employment or engage in a covered business. Especially for the major, broad-based social insurance programs— Social Security, Medicare (hospital insurance),

[4]See discussion of social insurance programs in FASAB's Exposure Draft, Supplementary Stewardship Reporting.

and unemployment compensation—the individuals and businesses have virtually no option except to pay.

23. The main sources of financing for the Government as a whole are exchange and nonexchange revenues and borrowing from the public. For component reporting entities, however, the sources of financing are provided through the budget and are largely financing sources other than revenue. Appropriations and other budget authority provide an agency with the authority to incur obligations to acquire goods and services or to provide benefits and grants. These other financing sources are not earned by an entity's operations. Therefore, as with nonexchange revenue, they should be accounted for in a way that does not obscure the entity's net cost.

24. Budgetary resources have a different character than both exchange revenue and nonexchange revenue. Budgetary inflows should be shown in a way that reflects two different perspectives: the proprietary effect and the budgetary effect. Proprietary accounting treats these resources much as capital and lines of credit are treated in private sector accounting, and provides information about their availability in the Balance Sheet or in notes. Appropriations are recognized as capital when enacted into law, while borrowing authority is disclosed in notes. Because Government entities are expected to expend capital from appropriations rather than maintain it, the accounting for the use of appropriations differs in this respect from the private sector's accounting for capital. The accounting for "appropriations used" has been simplified and parallels their budgetary effect.

25. The budget provides the principal basis for planning and controlling obligations and expenditures by Government entities. Budget execution tracks the flow of budgetary resources from the congressional authorizing and appropriating process, to the apportionment, allotment, and obligation of the budgetary resources, to the outlay of cash to satisfy those obligations. For the most part, obligations and cash, rather than accrual accounting, are the bases for budgeting and reporting on budget execution.

26. Those who prepare financial statements have recognized that accrual accounting and the budget are complementary. Accrual-basis accounting often provides better information than cash-basis accounting for evaluating performance. It can provide more

information for planning and control of operations. Accrual accounting provides an understanding of a reporting entity's net position and cost of operations. U.S. Government financial statements have not been used for planning and control as well as they might have been. In part, this is because accounting standards have not been fully attuned to the Government's needs and circumstances. Another important reason is the continuing primacy of the budget as a financial planning and control tool. General purpose financial reports have not presented budget execution information with the financial statements in a way that helped users relate these two important, but different, types of financial information. The standards presented in this document provide the basis for reports that can deal with this problem.

Accounting Standards

Scope

30. These standards determine how a Government reporting entity should account for inflows of resources from revenue and other financing sources in its general purpose financial reports. Revenue is an inflow of resources that the Government demands, earns, or receives by donation. Revenue comes from two sources: exchange transactions and nonexchange transactions. Exchange revenues arise when a Government entity provides goods and services to the public or to another Government entity for a price. Another term for "exchange revenue" is "earned revenue." Nonexchange revenues arise primarily from exercise of the Government's power to demand payments from the public, such as taxes, duties, fines, and penalties. Nonexchange revenue also includes donations.

31. The term "revenue" does not encompass all financing sources of Government reporting entities, such as most of the appropriations they receive. These other sources of financing do, however, provide resource inflows to Government reporting entities, although not to the Government as a whole. Accordingly, standards for accounting for these inflows are also provided.

32. Appendix B, "Guidance for the Classification of Transactions," provides authoritative guidance on which transactions should be classified as exchange transactions and which should be classified as nonexchange transactions or other financing sources.

Exchange Revenue

33. Exchange revenue and gains are inflows of resources to a Government entity that the entity has earned. They arise from exchange transactions, which occur when each party to the transaction sacrifices value and receives value in return. That is, exchange revenue arises when a Government entity provides something of value to the public or another Government entity at a price.

RECOGNITION AND MEASUREMENT OF EXCHANGE REVENUE

34. Revenue from exchange transactions should be recognized when goods or services are provided to the public or another Government entity at a price.

35. When a transaction with the public or another Government entity at a price is unusual or nonrecurring, a gain or loss should be recognized rather than revenue or expense so as to differentiate such transactions.

36. Revenue from specific types of exchange transactions should be recognized as follows:

    (a) When services are provided to the public or another Government entity (except for specific services produced to order under a contract), revenue should be recognized when the services are performed.

    (b) When specific goods are made to order under a contract (either short- or long-term), or specific services are produced to order under a contract (either short- or long-term), revenue should be recognized in proportion to estimated total cost when goods and services are acquired to fulfill the contract. If a loss is probable (more likely than not), revenue should continue to be recognized in proportion to the estimated total cost and costs should continue to be recognized when goods and services are acquired to fulfill the contract. Thus, the loss should be recognized in proportion to total cost over the life of the contract.[5]

[5]This standard is an exception to the general principle of SFFAS No. 5, Accounting for Liabilities of the Federal Government, which, but for this exception, would require a loss on a contract to be recognized at the time when expected costs exceeded expected revenue. However, the expected loss must be disclosed: see the disclosure requirement in paragraph (d) below.

(c) When goods are kept in inventory so that they are available to customers when ordered, revenue should be recognized when the goods are delivered to the customer.

(d) When services are rendered continuously over time or the right to use an asset extends continuously over time, such as the use of borrowed money or the rental of space in a building, the revenue should be recognized in proportion to the passage of time or the use of the asset. The interest received on money borrowed in an intragovernmental transaction is an exchange revenue when the source of the borrowed funds is predominantly exchange revenue and is a nonexchange revenue when the source of the borrowed funds is predominantly nonexchange revenue or other financing sources.

(e) When an asset other than inventory is sold, any gain (or loss) should be recognized when the asset is delivered to the purchaser.

37. When advance fees or payments are received, such as for large-scale, long-term projects, revenue should not be recognized until costs are incurred from providing the goods and services (regardless of whether the fee or payment is refundable). An increase in cash and an increase in liabilities, such as "unearned revenue," should be recorded when the cash is received. "Unearned revenue" should also be recorded if an agency requests advances or progress payments prior to the receipt of cash and records the amount.[6]

38. The measurement basis for revenue from exchange transactions should be the actual price that is received or receivable under the established pricing arrangements.

39. When cash has not yet been received at the time revenue is recognized, a receivable should be recorded. An appropriate allowance for estimated bad debts should be established.

40. To the extent that realization of the full amount of revenue is not probable due to credit losses (caused by the failure of the debtor to

[6]SFFAS No. 1, para. 41, provides that such request should be recorded if a claim to cash is established based on legal provisions, such as a payment due date.

pay the established or negotiated price), an expense should be recognized and the allowance for bad debts increased if the bad debts can be reasonably estimated.[7] The amount of the bad debt expense should be separately shown.

41. To the extent that realization of the full amount of revenue is not probable due to returns, allowances, price redeterminations, or other reasons apart from credit losses, the revenue that is recognized should be reduced by separate provisions if the amounts can be reasonably estimated. The amounts of such provisions should be reflected as revenue adjustments, rather than costs of operations, and should be separately shown.

42. The recognition and measurement of revenue and credit losses due to direct loans and loan guarantees is determined by SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees. Appropriate allowances should be established as determined by those standards.

43. Exchange revenue should be recognized in determining the net cost of operations of the reporting entity during the period. The exchange revenue should be recognized regardless of whether the entity retains the revenue for its own use or transfers it to other entities. Gross and net cost should be calculated as appropriate to determine the costs of outputs and the total net cost of operations of the reporting entity. The components of the net cost calculation should separately include the gross cost of providing goods or services that earned exchange revenue, less the exchange revenue earned, and the resulting difference. The components of net cost should also include separately the gross cost of providing goods, services, benefit payments, or grants that did not earn exchange revenue.

44. The net amount of gains (or losses) should be subtracted from (or added to) gross cost to determine net cost in the same manner as exchange revenue is subtracted. Exchange revenue that is immaterial or cannot be associated with particular outputs should be deducted separately in calculating the net cost of the program, suborganization, or reporting entity as a whole as appropriate. Nonexchange revenues

[7]SFFAS No. 1, Accounting for Selected Assets and Liabilities, paragraphs 40-52, is the standard for estimating bad debts. The standard is further explained in SFFAS No. 1's Basis for Conclusions, paragraphs 116-133.

and other financing sources should not be deducted from the gross cost in determining the net cost of operations for the reporting entity.

45. Under exceptional circumstances, such as rents and royalties on the Outer Continental Shelf, an entity recognizes virtually no costs (either during the current period or during past periods) in connection with earning revenue that it collects.

45.1 The collecting entity should not offset its gross costs by such exchange revenue in determining its net cost of operations. If such exchange revenue is retained by the entity, it should be recognized as a financing source in determining the entity's operating results. If, instead, such revenue is collected on behalf of other entities (including the U.S. Government as a whole), the entity that collects the revenue should account for that revenue as a custodial activity, i.e., an amount collected for others.

45.2 If the collecting entity transfers the exchange revenue to other entities, similar recognition by other entities is appropriate.

a. If the other entities to which the revenue is transferred also recognize virtually no costs in connection with the Government earning the revenue, the amounts transferred to them should not offset their gross cost in determining their net cost of operations but rather should be recognized as a financing source in determining their operating results.

b. If the other entities to which the revenue is transferred do recognize costs in connection with the Government earning the revenue, the amounts transferred to them should offset their gross cost in determining their net cost of operations.

45.3 Because the revenue is exchange revenue regardless of whether related costs are recognized, it should be recognized and measured under the exchange revenue standards.

DISCLOSURES AND OTHER ACCOMPANYING INFORMATION

46. Each reporting entity that provides goods or services to the public or another Government entity should disclose the following:

(a) differences in pricing policy from the full cost or market pricing guidance for exchange transactions with the public as set forth in OMB Circular No. A-25, User Charges (July 8, 1993), or in subsequent amendments in circulars that set forth pricing guidance;

(b) exchange transactions with the public in which prices are set by law or executive order and are not based on full cost or on market price;[8]

(c) the nature of intragovernmental exchange transactions in which the entity provides goods or services at a price less than the full cost or does not charge a price at all, with explanations of the amount and reason for disparities between the billing (if any) and the full cost; and

(d) the full amount of the expected loss when specific goods are made to order under a contract, or specific services are produced to order under a contract, and a loss on the contract is probable (more likely than not) and measurable (reasonably estimable).

47. When making the disclosures called for by (a) and (b) in paragraph 46, cautionary language should be added to the effect that higher prices based on full cost or market price might reduce the quantity of goods or services demanded and, therefore, the difference between revenue received and such higher prices does not necessarily provide an indication of revenue foregone. If a reasonable estimate is practicable to make, the entity should provide as other accompanying information the amount of revenue foregone and should explain whether, and to what extent, the quantity demanded was assumed to change as a result of a change in price.

Nonexchange Revenue

RECOGNITION AND MEASUREMENT OF NONEXCHANGE REVENUE

The General Standard

48. Nonexchange revenues are inflows of resources that the Government demands or receives by donation. Such revenue should be recognized

[8]The pricing guidance in OMB Circular No. A-25 does not apply to prices set by law or executive order.

when a specifically identifiable, legally enforceable claim to resources arises, to the extent that collection is probable (more likely than not) and the amount is reasonably estimable. Nonexchange revenue should be **measured** by the collecting entities, but should be **recognized** by the entities legally entitled to the revenue (the recipient entities). Paragraphs 49 through 63 describe the application of this general standard.

Taxes and Duties

49. **Revenue measured by the collecting entities.** Taxes and duties also should be measured on the cash basis, and the cash basis amount(s) should be shown in conjunction with the accrual amounts recognized. The source and disposition of revenue from taxes, duties (which are a type of tax), and related fines, penalties and interest should be measured by the collecting entities in a manner that enables reporting of (1) cash collections, refunds, and the "accrual adjustment" necessary to determine the total revenue and (2) cash or cash equivalents transferred to each of the recipient entities and the revenue amounts to be recognized by each of them. The collecting entities function in a custodial capacity with respect to revenue transferred or transferable to the recipient entities. The collecting entities should not recognize such revenue, but should account for and report upon the above mentioned custodial activities. The entities that collect taxes and duties may change the general standard (para. 48) to accrue amounts now required to be presented as supplementary information (paragraphs 67.1 and 67.2) and make other changes that would result in a fuller and more complete application of accrual accounting.

50. **Cash collections** should be based on amounts actually received during the fiscal period, including withholdings, estimated payments, final payments, and collections of receivables. Cash collections include any amounts paid in advance of due dates unless they are deposits.

51. **Cash refunds** should be based on repayments of taxes and duties during the period. Refunds include refund offsets and drawbacks. Refund offsets are amounts withheld from refunds on behalf of other agencies and paid to such agencies. Drawbacks are refunds of duties paid on imported goods that are subsequently exported or destroyed.

52. **The "accrual adjustment,"** which modifies the net of cash collections and refunds to determine the amount of revenue recognized, should be the net increase or decrease during the reporting period in net revenue-related assets and liabilities. The net revenue-related assets and liabilities include accounts receivable, the allowance for uncollectible accounts, and amounts payable for refunds. Recognition standards for these accounts of the collecting entities are described in paragraphs 53 to 57.

53. **Accounts receivable** should be recognized when a collecting entity establishes a specifically identifiable, legally enforceable claim to cash or other assets through its established assessment processes to the extent the amount is measurable. This definition of accounts receivable from nonexchange transactions requires the standard for recognition of accounts receivable to be amended so that such receivables are not recognized on the basis of payment due dates but rather on the basis of the completion of the assessment processes.[9] Under such processes, assessments are enforceable claims for which specific amounts due have been determined and the person(s) or entities from whom the tax or duty is due have been identified. Assessments include both self-assessments made by persons filing tax returns or entry documents and assessments made by the collecting entities.

54. Assessments recognized as accounts receivable include tax returns filed by the taxpayer (or customs documents filed by the importer) without sufficient payments, taxpayer agreements to assessments at the conclusion of an audit or to a substitute for a return (or importer agreements to supplemental assessments), court actions determining an assessment, and taxpayer (or importer) agreements to pay through an installment agreement or through accepted offers in compromise. Receivables determined to be currently not collectable are included, but assessments where there is no future collection potential such as where the taxpayer (or importer) has been either insolvent or deceased for specified periods are not included. Accounts receivable,

[9]SFFAS No. 1, Accounting for Selected Assets and Liabilities, para. 41, states that "a receivable should be recognized . . . based on legal provisions, such as a payment due date (e.g., taxes not received by the date they are due) . . ." Under the revenue standard, past due taxes are not recognized on the date they are due, but rather on the date when tax returns are received without sufficient payment or legally enforceable claims against non-compliant taxpayers are established through enforcement processes.

therefore, include only unpaid assessments made through the end of the period plus related fines, penalties, and interest. Accounts receivable do not include amounts received or due with tax returns received after the close of the reporting period or amounts that are compliance assessments[10] or pre-assessment work in process.

55. **Compliance assessments and pre-assessment work in process.** Compliance assessments and pre-assessment work in process may or may not be legally assessed depending on the resolution of subsequent events.

A. **Compliance assessments** are proposed assessments by the collecting entity in definitive amounts, but the taxpayer (or importer) still has the right to disagree or object, such as in the case of assessments made at the conclusion of an audit (or at the conclusion of a review by an import specialist or when a violation of applicable law is discovered), or the issuance by IRS of a substitute for a return, or where assessment is in appeals or in the tax court. These compliance assessments may become accounts receivable if the taxpayer files an amended return (or Customs' protest/retention period lapses), or an appeal or court action finally determines the assessment, or the taxpayer (importer) agrees to pay currently or through an installment agreement, or an offer in compromise is accepted.

B. **Pre-assessment work in process** is assessments not yet officially asserted by the collecting entity which are subject to a taxpayer's right to conference in response to initial information notices, e.g., revenue agent reports (or are unasserted assessments on merchandise released into commerce for which the importer did not submit an entry summary document or for projected revenues due as a result of Customs' compliance measurement programs). The amount or range of amounts that will ultimately be assessed or the duration of the notice period may be reasonably estimable, but there are no amounts for pre-assessment work in process presently included in the dollar based accounting systems. Estimates of the amount or range of amounts of pre-assessment work in process that may ultimately

[10]Customs refers to "compliance assessments" as protested assessment amounts.

be collectable are not presently sufficiently reliable to be recognized.

56. **Allowance for uncollectible amounts** should be recognized based on an analysis of both individual accounts receivable and groups of accounts receivable, as prescribed by other standards.[11] A provision to increase or decrease the allowance will result in an adjustment of nonexchange revenue, rather than a bad debt expense.

57. **Amounts payable for refunds** (including refund offsets and drawbacks) should be recognized when measurable and legally payable under established processes of the collecting entities. The amounts include those refunds, where returns (or claims for refund) have been filed by the taxpayer and the Government has determined the specific amounts refundable and has identified the payee. Refunds with respect to returns or claims filed as of the end of the reporting period that do not require specific approval before payment are included in accounts payable for refunds.

58. **Other claims for refunds.** Claims filed for which specific administrative actions are required before payments can be made and unasserted claims for refund by taxpayers or importers that may or may not become payable depending upon the resolution of subsequent events.

    A. Claims filed for refunds where required administrative actions are not yet complete as of the close of the reporting period are not recognized. The refunds, however, may be reasonably estimable.

    B. Unasserted claims for refund such as unfiled claims for refunds or drawbacks for which no claim has been filed, are not recognized.[12] These amounts may be reasonably estimable, but are not presently included in dollar-based accounting systems.

[11]SFFAS No. 1, Accounting for Selected Assets and Liabilities, para. 44 to 51, provides the basis for determining this allowance.

[12]Future income taxes from corporations may be reduced by more than $100 billion dollars as a result of net operating loss carryforwards and tax credit carryforwards. Information in returns filed by corporations and in their financial statements appears to provide the basis for a reasonable estimate of the amount of potential reduced future income tax revenue attributable to these provisions of tax law. Information about net operating loss carryforwards is not an unasserted claim, as defined here.

59. **Deposits**. Amounts voluntarily paid to the reporting entities as deposits, such as those made to stop the accrual of interest or those made pending settlements and judgments, are separately recognized as deposit liabilities.

60. **Revenue recognized by the recipient entities** should equal the sum of (a) cash or cash equivalents transferred to them by collecting entities and (b) the net change in any related inter-entity balances between the collecting and receiving entities (i.e., the amount to be transferred to the recipient entities from the collecting entity or vice versa). Equivalents are normally special Treasury securities issued by the Treasury Department acting in conjunction with the collecting entities. Inter-entity balances of amounts to be transferred normally should be recognized when (1) a legally enforceable claim exists between a collecting entity and a recipient entity for the transfer or repayment of taxes or duties, and (2) payment of such claim is probable and measurable. Inter-entity balances typically represent estimated settlements of transfers made during the period and revenue received by the collecting entity at year end but not yet transferred. Revenue should be recognized as a financing source in calculating the results of operations and not as a deduction in determining net cost of operations. Principles for the application of this standard to major groups of recipient entities are described in paragraphs 60.1 through 60.4.

60.1 **Trust funds legally entitled to excise taxes collected**. Certain trust funds are legally entitled to receive only excise taxes that are actually collected by the collecting entity. However, transfers to such trust funds currently are based on assessed excise taxes, because data on the components of cash collections by type of tax are not currently obtained from taxpayers. This standard affirms that revenues may be recognized on the basis of assessed excise taxes in lieu of excise taxes actually collected.

60.2 **Trust funds legally entitled to receive Social Security taxes accrued.** By law, the trust funds are to receive Social Security taxes on the basis of the earnings of participants and the applicable tax rates. Social Security taxes accrued are presently determined by the assessment processes of the Internal Revenue Service (IRS). Non-compliance by taxpayers may result in such amounts being less than taxes based on actual earnings of participants. Amounts for individual participants are separately reported to the Social Security

Administration (SSA), but because of employer reporting deficiencies these amounts are currently even less than amounts determined by the IRS. SSA is legally entitled to retain the higher amounts actually transferred by the IRS. This standard affirms that revenue should be recognized on the basis of the best available information, i.e., on the basis of the higher of the amount determined by the IRS assessment process or the individual participant amounts based on reports to SSA of participants' earnings, subject to any later adjustments necessary to bring the amounts transferred to the trust funds up to the amount of taxes due based on the actual earnings history of the participants.

60.3 **Collecting entities entitled to retain revenue.** When legally retained by the collecting entity as a reimbursement of the cost of collection, revenue should be recognized as an exchange revenue and deducted in determining the collecting entity's net cost of operations.

60.4 **General Fund.** The General Fund recognizes all nonexchange revenue not recognized by trust funds and other recipient entities. Interest on delinquent taxes should be recognized as exchange revenue. The General Fund should recognize in succeeding periods revenue adjustments for any recognized revenue that is determined after the books are closed for the period to have been properly transferable (or improperly transferred) to other recipient entities.

Fines and Penalties

61. Fines and penalties are monetary requirements imposed on those who violate laws or administrative rules. They may be imposed by the entities collecting taxes and duties, or by other government entities. The time when a claim to resources arises will depend on the nature of the fine and the associated legal and administrative processes. Some examples of conditions that, depending on the circumstances, could establish a legally enforceable and measurable claim include (1) the date by which an individual may contest a court summons expires, (2) the offender pays the fine before a court date, or (3) the court imposes the fine. An allowance for uncollectible accounts should, as in the case of taxes and duties, be recognized as a revenue adjustment and determined in accordance with other standards.[13] The allowance

[13]SFFAS No. 1, para. 44-51.

should reduce the gross amount of the receivable and revenue to its net realizable value, based on the criterion that losses should be recognized to the extent it is probable (more likely than not) that some or all of the receivables will not be totally collected.

Donations

62. Donations are contributions to the government, i.e., voluntary gifts of resources to a government entity by a nonfederal entity. Donations may be financial resources, such as cash or securities, or nonfinancial resources such as land or buildings. Revenue arising from donations should be recognized for those inflows of resources which meet recognition criteria for assets[14] and should be measured at the estimated fair value of the contribution.

Other Nonexchange Revenue

63. The various types of nonexchange revenue are described in Appendix B: Guidance for the Classification of Transactions. Some of these are not specifically mentioned in this standard. They should be recognized and measured in accordance with the general rule (see para. 48) except where other Board standards apply.

DISCLOSURES, SUPPLEMENTARY INFORMATION, AND OTHER ACCOMPANYING INFORMATION

Disclosures

64. **Basis of Accounting**. Collecting entities should disclose the basis of accounting when the application of the general rule of paragraph 48 results in a modified cash basis of accounting. The disclosure should point out the specific potential accruals which are not made as a result of this practice and the practical and inherent limitations affecting the accrual of taxes and duties. The disclosure should refer to the related other required disclosures and to the supplementary information and should mention that other accompanying information also provides related information. If a collecting entity adopts accounting standards that embody a fuller application of accrual accounting concepts, as

[14]For the recognition criteria for donated property, plant and equipment, see SFFAS No. 6, Accounting for Property, Plant, and Equipment, para. 30, 62, and 71.

permitted in paragraph 49, then the disclosure should describe that change in accounting and point out how it differs from that prescribed by this standard.

65. Entities that collect taxes and duties should disclose the following relating to future cash flows, revenue-related transactions, and custodial responsibilities:

65.1 **Accounts receivable.** Factors affecting collectability and timing of categories of accounts receivable and the amounts involved.

65.2 [Rescinded by SFFAS 20.]

65.3 **Cumulative cash collections and refunds by tax year and type of tax.** Cash collections and refunds by tax year and type of tax should include cash collections and cash refunds for the reporting period and for sufficient prior periods to illustrate (1) the historical timing of tax collections and refunds, and (2) any material trends in collection and refund patterns. Sufficient prior periods for each type of tax are the periods which end when the statutory period for collection ends. Collecting entities may shorten these periods if evidence for prior tax years indicates that a shorter period would reflect at least 99 percent of the collectible taxes.

66. If trust fund revenues are not recorded in accordance with applicable law, both the collecting and recipient entities should disclose the reasons.

Supplementary Information

67. Entities that collect taxes and duties should provide the following supplementary information relating to their potential revenue and custodial responsibilities:

67.1 The estimated realizable value, as of the end of the reporting period, of compliance assessments and, if reasonably estimable, pre-assessment work in process. The amounts furnished should represent management's best estimate of additional revenues likely to be collected from compliance assessments and from pre-assessment work in process, appropriately qualified as to their reliability. A range of amounts may be provided for pre-assessment work in process if estimable. The change in the total(s) of compliance assessments and

of pre-assessment work in process during the reporting period also should be provided.

67.2 If reasonably estimable, other claims for refunds that are not yet accrued but are likely to be paid when administrative actions are completed. If estimated, unasserted claims for refunds should be provided separately from claims filed and may be expressed as a range of amounts. The amounts furnished should represent management's best estimates, appropriately qualified as to their reliability. The change in the total of these amounts during the reporting period also should be provided.

67.3 The amount of assessments that the entity still has statutory authority to collect at the end of the period, but that have been written off and thus excluded from accounts receivable.

67.4 If reasonably estimable, the amounts by which trust funds may be over- or under-funded in comparison with the requirements of law.

68. Recipient entities that are trust funds should provide the same information as required for collecting entities in para. 67.4.

Other Accompanying Information

69. The following guidance for other accompanying information is intended to provide flexibility to enable preparers to present the most relevant information with respect to these topics, considering the needs and interests of users and the availability of data.

69.1 **A perspective on the income tax burden.** The IRS should provide a perspective on the income tax burden. This could take the form of a summary of the latest available information on the income tax and on related income, deductions, exemptions, and credits for individuals by income level and for corporations by size of assets. The objective is to show the tax burden borne by different classes of individuals and corporations and how that burden is affected by the tax rates, deductions, credits, etc., provided by the tax laws.

69.2 **Available information on the size of the tax gap.** Collecting entities should provide any relevant estimates of the annual tax gap that become available as a result of federal government

surveys or studies. The tax gap is defined as taxes or duties due from non-compliant taxpayers or importers. Amounts reported should be specifically defined, e.g., whether the tax gap includes or excludes estimates of taxes due on illegally earned revenue. Appropriate explanations of the limited reliability of the estimates also should be provided. Cross references should be made to portions of the tax gap due from identified non-compliant taxpayers which are shown as supplementary information, i.e., compliance assessments and pre-assessment work in process (para. 67.1).

69.3 **Tax expenditures related to entity programs.** Information on tax expenditures that a reporting entity considers relevant to the performance of its programs may be presented, but should be qualified and explained appropriately to help the reader assess the possible impact of specific tax expenditures on the success of the related programs.

69.4 **Directed flows of resources related to entity programs.** Information on directed flows of resources related to an entity's programs may be presented, but if this information is presented the estimated amounts should be accompanied by a description of the basis for the estimates and appropriate cautionary language about their reliability. Information should also be appropriately qualified and explained to help the reader assess the possible impact on the success of the programs.

Other Financing Sources

70. Financing sources, other than exchange and nonexchange revenues, that provide inflows of resources that increase results of operations during the reporting period include appropriations used, transfers of assets from other Government entities, and financing imputed with respect to any cost subsidies.[15] Financing outflows may result from transfers of the reporting entity's assets to other Government entities or from exchange revenues earned by the entity but required to be transferred to the General Fund or another Government entity. Unexpended appropriations are recognized separately in determining net position but are not financing sources until used.

[15]Other accounting standards will determine the criteria for the imputation of costs and how those costs shall be measured. This standard provides guidance for accounting for the corresponding financing source that is reported in such cases.

RECOGNITION AND MEASUREMENT OF OTHER FINANCING SOURCES

Appropriations

71. **Unexpended Appropriations.** Appropriations, until used, are not a financing source. They should be recognized in capital as "unexpended appropriations" (and among assets as "funds with Treasury") when made available for apportionment, even if a Treasury Warrant has not yet been received, or the amount has not been fully apportioned. Unexpended appropriations should be reduced for appropriations used and adjusted for other changes in budgetary resources, such as rescissions and transfers. The net increase or decrease in unexpended appropriations for the period should be recognized as a change in net position of the entity.

72. **Appropriations Used.** When used, appropriations should be recognized as a financing source in determining net results of operations.[16] Appropriations are used in operations when goods and services are received or benefits and grants are provided. Goods and services (including amounts capitalized) are considered received when a liability is established. Benefits are considered to be provided when the related liability is established. Grants are considered to be provided when grantees meet the requirements that allow them to use the grants.[17]

Financing Imputed for Cost Subsidies

73. Government entities often receive goods and services from other Government entities without reimbursing the providing entity for all the related costs. In addition, Government entities often incur costs, such as for pensions, that are paid in total or in part by other entities. These constitute subsidized costs to be recognized by the receiving entity to the extent required by other accounting standards. An imputed financing source should be recognized equal to the imputed

[16]As is explained in the Basis for Conclusions, in the private sector, the term "net results of operations" is synonymous with net income and net income is the "bottom line" measure of performance for profit-seeking businesses. For most Government reporting entities, on the other hand, this is not the "bottom line" for performance measurement. See para. 224 and following.

[17]FASAB plans to undertake a project on accounting for grants.

cost. This offsets any effect of imputed cost on net results of operations for the period.

Transfers of Assets

74. An intragovernmental transfer of cash or of another capitalized asset without reimbursement changes the resources available to both the receiving entity and the transferring entity. The receiving entity should recognize a transfer-in as an additional financing source in its result of operations for the period. Similarly, the transferring entity should recognize the transfer-out as a decrease in its result of operations. The value recorded should be the transferring entity's book value of the asset. If the receiving entity does not know the book value, the asset should be recorded at its estimated fair value as of the date of transfer.

75. To the extent that a Government entity's exchange revenue that is included in calculating net cost of operations is required to be transferred to the Treasury or another Government entity, the amount should be recognized as a transfer-out in determining the net result of operations.[18]

[18]These transfers are distinguished from custodial transfers in that transfers involve assets that have been earned or in use by the entity in carrying out its programs whereas custodial transfers involve funds that have been collected on behalf of another entity. Accounting for custodial transfers is described in the section covering nonexchange revenue.

PRIOR PERIOD ADJUSTMENTS

76. Prior period adjustments should be limited to corrections of errors and accounting changes with retroactive effect, including those occasioned by the adoption of new federal financial accounting standards, and should be recognized and measured under applicable standards. Adjustments should be recognized as a change in cumulative results of operations (rather than as an element of net results of operations for the period). Prior period financial statements should not be restated for prior period adjustments recognized in the current period.

BUDGETARY INFORMATION

77. The budget is the primary financial planning and control tool of the government. For this reason, and because of the importance of this information to users of federal financial information, the following material budgetary information should be presented by reporting entities whose financing comes wholly or partially from the budget:

(a) total budgetary resources available to the reporting entity during the period;

(b) the status of those resources (including "obligations incurred");

(c) outlays.

78. Recognition and measurement of budgetary resources should be based on budget concepts and definitions contained in OMB Circulars A-11 and A-34. In addition, the reporting entity should provide this information for each of its major budget accounts as supplementary information. Small budget accounts may be aggregated.

79. The following information about the status of budgetary resources should be disclosed.

(a) the amount of budgetary resources obligated for undelivered orders at the end of the period;

(b) available borrowing and contract authority at the end of the period;

(c) repayment requirements, financing sources for repayment, and other terms of borrowing authority used;

(d) material adjustments during the reporting period to budgetary resources available at the beginning of the year and an explanation thereof;

(e) existence, purpose, and availability of permanent indefinite appropriations;

(f) information about legal arrangements affecting the use of unobligated balances of budget authority such as time limits, purpose, and obligation limitations;

(g) explanations of any material differences between the information required by paragraph 77 and the amounts described as "actual" in the Budget of the United States Government;

(h) the amount, and an explanation that includes identification of balance sheet components, when recognized unfunded liabilities do not equal the total financing sources yet to be provided; and

(i) the amount of any capital infusion received during the reporting period.

80. Budgetary and financial accounting information are complementary, but both the types of information and the timing of their recognition are different, causing differences in the basis of accounting. To better understand these differences, a reconciliation should explain the relationship between budgetary resources obligated by the entity during the period and the net cost of operations. It should reference the reported "obligations incurred" and related adjustments as defined by OMB Circular A-34. It also should include other financing sources not included in "obligations incurred" such as imputed financing, transfers of assets, and donations of assets not included in budget receipts. [Text deleted by SFFAS No. 22] The total of these items comprises obligations and nonbudgetary resources.

81. This total should then be adjusted by:

    (a) Resources that do not fund net cost of operations (e.g., changes in undelivered orders, appropriations received to pay for prior period costs, capitalized assets),

    (b) Costs included in net cost of operations that do not require resources (e.g., depreciation and amortization expenses of assets previously capitalized), and

    (c) Financing sources yet to be provided (those becoming available in future periods which will be used to finance costs recognized in determining net cost for the present reporting period).

82. The adjustments should be presented and explained in appropriate detail and in a manner that best clarifies the relationship between the obligations basis used in the budget and the accrual basis used in financial (proprietary) accounting.

ACCOUNTABILITY FOR DEDICATED COLLECTIONS

83. A reporting entity may be responsible for funds financed with dedicated collections that are held for later use to accomplish the fund's purpose. Some of these are held in a fiduciary capacity. Special accountability is required for the sake of the taxpayers or other contributors who make payments to the fund with the expectation that the collections will be used for the purposes for which they were dedicated, and for the sake of those who expect to benefit from the fund's future expenditures. Such funds include all funds within the budget classified as trust funds, those funds within the budget that are classified as "special funds" but that are similar in nature to trust funds, and those funds within the Federal universe (inside or outside the budget) that are fiduciary in nature. Management should, therefore, identify those special funds that are similar in nature to trust funds and those funds inside and outside the budget that are fiduciary in nature. Identification of funds that are similar in nature to trust funds is a judgmental matter; management is best qualified to make this judgment.

84. Separate financial information about these dedicated collections should be provided if they are material either to the reporting entity or to the beneficiary or contributors. The separate information may be

reported on the face of the entity's general purpose financial statements, or the information may be disclosed in the notes to the financial statements. When not material to the reporting entity, this information may be provided separately in special reports to the contributors and beneficiaries (or their representatives) rather than separately in the reporting entity's general purpose financial statements or notes thereto.

85. The following information, at a minimum, should be reported for individual funds that account for dedicated collections.

    (a) A description of each fund's purpose, how the administrative entity accounts for and reports the fund, and its authority to use those collections.

    (b) The sources of revenue or other financing for the period and an explanation of the extent to which they are inflows of resources to the Government or the result of intragovernmental flows.

    (c) Condensed information about assets and liabilities showing investments in Treasury securities, other assets, liabilities due and payable to beneficiaries, other liabilities, and fund balance.

    (d) Condensed information on net cost and changes to fund balance showing revenues by type (exchange/nonexchange), program expenses, other expenses, other financing sources, and other changes in fund balance.

    (e) Any revenues, other financing sources, or costs attributable to the fund under accounting standards, but not legally allowable as credits or charges to the fund.

    When the above information is provided separately in special reports, as described in paragraph , the financial information required in (c) and (d) above should be combined for all such funds and the information described as "amounts for immaterial funds not presented separately in this general purpose report."

86. The law may require the accounting for a fund to be done in a particular way. The disclosures called for by item (e) are required if the fund's recognition requirements, as determined by law, are contrary to applicable accounting standards with respect to certain

revenue, other financing sources, or costs. For example, a trust fund may be required to recognize revenue based on cash collected by the Government during the reporting period rather than the accruals due the Government. In the case of some funds, payments from the fund are also subject to legal limitations. Although the accounting used within the fund itself should be in accordance with the applicable legal requirements, the larger reporting entity of which the fund is a component, the administrative entity, or the next higher level of the Government (e.g., a department or the governmentwide entity), should recognize the revenues, other financing sources, or costs associated with but not legally allowable to the fund.[19]

87. Most dedicated collections are included in the financial statements of the entity carrying out the program and responsible for administration of the fund. However, this may not be the case where collections are outside the budget or are not otherwise included in the reporting entity under the concepts of Entity and Display. In either case, the information is required to be disclosed. If more than one reporting entity is responsible for carrying out the program financed with the dedicated collections, then the entity with the largest share of the activity should be responsible for reporting all revenues, other financing sources, assets, liabilities, and costs of the fund.

Part II: Concepts For Reconciling Budgetary And Financial Accounting

Introduction

88. The Statement of Federal Financial Accounting Concepts (SFFAC) No. 2, Entity and Display, was issued to provide conceptual guidance as to what would be encompassed by a federal entity's financial report. It identifies the types of financial information to be communicated to

[19]When information on funds is reported separately and the basis of accounting is not in accordance with applicable accounting standards, the report should state that it is prepared on the basis of legal requirements.

users and suggests the types of information to be included in an entity's report to help meet the objectives of federal financial reporting. Among other things, SFFAC No. 2 supports reporting both budget information and operating performance (i.e., proprietary) information to meet the needs of users and the objectives of reporting. The budget information focuses on the obligation and outlay of financial resources to acquire or provide goods and services as defined by budget concepts. Operating performance information focuses on the cost of resources used as defined by accrual accounting standards.

89. Budgetary and financial accounting information are complementary, but both the types of information and the timing of their recognition is necessarily different because of the difference in focus. To better understand the differences and make better use of the complementary information provided, information needs to be provided to reconcile the use of budgetary resources to acquire or provide goods and services with the net cost of using those goods and services. An approach to doing this was explored in the exposure draft, Accounting for Revenue and Other Financing Sources, and received substantial support from respondents. Therefore, Entity and Display is being amended to include in its concepts the need to communicate information about the differences between the use of resources as reported in the budget and in the net cost of operations.

Amendments To SFFAC No. 2, Entity And Display

90. The following heading and two paragraphs (numbered 91 and 92 in this document) are added to the section of SFFAC No. 2 titled "Displaying Financial Information."

Reconciliation Statement—Budgetary And Financial Accounting

91. Subobjective 1C of the budgetary integrity objective states that information is needed to help the reader to determine "how information on the use of budgetary resources relates to information on the costs of program operations and whether information on the status of budgetary resources is consistent with other accounting information on assets and liabilities." This objective arises because accrual-based expense measures used in financial statements differ from the obligation-based measures used in the budgetary reports.

92. To satisfy this objective, information is needed about the differences between budgetary and financial (i.e., proprietary) accounting that arise as a result of the different measures. This could be accomplished

through a **Statement of Financing** that reconciles the budgetary resources obligated for a federal entity's programs and operations to the net cost of operating that entity. The data presented could be for the reporting entity as a whole, for the major suborganization units, for major budget accounts, or for aggregations of budget accounts, rather than for each individual budget account of the entity.

93. The Statement of Financing is added to SFFAC No. 2's suggested list of items included in the section titled "Financial Reporting for an Organizational Entity." In addition, a footnote (referenced to the Statement of Financing) shall be added stating:

> OMB will provide guidance regarding details of the display for the Statement of Financing, including whether it shall be presented as a basic financial statement or as a schedule in the notes to the basic financial statements.

94. The following heading and paragraphs (numbered 95 through 101 in this document) are added to the section of SFFAC No. 2 titled "Recommended Contents for the Recommended Displays."

Statement Of Financing

95. The purpose of the Statement of Financing is to explain how budgetary resources obligated during the period relate to the net cost of operations for that reporting entity. This information should be presented in a way that clarifies the relationship between the obligation basis of budgetary accounting and the accrual basis of financial (i.e., proprietary) accounting. By explaining this relationship through a reconciliation, the statement provides information necessary to understand how the budgetary (and some nonbudgetary) resources finance the cost of operations and affect the assets and liabilities of the reporting entity. The appropriate elements for the Statement of Financing would be as indicated in the following paragraphs. They provide logical groupings of reconciling items that help the reader move from obligations to net cost of operations.

96. **Obligations incurred** are amounts of new orders placed, contracts awarded, services received, and other similar transactions during the period that will require payments during the same or a future period. A deduction is needed for spending authority from offsetting collections and recoveries of prior period obligations.

97. **Nonbudgetary resources** represent the net amount of resources received by the entity that are not included in budgetary resources. These items could include donations of assets, transfers of assets from (to) other federal entities, and financing imputed for cost subsidies. [Text deleted by SFFAS No. 22].

98. **Resources that do not fund net cost of operations** are primarily (a) the change in amount of goods, services, and benefits ordered but not yet received or provided, (b) amounts provided in the current reporting period that fund costs incurred in prior years, and (c) amounts incurred for goods or services that have been capitalized on the balance sheet.

99. **Costs that do not require resources** are most commonly the result of allocating assets to expenses over more than one reporting period (e.g., depreciation) and the write-down of assets (due to revaluations).

100. **Financing sources yet to be provided** are the financing amounts needed in a future period to cover cost incurred in the current period.

101. The bottom line of this reconciliation would be the **net cost of operations**.

102. The following example financial statement format will be added to the appendices of SFFAC No. 2:

Entity and Display, Appendix 1-G

EXAMPLE FINANCIAL STATEMENT FORMATS - STATEMENT OF FINANCING - For the year ended September 30, 19X4

Obligations and Nonbudgetary Resources	
Obligations incurred	$XXX
Spending authority for offsetting collections and other budgetary adjustment	(X)
Donations not in the budget	X
Financing imputed for cost subsidies	X
Transfers-in (out)	X
Other	X
Obligations, as adjusted, and Nonbudgetary Resources	XXX

Resources That Do Not Fund Net Cost of Operations	
Change in amount of goods, services, and benefits ordered but not yet received or provided	(X)
Cost capitalized on the balance sheet	(X)
Financing sources that fund costs of prior periods	(X)
Other	(X)

Costs That Do Not Require Resources	
Depreciation and amortization	X
Revaluation of assets and liabilities	X
Other	X

Financing Sources Yet to be Provided	X

Net Cost of Operations	$XXX

Appendix A: Basis For Conclusions

103. This appendix does not constitute authoritative guidance for those who prepare and audit general purpose federal financial reports. It summarizes important considerations that FASAB members considered as they deliberated on this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

104. FASAB published the exposure draft Accounting for Revenue and Other Financing Sources in July 1995. The exposure draft included 18 specific questions for respondents and invited comments on other topics. The Board received 42 letters of comment from the following sources:

Source	Internal To The U.S. Govt.	External To The U.S. Govt.	Total
Users, Academics & Others[20]	2	7	**9**
Auditors	10	1	**11**
Preparers	22		**22**
Totals	**34**	**8**	**42**

105. FASAB also held a public hearing on the exposure draft on September 20, 1995. One individual (a professor of accounting), representatives of four federal organizations that prepare financial statements, and representatives of one federal audit organization presented comments and discussed the exposure draft with the Board. Most of those who commented orally or in writing supported most of the provisions of the exposure draft. Most responses did suggest widening the proposed disclosures for trust funds to include other funds with similar special accountability for dedicated collections. Also, most respondents suggested retaining the customary business practice of recognizing bad debt expense for credit losses from exchange transactions. The Board made these changes. (See paragraph 128 for details on the change regarding credit losses. See paragraphs 226 and following for details on the change regarding disclosures for trust funds and similar funds). Concurrently with the widening of disclosures about funds, the Board required disclosures and supplementary information about any

[20]This category includes representational organizations, retired federal employees, federal employees responding as individuals, and federal contractors, as well as academics and other users

over- and under-funding of the trust funds (see para. 66, 67.4 and 68). The Board also made other less material changes in the exposure draft as a result of considering the comments it received.

106. As a result of further information received from IRS following the exposure draft, the Board made terminology changes with respect to "pre-assessments," now referred to as "compliance assessments," and "proposed assessments, now called "pre-assessment work in process." More importantly, the Board provided for the possibility that amounts for pre-assessment work in process might not be reasonably estimable (see para. 67.1). As a result of further information from Customs following the exposure draft, the Board added a supplementary information requirement for unasserted claims for refund (see para. 67.2). (These include potential drawbacks that may approximate 20% of Customs reported revenue.)

107. After some deliberation, the Board also concluded that it would permit a fuller application of accrual accounting for taxes and duties than is required by the general rule (see para. 49). This would apply in the interim period between the issuance date of the Statement and any reconsideration of the standard by the Board. Coincident with extending the effective date of the standard for one year beyond that proposed in the exposure draft, and because of the importance of accurate information, the Board decided to require that material revenue-related transactions should be accounted for under a double entry accounting system (rather than estimated) and changed the designation of this information from supplementary to disclosure information ([Text deleted by SFFAS No. 20] see par. 65.3).

108. Finally, the Board recognized that, under certain circumstances, reporting entities may appropriately report information about tax expenditures and directed flows of resources that are related to their programs. However, the standard only permits this information to be presented as other accompanying information if it is properly qualified and explained (see para. 69.3 and 69.4).

Exchange Revenue

Special Nature of Government Exchange Transactions

109. Revenue from exchange transactions plays a different role in Government than in private business. Most Government output is provided to the public directly as the result of political decisions

rather than in exchange for revenue. This is regardless of whether the output is the provision of services, transfer payments to individuals, or grants to state and local governments. Likewise, most of the Government's receipts are collected as a result of exercising its power to compel tax payments rather than earned by providing goods and services to the public at a price.

110. Where Government goods and services are provided in exchange for revenue, prices may be set to cover cost. Sometimes they may be set in the market as they would be set by a business (such as auctioning the right to drill for oil on Government land). However, law or policy sets many prices below the amount that might be obtained in an auction or other market transaction (such as fees for grazing rights). In some of these cases, prices may be set with little or no regard to the related cost (such as fees to visit national parks).

111. Exchange transactions also occur between entities within the Government, sometimes as stipulated by law and in other cases by mutual agreement. These exchange transactions, also, are often not conducted at fair market prices. Services are often provided to a program free, such as the litigation the Department of Justice does for the Internal Revenue Service. Another common example is a central computer used without charge by several programs within an agency. Where charges are imposed, the internal sales price or reimbursement is not necessarily based on the full cost of providing the goods or services or on competitive market equivalents.

112. Some exchange transactions within the Government are carried out by intragovernmental revolving funds. In many instances, these funds have been established with the goal of recovering their full cost by selling their output. This would allow them to be self-sustaining from their sales, including the maintenance of their capital, without the need for additional appropriations. Goods and services must be priced at full cost to achieve this goal, but full cost is not always charged. As a result, revolving funds have often failed to be self-sustaining and have required extra appropriations.[21]

[21]Even revolving funds that are self-financing do not recover full cost from their customers if they are not charged for all of their own costs, such as pension and retirement health benefits for their employees.

Recognition: General Considerations

113. **Matching revenue with cost**. It is often said that private sector accounting matches expense with revenue to measure the net income of the business. This provides a measure of effort compared with accomplishment that cannot be used for most government activities. Most government activity either provides collective goods and service (such as national defense and justice) or redistributes income and wealth (as in benefit payments and grants). Therefore, the Government's output—its goods, services, transfers, and grants—is usually not provided in exchange for voluntary payments. In such cases, directly measuring the value that the Government's activity adds to society's welfare is difficult.

114. The Objectives of Federal Financial Reporting focuses on cost in relationship to accomplishment as the main objective in reporting an entity's operating performance. This is because of the fundamental importance of cost information. It is important to program managers in operating their activities efficiently and effectively. It is equally important to Executive and Congressional decision makers in making resource allocations. Subobjectives 2A and 2B declare that:

> Federal financial reporting should provide information that helps the reader to determine ...the costs of providing specific programs and activities and the components of, and changes in, these costs... [and] the efforts and accomplishments associated with federal programs and the changes over time and in relation to costs.[22]

115. The Board's explanation of the operating performance objective defines more exactly what this means:

> ...expenses can be matched against the provision of services year by year. The resulting cost can then be analyzed in relationship to a variety of measures of the achievement of results.[23]

116. SFFAS 4, Managerial Cost Accounting Concepts and Standards, discusses the need for Government accounting to emphasize cost as a way to improve decision making and program management. It says that good cost information can be used for: (1) budgeting and cost

[22]SFFAC No. 1, Objectives of Federal Financial Reporting, paragraphs 126 and 128.

[23]Ibid., para. 124. For more extended discussion, see ibid., chapter 8. As explained there, difficulties arise in practice for many reasons, e.g., the specific measures that are appropriate and feasible will vary from program to program, outcomes are influenced by external factors as well as actions of government, focusing attention on selected measures can have unintended—and sometimes undesired—consequences, etc.

control, (2) performance measurement, (3) determining reimbursements and setting fees, (4) program evaluations, and (5) economic choice decisions (such as whether to contract-out a project).[24]

117. To meet these goals, cost must be matched with the provision of goods and services to the public or other Government entities. To determine the net cost of an exchange activity—i.e., the part of the cost that is not offset by revenue earned from the goods and services provided—the related revenue must be matched with the cost.

118. Matching revenue with cost in a uniform manner is essential in evaluating agency performance and setting price. Cost and revenue must pertain to the same output in order to estimate the extent to which the revenue covers the cost. Therefore, costs should be matched against the provision of goods and services with revenue matched against those costs and thus with revenue also matched against the same provision of goods and services. When this is done, the gross and net cost of an entity can be compared with the related outputs and outcomes to evaluate its operating performance, pricing policy, and economic decisions. Similarly, when this is done, the net cost to the taxpayer can be estimated for the entity's related outputs provided to the public.

119. The standards in this Statement therefore use the accrual basis for recognizing exchange revenue and provide for matching exchange revenue against related cost as closely as practicable. The standards specify how the matching is to be achieved for different types of transactions.

120. **Assigning revenue to the costs of earning it**. Determining the net cost of producing outputs, providing programs, or carrying out missions will often be more important than determining the net cost for the reporting entity as a whole. A reporting entity may have several missions carried out by different suborganizations, all of them having component programs and outputs. For each of these, both gross and net cost are important in evaluating performance and managing cost. Furthermore, either an entity as a whole or its suborganizations and

[24]SFFAS No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, para. 31-40.

programs may have material costs that are not incurred to earn revenue, as well as material costs that are incurred for that purpose. Therefore, the revenue-earning and nonrevenue-earning components need to be separately evaluated in order to assess the net cost of particular activities. Additionally, various components may earn revenue but cover costs to different degrees.

121. In all these cases, the net cost of the reporting entity as a whole does not show the extent to which earned revenue covers the cost of providing a particular output. This can only be calculated for the entity's components. Determining the net cost for components is therefore essential to achieve the goals of the standards in this Statement: to match exchange revenue with the gross cost of outputs and to offset exchange revenue against that related gross cost.

122. To be most useful, therefore, the gross costs and net cost of operations should be calculated by suborganization, program, or output. Suborganizations are generally equivalent to responsibility segments as defined by the standards on managerial cost accounting.[25] Each responsibility segment must be able to assign full costs to the measurable outputs of its programs.[26] As a result, users of general purpose federal financial reports will be able to relate the net costs of a program to program outputs and outcomes.

123. Preparers should decide the exact classification of suborganizations and programs based on the nature of the entity, the missions and outputs for its GPRA strategic and annual performance plans, the concepts in Entity and Display, Federal accounting standards, and OMB's bulletin prescribing the form and content of agency financial statements. Exchange revenue should be assigned to the costs of outputs unless it is not reasonably possible to do so. If that cannot be done, exchange revenue should be assigned to the costs of programs, or, if that also is not reasonably possible, to the costs of suborganizations. Assigning exchange revenue to the components of an entity in this way is more effective for performance evaluation,

[25]See ibid., para. 77-88. Also see SFFAC No. 2, Entity and Display, para. 75 and footnote 14.

[26]SFFAS No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, para. 89-104 and 116-143.

price setting, and other purposes than assigning it to the reporting entity as a whole.

124. The gross cost, the exchange revenue, and the difference or net cost should be determined for each such component. The net cost and gross cost for each component could be used for such purposes as comparison with the outputs and outcomes of that component in order to assess the efficiency and effectiveness with which resources were used to achieve results.[27]

125. Good information on gross cost and net cost, determined and analyzed in this manner, is essential to the success of the Government Performance and Results Act of 1993 (GPRA)[28] in relating costs to accomplishments. GPRA requires agencies to set performance goals for program activity and establish performance indicators to measure outputs and outcomes of the program activity. Performance measurement under GPRA is to begin in FY 1999, and pilot projects started in FY 1994. Under the OMB plan to carry out GPRA, performance reports will show the results of what was actually accomplished (outputs and outcomes) with the resources used. The net cost of operations (as well as gross cost) should be a fundamental measure of these resources.

126. **Uncollectible amounts**. When realization of the full amount of recognized revenue is not probable, the standards require that a separate provision be made if the uncollectible amount can be reasonably estimated. The Board defines "probable" as "more likely than not." This definition, and measurability, are the criteria for recognizing losses due to uncollectible amounts of accounts receivable under Federal accounting standards.[29]

127. Government entities have an extraordinary responsibility to be accountable—to the President, the Congress, and the public. Because of this, it is appropriate to show separately (1) the full revenue due

[27]As noted previously, the specific measures of program economy, efficiency, and effectiveness that are feasible and appropriate will vary among programs.

[28]Public Law 103-62.

[29]SFFAS No. 1, Accounting for Selected Assets and Liabilities, paragraphs 44-45 and 124-30.

under their established pricing arrangements, and (2) the amount of this revenue that they estimate will not be realized.

128. The Exposure Draft proposed that the entire provision for estimated uncollectible amounts be recognized as a revenue adjustment. It reasoned that, if some of the potential revenue is not likely to be received, this should be viewed as the failure to realize revenue or the absence of an inflow of resources. Some of the respondents also viewed the entire uncollectible amount as a shortfall in revenue, but a majority believed that credit losses were a cost of doing business. Businesses extend credit in order to finance their customers, and any losses in this line of activity are another kind of expense. Such treatment is required for direct loans and loan guarantees that follow the credit reform accounting standards of SFFAS No. 2. A particularly telling argument, made by some, was that credit losses should be a component of full cost when establishing prices for the sale of goods and services. This would be facilitated by recognizing credit losses as a bad debt expense rather than a revenue adjustment. For these reasons, the Board concluded that credit losses should be recognized as an expense.

129. Uncollectible amounts due to other reasons— such as returns, allowances, and price redeterminations—would, however, be recognized as revenue adjustments. This treatment is parallel with the treatment in this Statement of taxes and other nonexchange revenue, where refunds, adjustments, and abatements are deducted from gross revenue rather than recognized as an expense. Under current practice and private sector standards, these uncollectible amounts are commonly treated as revenue adjustments but are not always separately disclosed.

130. The bad debt expense and the revenue adjustment each needs to be separately shown in order for the entity to be accountable for the different reasons why revenue is not collectible.

131. The allowance for bad debts should be based on an analysis of both individual accounts and groups of accounts, as appropriate under the circumstances. This principle is explained in the standard for accounts receivable.[30] For intragovernmental transactions, allowances for bad

[30]Ibid., para. 44-51 and 131-133.

debts may not always be needed, because full payment can often be assumed.

Recognition: Special Cases

132. The general principles underlying exchange revenue recognition are supplemented for special cases.

133. **Gains and losses.** Gains and losses are recognized rather than revenues and expenses in order to differentiate unusual or nonrecurring transactions for evaluating an entity's performance or setting its prices. Material gains and losses are expected to be infrequent. They would normally be of a type that management would want to be considered in appraisals of its operations.

134. **Direct loans and loan guarantees**. Standards for direct loans and loan guarantees were established in SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees. The basic principle is to recognize the subsidy cost of the direct loan or loan guarantee as an expense when the loan is made. Subsidy cost is inherently a net concept: the present value of estimated cash outflows less the present value of estimated cash inflows over the life of the loan. This requires that the present value of estimated fees be recognized as a deduction in calculating subsidy cost, and that the present value of estimated defaults be included in calculating the subsidy cost. The standards for direct loans and loan guarantees that follow credit reform accounting thus differ from the standards in the present Statement in three respects: revenue is deducted in calculating the subsidy cost, bad debts are included in calculating the subsidy cost, and both revenue and bad debts are measured as present values.

135. Determining the subsidy cost in this way is a method of matching revenue with cost, and it is also a method of matching the subsidy cost with the provision of the subsidy to the public. SFFAS No. 2 is therefore consistent with the objectives of this Statement for exchange revenue, and the standards in this Statement do not apply to the recognition and measurement of revenue and credit losses for direct loans and loan guarantees that follow credit reform accounting. This exception includes pre-1992 direct loans and loan guarantees that have been restated on a present value basis. The guidance for classifying transactions in Appendix B reflects the provisions of SFFAS No. 2.

136. **Exchange revenue collected for others**. Many entities that collect exchange revenue keep that revenue for their own use. Revolving funds keep the revenue they earn. By their nature, they are expected to finance at least a material part of their cost by selling goods and services in a continuing cycle of business-type activity. Other collecting entities may also keep the revenue they earn. Sometimes, however, the exchange revenue is transferred to the General Fund or to other entities in whole or in part. For example, the Southeastern and Southwestern Power Administrations transfer the revenue they collect from the public to the General Fund of the Treasury; similarly the Western Area Power Administration, while retaining some of the revenue that it collects, transfers the rest to the General Fund and various special funds designated by law.

137. As a general rule, exchange revenue transferred to others must be offset against the collecting entity's gross cost to determine its net cost of operations. Exchange revenue reduces the net cost of operations incurred by the entity in producing outputs, regardless of whether the entity keeps the exchange revenue for its own use or transfers it to another operating entity or the General Fund. Likewise, exchange revenue reduces the net cost of the entity's operations to the taxpayer regardless of its disposition. Therefore, all exchange revenue related to the cost of operations must be deducted from gross cost to determine the net cost of operations for the entity.

138. Any exchange revenue that is transferred to others, however, does not affect the collecting entity's net position. Therefore, as required by the standards for other financing sources, such exchange revenue is recognized as a transfer-out in calculating the entity's operating results.

139. The only exception to the general rule occurs when the entity recognizes virtually no cost in earning the exchange revenue, as explained in the following section.

140. **Exchange revenue unrelated to recognized cost.** In exceptional cases, an entity may recognize virtually no costs in connection with earning exchange revenue that it collects. A major example for many years has been the Minerals Management Service (MMS) of the Department of the Interior. It manages energy and other mineral resources on the Outer Continental Shelf (OCS) and collects rents, royalties, and bonuses due the Government and Indian tribes from

minerals produced on the OCS and other Federal and Indian lands. The rents, royalties, and bonuses are exchange revenues, earned by sales in the market. If the value of natural resources were recognized as an asset by MMS, then depletion could be recognized as a cost according to the units of production method as minerals were extracted.[31] The revenue from rents, royalties, and bonuses could then be matched against MMS's gross cost, including depletion and minor other costs, to determine its net cost of operations.

141. MMS does not recognize a depletion cost for various reasons, including the fact that under present accounting standards the value of natural resources is not recognized as an asset. As a result, this exchange revenue cannot be matched against the economic cost of operations and bears little relationship to the recognized cost of MMS. Therefore, it should not be subtracted from MMS's gross cost in determining its net cost of operations. If it were subtracted, the relationship between MMS's net cost of operations and its measures of performance would be distorted. The net cost of operations of the Department of the Interior would likewise be distorted.

142. MMS collects this revenue acting as an agent for the recipients designated by law: the Treasury, certain entities within the Government to which amounts are earmarked, the states, and Indian tribes and allottees. Therefore, MMS should account for the exchange revenue as a custodial activity, which is an amount collected for others, in the same way as the Internal Revenue Service accounts for the nonexchange revenue that it collects. Because the revenue collected by MMS is exchange revenue, it should be recognized and measured under the exchange revenue standards when the rents, royalties, and bonuses are due pursuant to the contractual agreements.

143. The rents, royalties, and bonuses transferred to Treasury for the General Fund or to other Government reporting entities should be recognized similarly by these recipient entities. The revenue is exchange revenue and should be recognized and measured under the exchange revenue standards. However, neither the Government as a

[31]Methods of calculating depletion based on the economic cost of extraction, such as represented here, should be distinguished from depletion methods allowed under the Internal Revenue Code.

whole nor the other recipient entities recognize the natural resources as an asset and depletion as a cost. Therefore, the revenue should not offset the cost of operations for the U.S. Government as a whole or for these entities. As in the case of MMS, offsetting cost by this revenue would distort the relationship between the net cost of operations and the measures of the performance of these entities. The exchange revenue should instead be a financing source in determining the operating results and change in net position.

144. The Board is addressing the accounting for natural resources in a separate project. If it concludes that the value of mineral rights should be recognized as an asset and depletion as a cost, it would be appropriate to recognize the exchange revenue from rents, royalties, and bonuses in determining the net cost of operations.

145. Although MMS is the most prominent case of an entity collecting exchange revenue for which it recognizes virtually no cost, there can be other instances. The Federal Communications Commission collects exchange revenue from the auction of the radio spectrum. Such revenue should be accounted for in the same way as the revenue collected by MMS.

146. One respondent to the Exposure Draft asked about the meaning of the term "virtually no costs." If an entity sells scrap metal or fully depreciated equipment, the exchange revenue or gain is not related to any cost that is recognized at the time of sale. These assets are recorded on the balance sheet as having no value at the time of sale, so the gross proceeds from the sale are not offset by any remaining book value in calculating the entity's gain. However, unlike the auctions of petroleum rights or the radio spectrum, costs were recognized in past periods for the purchase of the materials or the use of the equipment. Therefore, offsetting the entity's cost by its gains from sale provides a more accurate measure of its net cost of operations over time for comparison with measures of its performance over time. The standard has been clarified to say that the term "virtually no costs" means that virtually no costs are recognized during past periods as well as during the current period.

147. It is also possible that an entity's cost accounting may not assign any costs to byproducts of its major goods or services. However, cost is recognized for the activities that produced both the major products and the byproducts. All revenue earned in connection with these

activities needs to be offset against the cost of these activities in determining the entity's net cost for the purpose of making comparisons with its measures of performance.

148. **Specific goods (or services) made to order compared with goods made for inventory**. When an entity produces goods for sale, revenue can be matched with cost in either of two ways: (1) revenue and expense can be recognized as costs are incurred, or (2) the expenditures can be recorded in inventory, with the revenue and expense recognized subsequently when the goods are delivered to the customer.

149. For specific goods made to order under a contract (or specific services produced to order), the standard requires that revenue be recognized as goods and services are acquired to fulfill the contract. More precisely, the standard requires that revenue, as determined by the contract price, be recognized in proportion to the estimated total cost as goods and services are acquired to fulfill the contract. This means that the percentage-of-completion method must be used and the amounts of revenue must be calculated based on the costs of the goods and services acquired to date to fulfill the contract in relationship to the estimated total cost under the contract. If the time period and estimated total cost are uncertain, revenue recognition should be deferred until a firm basis can be established to assign cost. Goods and services made (or produced) to order include such projects as building construction and ship repair, where costs are incurred over a period of time to provide a particular good or service to a specific customer according to characteristics determined by contract. They do not include the sale of standard services, such as electricity, under a contract.

150. Recognizing revenue and cost in this way provides an up-to-date measure of the entity's operations in providing goods and services. The revenue and cost are generated by the entity's activities during the current reporting period, unlike alternative recognition standards. In particular, this is unlike the completed contract method, under which the revenue and cost recognized in a period may have been generated substantially during previous periods. Because the revenue and cost recognized in the reporting period are up-to-date, they can more readily be compared with each other and with current outputs in evaluating the entity's performance and pricing policy in that period.

151. In some instances, however, there may be no material difference between the percentage-of-completion method and the completed contract method. This is especially likely for small or short-term contracts. In such instances, the completed contract method could be followed.

152. The standard also requires that when a loss on a contract is probable (more likely than not) and measurable (reasonably estimable), it should be recognized over the life of the contract in proportion to the estimated total cost instead of immediately. This will come about by continuing to recognize revenue in proportion to estimated total cost and by continuing to recognize costs as goods and services are acquired to fulfill the contract. This requirement is an exception to SFFAS No. 5, Accounting for Liabilities of the Federal Government, under which a loss on a contract is recognized at the time when expected costs exceed expected revenue. The Board believes this exception is appropriate, because it provides a more accurate measure of the entity's net cost of operations during each reporting period than if the entire estimated loss were recognized in the single period when it was concluded that the loss was probable and measurable. The entire estimated loss, however, would be disclosed.

153. The standard is different when an entity produces goods to be kept "on the shelf" until ordered. It requires that manufacturing costs be charged to inventory and that revenue not be recognized until the goods are delivered to the customer. Costs and revenue are recognized later than when goods and services are made to order, because there is less assurance of revenue at the time when the costs are incurred. The term "delivery to the customer" includes instances in which the sale has taken place and the goods have been segregated or set aside for delivery.

154. **Classification of interest on intragovernmental balances**. Large amounts of interest are paid and received on intragovernmental balances. Most trust funds and some special funds and revolving funds have invested in special Treasury securities on which they earn interest due from the Treasury. Treasury and the Federal Financing Bank have made loans to a number of funds, on which those funds incur interest expense and on which interest is due to the Treasury or the Bank. The recorded interest revenue should be classified as exchange or nonexchange depending on the predominant source of funds upon which the interest payment is based. Other

intragovernmental balances bear no interest. The Board is considering a project that might result in imputing interest where the balances bear no interest or the interest does not reflect the cost of borrowing by the Treasury.

155. The interest on these intragovernmental liabilities has the form of an exchange transaction, but often it does not also have the substance of an exchange. The standards in this Statement and the guidance in Appendix B, "Guidance on the Classification of Transactions," differentiate among inflows of resources according to whether or not they should be deducted from an entity's gross cost in determining its net cost of operations. This differentiation depends fundamentally on whether the inflow of resources is related to costs that the entity incurs and recognizes in order to produce outputs and the inflow of resources.

156. When applied to the receipt of interest by a Government account from the Treasury, this criterion implies that interest should be classified in the same way as the predominant source of revenue to the fund: as exchange revenue, if the predominant source is exchange revenue; and as nonexchange revenue, if the predominant source is nonexchange revenue. If the invested funds come from exchange revenue, the interest on these funds derives from exchange revenue and the costs incurred to earn that revenue; if the invested funds come from nonexchange revenue, the interest on these funds is based ultimately on the government's power to compel payment rather than on a market transaction. With certain exceptions, this means that interest received by trust funds and special funds should be classified as nonexchange revenue, whereas interest received by revolving funds and trust revolving funds should be classified as exchange revenue. This is explained below, together with the exceptions and certain analogous transactions.

157. Invested balances of trust funds (and special funds) predominantly derive from earmarked taxes, which are nonexchange transactions with the public (e.g., employment taxes and gasoline taxes). To a lesser extent they derive from other financing sources (e.g., the General Fund payment appropriated to the Supplementary Medical Insurance fund). The balances are not earned in exchange transactions by the entity's operations. Most fundamentally, they are not produced by operations in which the entity incurs any costs. Therefore, the interest on Treasury securities should not be deducted

from the gross costs of the trust fund (or special fund) in determining its net cost of operations. As a result, that interest should not be classified as an exchange revenue. It should instead have the same classification as the predominant source of the invested balances, which for most trust funds (and special funds) is nonexchange revenue.

158. The invested balances of revolving funds, on the other hand, predominantly derive from the funds' business-type operations. Revolving funds need capital in their operations and may invest some of that capital in Treasury securities. Since the holding of invested balances and the sale of goods and services are both integral to the funds' operations, the interest on their securities is related to the funds' costs of operations just as is the revenue earned from selling goods and services. Furthermore, the source of the invested balances is predominantly revenue previously earned from the sales of goods and services, for which the funds incurred costs of operations when that revenue was earned. The interest they receive should therefore be classified in the same way as their revenue earned from selling goods and services and should likewise be deducted from gross cost in determining the net cost of operations. For this reason, interest earned by revolving funds should be classified as exchange revenue.

159. A few revolving funds are classified by law as trust funds. Trust revolving funds need capital in their operations, just like other revolving funds, the source of which is predominantly the revenue they have earned. When some of their capital is invested in Treasury securities, the interest is related to their cost of operations in the same way as the revenue earned from selling services; and the source is predominantly revenue previously earned from the sales of services, for which they incurred costs of operations. Their interest should therefore be classified in the same way as for other revolving funds, which is exchange revenue.

160. The three previous paragraphs explain the rationale for the normal classification of interest received by trust funds, special funds, revolving funds, and trust revolving funds. However, in some cases, the source of balances for trust funds and special funds may not be predominantly nonexchange revenue, and the source of balances for revolving funds and trust revolving funds may not be predominantly exchange revenue. For example, the main source of balances for two major trust funds, the Civil Service Retirement and Disability Fund

and the Military Retirement Fund, consists of exchange revenue and other financing sources. In such exceptional cases, interest should be classified in the same way as the predominant source of balances rather than according to the normal rule.

161. Agencies may receive authority to borrow from Treasury (or the Federal Financing Bank), and they pay interest on their borrowings. The interest is a cost to the agency and an inflow of resources to the Treasury. The Treasury may be deemed to have borrowed from the public to finance the outlays for which the agency borrowed, and thus to have incurred a corresponding interest cost of its own. The interest received by Treasury from the agency is therefore related to Treasury's cost of borrowing from the public and should be classified as an exchange revenue.

162. When debt securities are retired before maturity, there may be a difference between the reacquisition price and the net carrying value of the extinguished debt. This difference is a gain or loss that should be classified in the same category as the interest on the extinguished debt.

Measurement

163. Exchange transactions with the public ordinarily take place at prices set by the agency or the Congress, such as electricity rates, book prices, and interest on delinquent taxes. Sometimes the market sets the price, as with the rents and royalties from companies that bid to explore and produce oil and gas on the Outer Continental Shelf. In either case the actual prices represent the inflow of resources to the entity and, therefore, are the appropriate basis for measuring revenue.

164. Except for prices set by law, OMB Circular No. A-25 and other regulations generally provide that user charges for transactions with the public should be set at full cost or market price.[32] However,

[32]Circular No. A-25, User Charges, as revised July 8, 1993, establishes Federal policy regarding fees assessed for government services and for the sale or use of government goods or resources. It implements the provisions of Title V of the Independent Offices Appropriations Act of 1952 (31 U.S.C. 9701), which generally calls for "each service or thing of value provided by an agency . . . to a person . . . to be self-sustaining to the extent possible" and says that charges shall be based on a number of specified criteria including "the costs to the Government." The guidance of Circular A-25 also applies to the assessment of user charges under other statutes. However, Circular A-25 is intended to be applied only to the extent permitted by law or executive order; it does not apply to the legislative and judicial branches or to mixed-ownership government corporations; and its requirements are deemed to be met by other OMB circulars that provide guidance concerning a specific user charge area.

compliance with these regulations is partial, and potential revenue is not realized in many cases. To help report users understand how the entity's operations are financed, disclosures are needed about (1) differences in pricing policy from the guidance in OMB's circular on user charges and (2) transactions where prices are set by law or executive order and are not based on full cost or market pricing. Other accompanying information is needed about the revenue foregone in these transactions but only if a reasonable estimate is practicable. The other accompanying information should explain whether, and to what extent, the quantity demanded was assumed to change as a result of the change in price.

165. Circular A-25 defines "full cost" as "all direct and indirect costs to any part of the Federal Government of providing a good, resource, or service."[33] This generic definition and the accompanying examples in the circular are generally consistent with the definition of "full cost" in the managerial cost accounting standards[34] and the recognition and measurement of many particular expenses in other Federal accounting standards.[35] However, unlike those standards, Circular A-25 also includes as part of the definition of full cost an annual rate of return on land, structures, equipment, and other capital resources (unless they are rented);[36] and it includes depreciation not only on structures and equipment that are classified as general PP&E (property, plant, and equipment), which is required by Federal accounting standards, but also on structures and equipment classified as stewardship PP&E, which in a few cases may be used in connection with the production of goods or services for sale.[37] Aside from these differences, the cost accounting and other accounting standards should enable the Circular

[33]Circular A-25, section 6(d)(1).

[34]SFFAS No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, para. 93-107.

[35]For example, the standards for expenses related to credit are stated in SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees; and numerous standards for expense are stated in SFFAS No. 5, Accounting for Liabilities of the Federal Government.

[36]The Board currently has a project to consider whether the rate of return on capital should be recognized as a cost in financial accounting statements.

[37]The extent of differences between Circular A-25 and Federal accounting standards can be found by comparing Circular A-25, section 6(d)(1)(b), with SFFAS No. 6, Accounting for Property, Plant, and Equipment.

A-25 definition of full cost to be measured more accurately than has been possible heretofore.[38]

166. The appropriate basis for measuring revenue from intragovernmental exchange transactions is likewise the actual price (or reimbursement) that the seller receives from the buyer. Accounting systems should be able to provide the information needed to set the reimbursement at full cost, but often the full cost is not charged. In these cases, the amount of the reimbursement is an incomplete measure of the economic value of the transaction. When one entity receives goods or services from another without paying all related costs, the net operating cost of the receiving entity is understated if it does not recognize (by imputation) the additional cost paid by the providing entity.

167. Other Federal financial accounting standards require such inter-entity cost subsidies to be recognized by the receiving entity in certain cases.[39] This Statement, in the section on "Other Financing Sources," provides standards to recognize other financing sources that are imputed to offset whatever subsidy costs those other standards require to be recognized and imputed. Accounting for the imputed cost of goods and services provided by one Government entity to another requires the exercise of judgment, based on the specific circumstances of each case. Therefore, whether costs are imputed or not, the providing entity should disclose an explanation of the amount and reason for material disparities between the billing (if any) and the full cost.

[38]Circular A-25 says that "full cost shall be determined or estimated from the best available records of the agency, and new cost accounting systems need not be established solely for this purpose." See section 6(d)(1)(e). The cost accounting and other standards should improve agency records and specify the nature of costs more precisely and comprehensively.

[39]The general principles for recognizing imputed cost are stated in SFFAS No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, para. 105-115. The accounting is similar to the accounting for employee pensions and retirement health benefits, where the entity administering the plan does not provide goods or services to the reporting entity but does pay some or all of the cost. See SFFAS No. 5, Accounting for Liabilities of the Federal Government, para. 56-93 and 148-181.

Nonexchange Revenue

Inherent Limitations

168. **Inherent limitations on the ability to perform accrual accounting for nonexchange revenue.** Accrual accounting recognizes the financial effects of transactions and events when they occur, whether or not cash changes hands at that time. As it does with respect to exchange revenue, full accrual accounting for nonexchange revenue would enhance financial planning, control, and accountability. Full accrual accounting could provide important data with respect to future cash flows and tax policy and could improve the ability to evaluate the performance of the collecting entities and the exercise of their custodial responsibilities.

169. Unfortunately, the degree of accrual accounting that is practicable to perform for taxes and duties is limited by difficulties in ascertaining the amount of revenue arising from the underlying events and by the assessment processes used to manage the collecting functions. Taxpayers may not ascertain taxable income until after the underlying events. They may not file returns on their due dates, and due dates are generally set by the administrative processes after the occurrence of the underlying event. Also, the extent of non-compliance is a function of the laws establishing these entities and the expectations by the Congress and the Administration about how diligently the collecting entities should perform their collection functions. These inherent limitations on the ability to perform accrual accounting were considered by the Board.

Practical Limitations

170. **Practical limitations were also considered by the Board.** The Board's standards for accrual accounting require that accruals mirror the established assessment processes of the collecting entities. As such, they do not require, for example, the accrual of taxes or duties which are likely to be assessed under established processes, but only those that are actually assessed under the defined processes of the collecting entities. Having accounting mirror the established process by which collecting entities interact with taxpayers has value, though arguably accounting for revenue should not be so limited.

171. At the time the Board began deliberations on this standard, accounting systems necessary to determine even the limited revenue accruals that are now required for taxes did not exist. The changes in systems required by this standard are limited to those necessary to mirror the

established assessment processes. The Board understands that the Internal Revenue Service is attempting to improve its collection function and the related management information systems. Because such systems must also provide accounting information, the Board decided not to impose accounting standards at this time that might conflict with systems changes needed to improve the efficiency and effectiveness of the collection process or go beyond the minimum changes considered necessary to enable the collecting entities to properly discharge their responsibilities.

Modified Cash Basis for Taxes and Duties

172. As a result of both the inherent limitations and the practical limitations accepted by the Board, the accrual standard, as it applies to taxes and duties, might be best characterized as a "modified cash" basis of accounting. These limitations on full accrual accounting required the amendment of the accounting standard on recognition of receivables as provided in paragraph 41 of SFFAS No. 1, which said, in effect, that taxes should be recognized as receivables when they are due from taxpayers.

173. In the future, the general standard for accrual as it applies to taxes and duties could be tightened to produce a fuller application of the accrual concept. For fines, penalties and donations, no accountable event precedes the recognition point established by this standard. Therefore, the general standard for recognition as it applies to these sources of revenue results in full accrual accounting for them.

Cash Basis Information Needed

174. Cash basis information on taxes and duties continues to be very important because it is widely used for planning purposes at present and is a component of the budget. It is also available soon after the close of the reporting period and is needed to comply with laws that require cash-basis accounting in particular instances. Unfortunately, accurate cash-basis information to meet certain legal requirements and other information needs is not presently available. This standard accepts the importance of both types of information and requires entities that collect taxes and duties to provide both types of information.

Potential Changes

175. Requirements for disclosures, supplementary information, and other accompanying information compensate to some extent for the modified cash basis of accounting for taxes and duties being approved at this time. In the future, the Board plans to evaluate users'

satisfaction with reports prepared on the basis of the standard and to give consideration to improvements being made in IRS processes and related management information systems. Based on this evaluation and consideration, it may propose to extend the degree of application of accrual accounting in several years time. In the interim, the Board will permit changes in accounting made at the initiative of a collecting entity if the changes represent a fuller application of accrual accounting than that prescribed by the standard. For example, compliance assessments for taxes or unasserted claims for drawbacks may be recognized rather than shown as supplementary information if the amounts are both probable and reasonably estimable.

Entities Responsible for Measuring and Recognizing Revenue

176. Collecting entities, e.g., the Internal Revenue Service and the Customs Service, collect cash and administer the assessment processes that provide the basis for adjusting those collections to an accrual basis. They, therefore, have measurement and reporting responsibilities for these inflows of resources. They also, at the direction of the Treasury Department, account for the disposition of these inflows to recipient entities. The Treasury determines the amounts payable to the recipient entities and, in conjunction with the collecting entities, makes the actual cash payments, or issues special Treasury securities, as necessary, to fund the amounts transferred. Because the recipient entities are designated by law to receive the inflows and make ultimate disposition of the funds, they, rather than the collecting entities, must recognize the inflows as revenues in order to provide financial statements which are meaningful to users.

Possible Over- and Under-funding of Trust Funds

177. The standard provides that trust funds should recognize the amounts transferred (and the change during the period of the amounts to be transferred) from the collecting entity as revenue despite the fact that those transfers may not be made on the basis of applicable law. In the case of excise taxes, transferring more than the amounts actually collected may cause these trust funds to be over-funded. The Board is advised by its legal counsel that this is a violation of law by the IRS. Such violations cannot be remedied unless, and until, the IRS adopts methods to collect the needed data from taxpayers. In the case of Social Security, weaknesses in the data collection methods may cause these trust funds to be under-funded. The Board is advised by its legal counsel that so long as IRS and SSA act on the basis of the best available information there is no violation of law. In considering these two situations, the Board concluded that it should not set an accounting standard with which the recipient entities could not

comply and, therefore, accepted the present basis of making transfers to them as the basis of recognition of revenue by them. However, the Board believes that both the collecting entity and the recipient entity have the responsibility to disclose any violation of law and to provide, as supplementary information, if estimable, amounts by which the trust funds may be over- or under-funded.

Conceptual Criteria for Accrual and Limitations on Their Application

178. As mentioned earlier, this standard recognizes both inherent and certain practical limitations on the application of the accrual concept to taxes and duties. The conceptual criteria for full accrual accounting for taxes and duties are the underlying taxable events, a precondition for the government to assert a demand for payment, and a demand date itself. A demand date conceivably could be as early as a date contemporaneous with the underlying events.

179. **The underlying taxable events.** Conceptually, certain Government taxes and duties could be accrued based on particular events, and certain others on events that take place over a period. Excise taxes and customs duties are examples of taxes based on particular events (sales or importing goods). Individual and corporation income taxes are examples of taxes based on events that take place over a period (e.g., income earned over the course of a year). Indeed, some taxpayers who prepare accrual-basis financial statements for themselves normally accrue taxes due to the government based on the underlying events.

180. Data about underlying events is supplied to collecting entities through returns required to be filed by taxpayers. Unfortunately, non-compliance with return requirements is estimated to account for more than $100 billion annually in uncollected taxes. Only a relatively small portion of this amount is ultimately collected through the enforcement processes of the collecting entities. Estimates of this tax gap made from time-to-time have provided some information to guide enforcement efforts with respect to particular groups of tax payers, but do not provide sufficient information to establish claims against individual non-compliant taxpayers or defined groups of non-compliant taxpayers. Therefore, the underlying-event criterion for recognition can only be applied to the extent that taxpayers file tax

returns[40] or the collecting entities determine through their enforcement processes that specific non-compliant taxpayers owe or might owe taxes.

181. **The demand date.** To obtain taxes and duties, the government must demand the payment. The criterion for revenue recognition under this concept could be that the demand date for taxes and duties is the same as the date the underlying taxable event occurs or over the period that the underlying taxable event occurs, e.g., as taxable income is earned by the taxpayer. However, demand dates presently defined by established assessment processes are the dates payments are required to be received by the collecting entities. They include dates for withholding and estimated tax payment as well as the final due dates for tax returns. These dates provide administrative convenience for taxpayers and generally lag the underlying events. Because of the emphasis on cash, those payments made in advance of due dates for payment are not deferred for accounting purposes. Past-due taxes as a result of taxpayer failure to comply with established payment dates are not accrued until the collecting entities receive late tax returns from such taxpayers, or until the collecting entities determine through their enforcement processes that the Government has a legally enforceable claim. Only then are accounting accruals triggered under this standard. Those dates lag the underlying events by more than necessary to determine an accrual. The aforementioned limitations on the application of the demand criterion, which are arguably practical ones, further constrain the conceptual basis for accrual.

Limitations on the Scope of Accounting

182. Although relevant to the cost of the Government from an economic perspective, to Government fiscal policies, and to performance evaluation of Government reporting entities, the Board concluded not to require information on "tax expenditures" or expenditures that federal laws require others to make, i.e., "directed flows of resources." There were a variety of opinions among Board members on the need for this information and different reasons given for not requiring some form of disclosure, but all Board members agreed that relevant

[40]Even if all taxpayers filed returns, the underlying event criterion for most taxpayers is their income for the calendar year, whereas the government's fiscal year ends September 30. Presently required estimated tax payments do not eliminate the problem of measuring taxes based on an "artificial" nine months period ending September 30 for calendar year taxpayers whose income for the following three month "stub" period ending December 31 could be disproportionate.

amounts are not normally measured under present accounting concepts. However, information may be provided under certain circumstances, but outside the financial statements themselves.

Some Benefits of this Standard

183. **Some of the benefits of the accrual requirements of this standard:**

- Reporting the "accrual adjustment" as a separately identified adjustment of taxes and duties collected. This preserves needed cash-basis information.
- Improving the data for both accrual- and cash-basis information. The standard accomplishes this because all transactions for which accounting could be performed under the standard will need to be processed. Some of these have not been accounted for in past financial reports because of delays in processing transactions at the end of the year.
- Accrual of assessments. Accounts receivable would be accrued based on returns filed or enforcement actions taken through the end of the period where such returns or actions have not yet resulted in cash receipts. A statistical estimate of the effect of this standard, as of September 30, 1993, disclosed approximately $29 billion of net accounts receivable after deducting an allowance for uncollectible amounts of $42 billion. Heretofore, net accounts receivable were thought to be in excess of $100 billion. The accounting requirements for accrual should further improve the accuracy of the amount of accounts receivable.
- Recognition of refunds payable will provide some indication of the lag in making refunds to taxpayers.

Some Things this Standard Does Not Accomplish

184. **Some of the things this standard does not accomplish:**

- Recognizing events after the close of the reporting period, such as cash received on later due dates, even if the receipt results from the underlying taxable events of the period. For example, unemployment taxes for the September 30 quarter are due in October and will be recognized in October if received on the October due date.
- Deferring recognition of revenue for tax payments that may be received before the demand or underlying event. For example, voluntary over-withholding by taxpayers will be treated as revenue.

- Recognizing compliance assessments and pre-assessment work in process or refunds before completion of the assessment processes. As a result, variations in the speed and effectiveness of the assessment processes will affect the amount accrued at the end of a fiscal period. Another result is that accounting information relative to measurement of the performance of the compliance functions by the collecting entities will not be available.
- Recognizing the tax gap, i.e., taxes (which include duties) due from unidentified non-compliant taxpayers and importers. As a result, this large potential source of revenue will not receive as much attention as it would if it could be made a formal part of the collecting entity's accountability.
- Accounting for "tax expenditures," which may contribute to the programs of reporting entities, or "directed flows of resources," which may substitute for program costs which might otherwise need to be incurred by reporting entities. These amounts are very large in relation to the "on budget" program amounts which are measured by accounting. As a result, these materially important performance and cost related data may not be fully considered.

Accounting Systems Changes

185. The IRS accounting system at present does not account for revenue transactions on an accrual basis and, therefore, does not establish accounts receivable, refunds payable, and the allowance for uncollectible accounts on the basis of the flow of all the various events and transactions affecting these balances. Instead of being an accrual accounting system, all assessments are recorded in an operating file not designed to do accounting and not operated under a double entry concept where the revenue effects of assessments are determined. That operating file, for example, includes multiple assessments made for the same tax claim so that the IRS can pursue all potential sources for the payment of that claim. As a result of the present limitations of this operating file, to determine the accounts receivable at any point in time, the IRS must make a statistical projection of a representative sample of valid tax claims. The potential error in the estimates made to date have been material, i.e., in excess of $5 billion.

186. This standard contemplates that systems and accounting records will be put in place to permit the accurate determination and disclosure of all revenue and cash transactions which are reflected in the formal assessment process. By treating information relating to compliance assessments, pre-assessment work in process, and refunds before the

completion of the assessment process as supplementary information, this standard contemplates that statistical estimates, rather than transaction-driven accounting systems and auditable subsidiary accounting records for individual taxpayers, may be used to provide the dollar values for these important revenue-related items.

Disclosures, Supplementary Information, and Other Accompanying Information

187. This additional information will help users of federal financial reports in understanding the following:

187.1 **Components of the revenue stream**. By disclosing the dollar amounts of the material types of transactions reflected in the required "modified cash basis" revenue stream (from initial recognition by the established assessment process through cash collections and refunds), important accountability information for oversight and performance evaluation will be provided about the tax collection function. Providing as much accurate and detailed information as possible about the annual flow of taxpayer funds (now over $1 trillion) is important because the administration of the collection function is to some degree discretionary.[41]

187.2 **Cash flows.** By disclosing cash flows by type of tax and tax year, accurate historical information will be provided about the source and timing of the annual flow. Material trends in collection and refund patterns may be apparent from the comparative financial statements presented and by reference to financial statements of prior periods. Both the ability to accurately forecast future flows and to understand the speed and effectiveness of the collection function should be enhanced by this information. Also, an indication of the degree of potentially correctable "error" from the use of a modified cash basis of accounting should be provided by this cumulative cash flow data.

187.3 **Other future-oriented information**. Disclosures about categories of accounts receivable provide additional information about collection problems and timing of future cash flows. At IRS,

[41]Pursuant to law, Customs establishes legal assessments for fines in amounts which frequently materially exceed the value of the goods, then subsequently abates the fine to a fraction of that value, also in accordance with applicable law. Full disclosure and explanation of practice should aid better understanding of the significance of assessments, abatements, and uncollectible amounts reported by Customs. [Text deleted by SFFAS No. 22.]

different categories of receivables vary considerably in terms of ultimate collectability and timing of collection.

187.4 **Other potentially reportable revenue.** Supplementary information on compliance assessments and pre-assessment work in process and on refunds before the completion of the assessment processes provides indications of the amounts of potentially accruable revenue. If such amounts were ultimately accrued, the "accrual adjustment" on a modified cash basis would be converted to an "accrual adjustment" that came closer to an estimate of the effect of full accrual accounting. Some or all of these potential accounts receivable and payable may become measurable by the collecting entities, and the Board may require their accrual when the collecting entities' management systems are improved.

187.5 **Sharing of the income tax burden.** Other accompanying information about the tax gap and IRS historical information showing income, deductions, and credits by income level (assets for corporations) responds to those concerned with the extent of non-compliance with the laws and how the income tax burden is shared among compliant taxpayers.

187.6 **Administration of the tax laws by the collecting agencies.** Disclosures, supplementary information, and other accompanying information provide a more complete picture of how the collecting agencies are functioning. This information may be relevant to allocation of resources to collecting agencies, to their performance appraisal, and to their oversight.

- Supplementary information on compliance assessments and pre-assessment work in process and on refunds before the completion of the assessment process shows the backlog in processing assessments and refunds.
- The disclosure and supplementary information with respect to over-and under-funding of the trust funds identifies administrative problems to be overcome.
- Disclosure of abatement of assessed taxes with respect to non-compliant taxpayers ($37 billion by the IRS in 1993) provides some information about the administrative discretion exercised by collecting entities. However, no information is required about reductions of possibly material amounts in compliance assessments and pre-assessment work in process as a result of

the resolution of examinations, investigations, protests, and litigation. Therefore, accounting reports will not include data about these processes, which involve an even higher degree of administrative discretion than the formal assessment process. Nor will they provide data, e.g., compliance assessments made during the reporting period, that might be related to the cost of compliance, e.g., salaries of revenue agents and related administrative costs, that might be relevant to evaluating the performance of the collecting entities' compliance function.

Tax Gap

188. The exposure draft proposed that available information about the nonexchange revenue gap, including the tax gap, be provided as "other accompanying information." This information would not have been subject to audit, and the auditor's responsibility would have been limited to reporting if it was materially misleading in light of the information gathered during the audit. Substantially all of the revenue gap is the tax gap because duties are technically a type of tax, so the Board decided to deal only with the tax gap. The sources of non-compliance that cause the tax gap include unreported income, overstated exemptions, and overstated deductions. The largest component of the tax gap relates to income taxes. IRS originally estimated the gross income tax gap at $94 billion for tax year 1987. The net income tax gap for 1987, which is the gross income tax gap less the estimated amount that has been or will be collected through IRS's enforcement efforts, is now estimated at $72 billion. Thus, with respect to 1987, later collections from non-compliant taxpayers are about $22 billion. Estimates of the income tax gap cover only taxes on legally earned income of individuals and corporations—not taxes owed from illegal sources of income such as drugs and prostitution.[42]

189. Estimates of the tax gap by IRS have been made from time to time. Congress recently concluded not to authorize a current study[43] and there is no present plan to conduct another one. On the other hand, Customs makes estimates of amounts due from unknown non-compliant importers. The Board concluded, therefore, that the

[42]For details see Net Tax Gap and Remittance Gap Estimates (Supplement to Publication 7285), Publication 1415 (4-90), Internal Revenue Service; and Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed, GAO/GGD-94-123, May 1994.

[43]The Tax Compliance Measurement Program (TCMP) planned for 1996.

standard should require only that any estimates by the Government of the tax gap be presented when they were relevant, i.e., provided reasonably current information is available.

190. Some respondents to the exposure draft believed that tax gap information is important, but others believed it is too imprecise to be a required disclosure. The Board considered establishing a new category of information "Required Supplementary Stewardship Information" (RSSI) for the "unidentified persons or entities" portion of the tax gap. This concept is also being considered for application to certain "Stewardship Information." The Board concluded that for the time being this standard should say that available information about the tax gap should be provided as other accompanying information. In addition to the tax gap information requirements (see para. 69.2), other accompanying information is required or permitted under certain circumstances with respect to (a) the income tax burden (see para. 69.1), (b) tax expenditures (see para. 69.3), (c) directed flows of resources (see para. 69.4), and (d) revenue foregone for exchange transactions (see para. 47).

191. The Board intends to review the requirements in this standard to provide other accompanying information when it considers standards for the Management Discussion and Analysis (MD&A). The Board may decide to modify the information requirements when it considers the degree to which this information should be subject to some sort of audit scrutiny. Auditing standards for the MD&A have not been established by any auditing standard setters, including the Comptroller General, who establishes standards for auditors who audit federal organizations, programs, and activities. It is expected that audit standards for an MD&A will be considered by the Comptroller General's Advisory Council and standards may be set later by the Comptroller General. Particular audit requirements for MD&A may be set by agreement between OMB and GAO if consistent with any such standards then existing. When the Board's project on MD&A is considered, OMB and GAO plan to give consideration to the auditing requirements for MD&A and to the concept of RSSI.

Tax Expenditures

192. Tax expenditures are estimates of the revenue foregone because of preferential provisions of the tax structure. They are due to special exclusions, exemptions, deductions, credits, deferrals, and tax rates that depart from a "baseline." These exceptions are generally intended to achieve public policy objectives by providing benefits to qualifying

individuals or entities or by encouraging particular activities. They also may be intended to improve tax equity or offset imperfections in other parts of the tax structure. Tax expenditures are not revenue. They are not inflows of resources to the reporting entity.

193. The following are some examples of tax expenditures (with estimates from the Treasury Department of the revenue foregone in FY 1995):

- the exclusion from gross income of the housing and meals provided military personnel ($2.0 billion);
- tax credits for expenditures to preserve and restore historic structures ($0.1 billion) and to produce "alternative" fuels ($1.0 billion);
- exclusion from gross income of employee compensation in the form of health insurance premiums and other medical care ($59.4 billion); and
- deductions for mortgage interest ($48.1 billion) and state and local property taxes ($15.3 billion) on owner-occupied homes.

194. The Board considered a proposal to require each reporting entity to provide supplementary information on tax expenditures related to its missions. The amounts reported would have been the Treasury Department's estimates that are published in the President's budget.

195. Those who supported that proposal believe that this information is relevant to evaluating the performance of Government programs that have related tax expenditures. Some of these tax expenditures are very closely tied to program operations. Others are less closely tied to an agency's operating activities but still relate to its mission. For example, the preferential treatment of owner-occupied homes can be related to HUD's mission to promote good housing for the nation.

196. Furthermore, policy makers may compare changes in tax expenditures with changes in direct budgetary outlays. They did so, for example, in 1983 and 1993 when they increased the taxation of Social Security benefits but alternatively could have reduced the cost-of-living adjustment. In ways such as these, the reporting on the costs and accomplishments of an entity is incomplete unless it includes the tax expenditures related to its missions.

197. The Board decided not to require supplementary information on tax expenditures in component entity financial statements for several

reasons. The definition of the baseline for comparison is in part a matter of values and judgment. In some cases the association with particular programs is not sufficiently clear. Furthermore, the information is available elsewhere now. However, the Board agreed to permit reporting entities to present, as other accompanying information, information on tax expenditures that the reporting entity considers relevant to its programs, if suitable explanations and qualifications are provided.

Directed Flows of Resources

198. The Board considered a proposal to require each entity to provide supplementary estimates of the material annual expense to nonfederal entities of existing federal laws and regulations associated with its programs. The requirement would have been limited to regulations that establish standards for the characteristics of products or for the methods of production, or that mandate expenditures by state and local governments. These estimates would not necessarily have included nonpecuniary costs, although nonpecuniary costs might have been included to the extent identifiable. Each entity also would have provided any appropriate explanations about availability of data and limitations on the reliability of the estimates.

199. Advocates of the proposal believe that the Government pursues some of its goals by requiring states, local governments, and private entities to spend funds for specified public purposes. For example, the Government may require states to extend the coverage of Medicaid, communities to have water treatment plants that meet Government safety standards, firms to minimize their workers' exposure to asbestos, and automobile manufacturers to install air bags. When the regulations apply to state and local governments, they are generally called "unfunded mandates."

200. The costs and financing of federal regulations do not flow through the Government, but their effects are similar to the effects of direct federal expenditures and revenue. Fundamentally, both regulation and federal expenditure allocate resources to the purposes specified by the Government. The cost of regulation includes regulations imposed in the past as well as newly issued regulations. Furthermore, expenditure required by regulation may be an alternative means of achieving the same public policy goals as direct federal expenditure or other methods. For example, Medicaid coverage may be extended with or without more federal grants.

201. Advocates of this requirement believe that financial reports that omit important financial effects of Governmental action do not fairly present the results of the Government's operations. Such reports fail to achieve the objectives of federal financial reporting. They believe that the efforts and accomplishments with which an agency pursues its goals can be properly assessed only if the financial reports include all material information. This means that the reports should bring together information about the net cost of operations, the tax expenditures, and the directed flows of resources that are intended to achieve the same or similar missions.

202. The Board decided not to require supplementary information on directed flows for several reasons. Much of this information is not available now and will not be available to preparers of financial reports without added expense. In some cases the estimates would be very imprecise. Finally, most Board members believe that the scope of Government financial reporting should not extend to flows of financial resources that are not inflows to, or outflows from, federal Government reporting entities. However, the Board agreed to permit reporting entities to present, as other accompanying information, information on directed flows of resources that the reporting entity considers relevant to its programs, if suitable explanations and qualifications are provided.

Other Financing Sources And Budgetary Resources

General Principles

203. The standards for other financing sources and budgetary resources should satisfy several of the objectives of financial reporting such as: (1) explaining the relationship of budgetary resources obligated to the net cost of operations, (2) showing how budgetary resources were used and the status of budgetary resources at the end of the period, and (3) indicating the effect on the net results of operations of the entity of all the financing sources used to finance the net cost of operations. However, financing from a financial accounting (proprietary) perspective is different than the budgetary accounting perspective.

204. The budget is the primary financial planning and control tool of the Government. Its objectives, such as planning resource allocation, authorizing and controlling obligations, planning cash disbursements, and raising revenue, differ from those of financial reporting where the focus is on net cost of the entity's programs and activities and stewardship of its assets and liabilities. Differing objectives are responsible for some but not all of the many differences in these two financial management tools. Differences in standards for measuring and reporting budgetary and financial information, coupled with unreliable data, have caused financial statements to be under-utilized by Government managers, the budget community, and others who might benefit from financial information.

Reducing Differences

205. The problem of unreliable data is being addressed through financial statement audits that will include both proprietary and budgetary information and improvements in financial management systems. These federal accounting standards reduce unnecessary differences between the information reported in these two tools of financial management and require reconciliations and data to explain necessary differences. This should increase the utility of the financial planning and control information provided by the flow statements in general purpose financial reports and enhance the usefulness of the other accountability information provided, e.g., the Balance Sheet. This should occur because those who focus on the budget will better understand the financial statements and find them to be reliable and useful reports.

206. The new recognition and measurement standards for financial accounting adopt budgetary flow concepts for appropriations and provide consistent flow standards for nonbudgetary resources. As explained earlier, standards for recognition of nonexchange revenue reported by Government entities reflect legal requirements. These changes make the reporting on financing for entity net costs more consistent among entities and more comparable to the budget.

207. However, differences inherent in the different objectives of the budget and the financial statements must remain. The obligation basis for the budget differs from the costs-incurred basis for the financial statements. This difference must continue in order for both types of information to serve their purposes. Some budgetary resources are used to invest in assets and therefore are not reflected in operating costs. Also, an entity may incur costs that were covered by previously

provided budgetary resources (e.g., depreciation), costs not yet covered by budgetary resources (e.g., accrued annual leave), or costs covered by budgetary resources of other entities (e.g., some pension costs). Continuing these differences in the accounting reports is essential if financial statements are to report cost information that can be related to entities' outputs and if the statements are to report other information on the resources over which the entities are accountable. These remaining differences need to be explained in the financial statements to increase the utility of the financial statements.

The Budgetary Process and Its Linkage to Accounting

208. The budget controls obligations and thus ultimately controls expenditures by Government entities. In this sense, it is about their outflows of resources. Conversely, the budget makes inflows of resources available to component entities to finance expenditures. The inflows are reported in the financial statements as revenues and other financing sources (e.g., appropriations).

209. The budgetary process provides a component entity with budgetary resources through appropriations acts. Budget authority may be provided in the form of appropriations, borrowing authority, contract authority, or spending authority from offsetting collections. An appropriation may make funds available from the General Fund, special funds, or trust funds—including amounts received from earmarked taxes—or may authorize the spending of offsetting collections credited to expenditure accounts. Budgetary resources also include unobligated balances remaining from prior reporting periods and a number of adjustments (e.g., recoveries of prior year obligations). Execution of the budget includes the obligation of budgetary resources and the outlays to liquidate the obligations.

210. Borrowing authority is sometimes used instead of appropriations to incur obligations and make payments to liquidate them out of borrowed money. However, borrowing money under this authority does not change the net position of the entity. The liability created by the borrowing is recorded along with the related asset (the cash borrowed). Repayment of the liability later will normally require the use of an offsetting collection or an appropriation. Assets acquired as a result of borrowing may be later amortized or written off and become part of an entity's costs. When this occurs, or in the unusual event that the borrowing finances expenses rather than assets, the entity's net position will be reduced.

211. Contract authority is not a reportable financing source because it only allows agencies to incur obligations in advance of receiving funds to pay for any resulting liabilities. The funds to liquidate any resulting liabilities will come from an appropriation or offsetting collections. For financial statement purposes, a financing source is recognized in accordance with the appropriate accounting standards for the type of financing received to liquidate the liability. Under past practice the financing was recognized at the time liabilities were incurred, but under the new standard the financing will not be recognized until liquidating appropriations are made available, which may be in the same reporting period as the liability is incurred or a later period.

212. Appropriations, including permanent indefinite appropriations, are the most widely used form of budget authority. When obligated by orders for, or receipt or provision of, goods, services, or benefits, they are reflected as obligations incurred.[44] When used, appropriations are accounted for as an inflow of resources (i.e., an other financing source) in calculating net results of operations for the reporting period.

213. From the budgetary perspective, appropriations include dedicated tax receipts, such as Social Security taxes and Highway Trust Fund excise taxes. From a proprietary perspective, on the other hand, unexpended appropriations do not include dedicated tax receipts, because these receipts are accounted for as nonexchange revenue. Therefore, appropriations used do not include dedicated tax receipts, thus avoiding double counting of these amounts as financing sources.

214. The accounting treatment for recognizing "appropriations used" as a financing source parallels the budgetary accounting for expended appropriations. Expended appropriations are recognized when goods and services ordered have been delivered, when benefits are payable to recipients, or when funds available under a grant agreement are payable, and there is an available appropriation to pay these amounts. Under this standard, this is also the time when "appropriations used" is recognized as a financing source in the proprietary accounts.

[44]Amounts appropriated to liquidate contract authority or repay debt are not available to incur new obligations and hence are not considered budget authority.

215. Thus, at the time a liability is established which will be paid by an available appropriation, appropriations are considered used. Liabilities should be established in accordance with SFFAS No. 5. Under that standard, a liability can be established in several ways, and the type of transaction that has occurred governs when a liability has occurred. For example, grants can be provided under different transactions. Some can be provided without any required exchange of service with the federal government, while others may require specific activities to occur before the funds are available.

216. Providing funds from an appropriation does not necessarily cause the recognition of a financing source if that payment is an advance. For example, an entity may advance funds to a grantee under the grant agreement. This should not cause recognition of a financing source. The recognition of appropriations used would not occur until the grantee meets the requirements that allow it to use the funds in accordance with the grant agreement.

217. The focus on net cost rather than on matching financing with expenses as incurred provided an opportunity to simplify the accounting for appropriations and to eliminate one of the differences between financial and budgetary accounting. Reporting entities will no longer have to defer recognition of appropriations used nor accrue appropriations before they become available.

- Recognition was previously deferred for appropriations used to finance capitalized transactions, such as the purchase of a fixed asset or the making of a loan under pre-credit reform programs which have not converted their accounts to a present value basis. The use of financing was previously recognized at the same time and rate that depreciation of the asset's cost was recognized as an expense or that bad debts expense was recognized on pre-credit reform receivables which had not been converted to present values.
- Accrual of appropriations as amounts receivable was sometimes allowed for costs incurred but not funded until after the period the costs were incurred, such as subsidy reestimates under the Credit Reform Act. Reestimates of subsidy cost for credit programs are made at or after the end of a period for which the reestimate applies and for which an expense is recognized, but the permanent indefinite authority is not available until the following period. When a financing accrual was not used for

unfunded expenses, the unfunded expenses were removed from cumulative results of operations and reported separately in net position as future funding requirements.

218. These changes eliminate reporting invested capital and future financing sources in equity. These two equity accounts did not provide accurate information because invested capital was never expected to be returned and future financing requirements did not cover all future financing needed but only that amount which had been recognized as expenses.

219. An appropriation may provide an agency with the authority to obligate and expend earmarked receipts to which it is legally entitled and its offsetting collections. Most of these inflows of resources are classified and accounted for as either exchange or nonexchange revenue in accord with the accounting standards previously discussed. However, the relationship is not exact between these revenues and related new budget authority. For example, some offsetting collections are neither a revenue nor a financing source. They only change the form of a resource already reported on the Balance Sheet (e.g., funds received from the sale of an asset at book value). Some offsetting collections are credited to receipt accounts instead of expenditure accounts and cannot be obligated without specific appropriation. Some of these revenues are precluded from obligation in a fiscal year by a provision of law, such as a benefit formula that determines obligations, or by a limit on the amount of obligations that can be incurred. Amounts precluded from obligation are not counted as budget authority in that year.

220. By recognizing nonbudgetary resources, e.g., imputed financing and transfers, the financial statements of the entity will show how its recorded costs were financed by the budgetary resources of other entities as well as its own.

(a) "Imputed financing" sources are reported to offset budgeted costs of another entity that applicable accounting standards impute to the reporting entity.[45] The imputing process recognizes these costs in the net cost of operations of the responsible entity.

[45]Imputed financing sources may be reported to recognize imputed costs that have not yet been budgeted for other entities, such as for pensions and retirement health care.

By reflecting "imputed financing" in the changes in net position, the net position of the responsible entity is not affected and there is no double counting.

(b) "Transfers-in" and "Transfers-out" are necessary to show transfers of assets or revenue from one Government entity to another. In the case of assets, the transferor's budget reflected the original expenditure for the asset, but the budget normally does not reflect the subsequent transfer of the asset. The transfer changes the entity's financial position at the time of transfer but not its net cost of operations. Therefore, it is recognized in determining the net results of operations for the reporting period but not net cost.

221. In the case of earned revenue, the budget may require the earned revenue inflow related to the entity's costs to be paid to the General Fund or another entity. Reporting the transfer-out of such revenue as a reduction in net results of operations lets the responsible entity properly report its earnings in net cost of operations without increasing its net position.

222. Donations are not included as receipts in the budget, except for cash and near-cash items. However, some other kinds of donations are also recognized as revenue. Such revenues are permanent differences between the budget and the financial statements. Donation revenue will increase net results of operations under these standards. Under the standard, accounting for donations is consistent with current practice in the private sector where contributions are recognized as revenue.

223. Costs that are not yet covered by budgetary resources are "permanent" differences until Congress acts to finance them in the budget or until permanent budget authority becomes available. Under the new standards, financing yet to be provided for recorded costs will not be accrued. Accordingly, it will not increase cumulative results of operations.

Implications of the Term "Net Results of Operations"

224. Some of those who commented on the exposure draft expressed concern that some readers might infer that the amount of "net results of operations" reported on the new Statement of Changes in Net Position was a relevant performance measure. Some financial statement users might draw such an inference because, in the private

sector, the term "net results of operations" is synonymous with net income and net income is the "bottom line" performance measure. Similarly, the statement of operations used by federal reporting entities prior to implementation of SFFAS No. 7 focused on a similar bottom line, net results of operations. This was the result of showing the flow of all operating activities on a single statement. For most governmental entities, however, no single bottom line can accurately measure performance, and "net results of operations" normally provides little information on either the costs or the benefits of an entity's operations.

225. The new reporting model, illustrated in Entity and Display, focuses on measuring costs and reporting on performance. Both gross and net cost are key financial performance measures that can be related to outputs and outcomes of the entity's programs and activities.

Dedicated Collections

226. The exposure draft proposed disclosure requirements for trust funds that were included within the reporting entity's financial statements in total and for material individual fund. The information was proposed to provide users a basis for understanding these funds and for holding the Government accountable for the use and disposition of earmarked collections. Based on comments received, this standard changes what was proposed as follows.

    A. The proposed standard did not cover funds administered by a federal entity in a fiduciary relationship with beneficiaries that were not included in the entity's financial statement. In addition, it did not cover other funds which are of the same nature as many trust funds. The standard now requires disclosures for these funds also.

    B. The requirement for a total for all funds was modified. If the fund is not material to the reporting entity, disclosure may be made in a special report to the contributors and beneficiaries (or their representatives) and only disclosure of the total of these funds is required.

227. **User needs.** Funds that account for dedicated collections are of great interest to users of federal financial statements. First and foremost are the contributors and beneficiaries to which the Government needs to be accountable for the receipt and disposition of earmarked

collections and for the balances that remain available to pay beneficiaries in the future or serve other purposes determined by law. Other users are interested in the financing of other government operations with these fund balances.

228. External users of federal financial reports sometimes misunderstand the relationship of these funds, especially trust funds, to the Government. Very few Government trust funds are held "in trust" in a fiduciary relationship as is customarily the meaning of this term outside the Government. Also, some of the trust funds currently spend less than the receipts they collect each year. Most of the cash surplus that arises when receipts are greater than outlays is invested in Treasury securities until the amounts are needed for the trust fund to use in accordance with benefit formulas or other provisions of the law.

229. The Treasury uses these additional receipts to meet the cash needs of general operations, thus reducing the need to borrow from the public, raise taxes, or reduce spending. In the consolidated financial statements of the Government, the investments in Treasury securities held by trust funds and other fund entities and the corresponding debt owed by the Treasury to these funds cancel out. They are eliminated from the amounts reported in the consolidated Balance Sheet but footnote disclosure of these amounts normally has been included.

230. **Funds covered by the standard.** As pointed out by respondents, trust funds are not the only type of fund that collects dedicated moneys. However, the exposure draft did not specifically delineate which funds might be included in the wider scope. The Board decided to limit these disclosures to funds where there was a need to show accountability to contributors and expected beneficiaries. Therefore, the funds that are covered by this standard are all trust funds, all special funds that are similar to trust funds, and all fiduciary funds whether or not in the budget.

231. The federal government does not use a consistent fund designation for these types of collections. Funds classified by law as trust funds are established by specific legislation to carry out activities stipulated by law and frequently are financed by taxes. While the Government's use of the term "trust funds" ordinarily differs from use of the term in the private sector, a few trust funds within the federal universe have the stringent fiduciary characteristics similar to those of trust funds in the private sector. Furthermore, some funds within the budget are

classified as special funds and are similar in nature to non-fiduciary trust funds within the budget. Providing precise criteria for which non-trust funds are covered by this requirement is difficult. The Board realized that it will not always be easy for management to identify accountability expectations of contributors and beneficiaries.

232. On the other hand, no special accountability of a fund is needed for the sake of those who make voluntary payments in contemporaneous exchange for goods or services. Once goods and services have been rendered for the payment made, the purchaser generally does not expect the fund to provide additional accountability. For this reason the special reporting requirements do not apply to revolving funds or other funds financed similarly. However, special accountability may exist for a revolving fund that collects receipts for goods and services that are expected to be provided at a later period, such as long-term insurance contracts, and preparers are encouraged to provide the needed information in such cases.

233. **Funds not part of the reporting entity's financial statements.** In most cases, the requirement will apply to a fund that is included in the financial statements of the reporting entity. In the case of most fiduciaries, however, the fund is administered by a reporting entity but is not part of the reporting entity itself or included in its own general purpose financial statements. The disclosure requirement applies to such funds as well.

234. **Special reports.** Since the primary purpose of this requirement is accountability to the contributors and expected beneficiaries, all funds that meet the stated criteria are deemed material in this respect. Therefore, information needs to be provided regardless of whether it is material to the reporting entity. However, to minimize the amount of additional information required in financial statements, where the disclosures for dedicated collections are made to the contributors and beneficiaries in special reports and the information required is not material to the reporting entity, minimal disclosures are included in the reporting entity's general purpose financial statements or notes thereto. Special reports provided to representatives of contributors or beneficiaries may satisfy this requirement (for example, a report to an Indian tribal government).

Appendix B: Guidance For The Classification Of Transactions

Introduction

235. The Government of the United States has a great many types of transactions that finance its cost of operations, and they must be classified in various ways for revenue accounting in order to achieve the objectives of the standards in this Statement. The type of transaction may be an exchange transaction, a nonexchange transaction, or an other financing source; the transaction may be made between a Government reporting entity and the public or between two reporting entities within the Government (i.e., an intragovernmental transaction). If it is an exchange transaction, it will normally produce revenue but may produce gains and losses. This appendix provides guidance for the classification of specific transactions based on the standards for accounting for revenue and other financing sources, and the reasoning behind these standards as explained in the Introduction and the Basis for Conclusions.

236. To serve that purpose, this appendix provides guidance for classifying all major transactions that finance the Government's cost of operations and a significant number of lesser transactions. It is intended that these classifications--together with the explanation of these classifications, interpreted in the light of the Standards, the Basis for Conclusions, and the Introduction—will provide guidance for classifying all the financing transactions of the Government, including those that are not specifically listed. It should be understood that while some classifications are unequivocal, others are the result of balancing different considerations.

237. The transactions in this appendix are divided into several groups. Transactions recognized in the financial statements have a two-fold division: first, whether they are with the public or intragovernmental; and second, whether they are nonexchange transactions, exchange transactions that produce revenue, exchange transactions that produce gains or losses, or other financing sources. A separate group consists of gains and losses due to revaluation.

238. Exchange transactions are classified as producing gains or losses if they are likely to be unusual or nonrecurring. If the transactions classified in this appendix as gains or losses are usual and recurring for a particular reporting entity, that entity should classify them as producing exchange revenue or expense instead of gains or losses.

239. The final group of transactions in this appendix consists of transactions that produce amounts not recognized as revenues, gains, or other financing sources. Although in some instances there is overlap with other groups, they are presented together as a convenient reference to amounts not classified in any of the other categories. They include:

- A number of transactions in which there is no net inflow of resources (or the net inflow is less than the full amount of the transaction) because one asset is exchanged for another or there is an increase in both assets and liabilities.
- Certain transfers and donations that do not affect net cost or net position.
- A number of transactions involving direct loans and loan guarantees, which are recognized as expenses or reductions in expenses according to the standards in SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees.
- Deposit fund transactions.

240. As a guide to this appendix, the following table lists in order the transactions that are illustrated, group by group, and cites the page. Unless otherwise stated:

- Revenue from nonexchange transactions is included in determining the net operating results and hence the change in net position.
- Revenue from exchange transactions is subtracted from gross cost in determining the net cost of operations. (Gains and losses from exchange transactions also affect net cost.)
- Other financing sources are included in determining the net operating results and hence the change in net position.

241. In addition, the collection and disposition of most nonexchange revenue and a small part of exchange revenue is accounted for as a custodial activity of the collecting entity.

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Transactions With The Public

Nonexchange transactions with the public

242. Individual income taxes, corporation income taxes, social insurance taxes and contributions,[46] excise taxes, estate and gift taxes, and customs duties.—Taxes (including customs duties) are levied through the exercise of the power of the Government to compel payment. In broad terms, taxes are "the price we pay for civilization." More specifically they finance spending of many types to promote the general welfare, provide for the common defense, and ensure domestic tranquillity: national defense, a judicial system, aid to the elderly, construction of infrastructure, education and training, and so forth. The relationship between the tax paid and the value received is too indirect and disproportionate to relate the revenue that is received

[46]"Social insurance" does not include programs established solely or primarily for Federal employees, such as pension and other retirement plans. "Social insurance" taxes and contributions do, however, include payments made by or on behalf of Federal employees to social insurance plans, such as Social Security and Medicare.

from any identifiable taxpayer to the cost that is incurred for providing that identifiable taxpayer with benefits. This is especially the case where the benefits are of a collective or public nature, such as national defense, in which case consumption by one taxpayer does not reduce the consumption available for another; or where the benefits are designed to redistribute income from one group of people to another. Therefore, tax revenue is nonexchange revenue.

243. All excise taxes, like other taxes, are classified as resulting in nonexchange revenue. Some excise taxes (considered to be benefit taxes) are levied on bases that are related to the use of publicly provided goods and services or the public provision of other benefits, such as the gasoline tax; certain other excise taxes are levied on bases related to a cause of some damage and are dedicated to pay down costs, such as the tax on domestically mined coal, which is dedicated to the black lung disability trust fund. Even in these cases, however, the relationship between the tax and the benefit received by an identifiable recipient is relatively indirect and disproportionate. Moreover, these excise taxes, like other taxes, are determined through the exercise of the power of the Government to compel payment. Therefore, like other taxes, they are classified as producing nonexchange revenue.

244. Board members have differing views on whether social insurance programs result in exchange or nonexchange transactions.[47] However, they agree that social insurance tax revenue should be reported in the same way as other tax revenue for the purposes of financial reporting. This is because social insurance taxes, like other taxes, are determined through the exercise of the power of the Government to compel payment. Furthermore, individuals and businesses subject to social insurance taxes are subject to them as a byproduct of their decision to enter covered employment or engage in a covered business, so especially for the major, broad-based social insurance programs—Social Security, Medicare (hospital insurance), and unemployment compensation—they have virtually no legal option except to pay.

[47] See discussion of social insurance programs in FASAB, Exposure Draft, Supplementary Stewardship Reporting (August 1995).

245. Tax receipts are generally collected from the public by the IRS (Internal Revenue Service) and, to a lesser extent, by the Customs Service and other entities acting as agents for the recipient entities rather than on their own behalf. The collecting entity receives the cash and then transfers it to the General Fund, trust fund, or special fund on whose behalf it was collected. The amount so collected should be accounted for as a custodial activity by the collecting entity. The tax is recognized as a nonexchange revenue by the entity that is legally entitled to the amount. This would be a trust fund or special fund in the case of an earmarked (i.e., dedicated) tax. If collected on behalf of the Government as a whole, it would be recognized in the Government-wide consolidated financial statements.

246. Social insurance taxes and contributions paid by Federal employees.[48]—Federal employees may be covered by social insurance programs such as Social Security[49] and Medicare under the same terms and conditions as the remainder of the covered population. The payments made by Federal employees are in the nature of taxes, compulsory payments demanded by the Government through the exercise of its power to compel payment. Insofar as the social insurance program applies to employees of the United States government, the terms and conditions are generally the same as the program for private employees. The employer and employee contributions are generally calculated in the same way; the employee contribution is not earned by the social insurance program; and the benefits are generally calculated in the same way. The employee does not obtain particular benefits under the plan from rendering service in Federal employment, because he or she would have been similarly covered by the program if privately employed and would have obtained similar benefits. For these reasons, the employee contribution should have the same classification as contributions by non-Federal employees, which is nonexchange revenue.

247. Deposits by states for unemployment trust fund.—States deposit the receipts from the state unemployment tax to the U.S. Treasury for the unemployment trust fund in order to finance most of the benefits

[48]"Social insurance" does not include programs established solely or primarily for Federal employees, such as pension and other retirement plans.

[49]Most Federal civilian employees hired before 1984 are not covered by Social Security.

under the unemployment compensation system. The state unemployment tax differs from state to state in terms of the tax rate, tax base, and certain other characteristics, and unemployment benefits also differ from state to state. Nevertheless, the deposit has long been construed as a Federal budget receipt (a governmental receipt), and the unemployment trust fund has long been included as an account in the Federal budget.

248. This is for a combination of reasons taken together: (a) the unemployment compensation system—including the system of taxes, the system of benefits, and the trust fund—was established by the Social Security Act of 1935 and has been amended by Federal law many times; (b) deposits are held in a trust fund operated by the U.S. Government; (c) Federal law specifies extensive requirements for the state unemployment tax and unemployment benefits; (d) the Federal unemployment tax finances grants to states to cover their entire cost of administering the unemployment system; and (e) Federal law effectively coerces states to participate in the system, with participation requiring them to levy the state unemployment tax and deposit the collections in the U.S. Treasury. If a state does not participate (or is not certified by the Department of Labor as meeting Federal requirements): (i) the Federal unemployment tax is levied within the state at its maximum rate, (ii) the system does not pay any unemployment compensation benefits within the state, and (iii) the Federal Government provides no grants to state governments to pay for the costs of administration. The deposits of the state tax are therefore nonexchange revenue of the unemployment trust fund. (The Federal unemployment tax is levied and collected separately from the state unemployment tax.)

249. User fees, Harbor Maintenance trust fund. —This is an example of a tax that is termed a "user fee" by law while classified in the budget as a governmental receipt together with other taxes and duties. It is an ad valorem tax of 0.125 percent imposed on commercial cargo loaded and unloaded at specified U.S. ports open to public navigation. The receipt is earmarked to the Harbor Maintenance trust fund. It is similar in nature to other excise taxes that result from the Government's power to compel payment and that are dedicated to a trust fund or special fund to be spent for a designated purpose (for example, the gasoline excise tax, which is dedicated to the Highway Trust Fund). It therefore should be recognized as nonexchange revenue by the Harbor Maintenance trust fund.

250. Customs Service fees.—The Customs Service collects revenue primarily from duties on imported merchandise but also from two types of fees: the merchandise processing fee and a group of fees called "user fees."

251. The merchandise processing fee is primarily an ad valorem charge on formal merchandise entries into the United States (at 0.19 percent) subject to a maximum and minimum charge. It also includes flat fees on informally entered goods. The collections are earmarked by law to a special fund from which receipts are made available to finance Customs Service operations to the extent provided by current appropriations.

252. The merchandise processing fee is associated with the cost of the Customs Service's operations. The fee as originally enacted was modified by the Customs and Trade Act of 1990 to make it consistent with U.S. obligations under GATT (the General Agreement on Tariffs and Trade) after a GATT panel had ruled that the original fee (a straight ad valorem fee) exceeded the cost of services rendered and was a tax on imports that discriminated against imports in favor of domestic production. The maximum and minimum fees and the flat fees were enacted to meet the U.S. obligation.

253. However, the associated cost is primarily some of the costs of assessing and collecting duties on imported merchandise, such as the salaries of import specialists (who classify merchandise) and the costs of processing paperwork. The importer pays duties that are required by law; it does not receive anything of value from the Government in the nature of an exchange. Furthermore, these costs are not likely to depend significantly on the value of the merchandise, and the fee is levied through the power of the Government to compel payment. Therefore, for the purpose of a classification system for financial reporting, the fee is akin to dedicated taxes that are also related in the aggregate to associated costs and that are classified as nonexchange revenue (e.g., the excise tax on gasoline). The merchandise processing fee is therefore classified as a nonexchange revenue.

254. The user fees consist of a group of flat fees charged on passengers and conveyances entering the country.[50] The collections are dedicated by

[50]These fees are sometimes called the "COBRA user fees." This term comes from the Consolidated Omnibus Budget Reconciliation Act of 1985, which established these fees.

law to a special fund whose receipts are made available by permanent indefinite appropriation to finance Customs Service operations.

255. These fees are intended to offset certain inspection costs that relate to the processing of passengers and conveyances entering the country. They are levied through the power of the Government to compel payment, and the person or entity that pays these fees does not receive anything of value from the Government in exchange. The inspection activities are for a variety of purposes: to ensure that dutiable merchandise is declared, to seize contraband (such as narcotics and illegal drugs), to detect infringements of patent and copyright laws, and so forth. Some of these purposes are related to the Government's powers to raise taxes, which are nonexchange revenue, and to enforce laws. Only to a limited extent are they like regulatory user fees, based on the Government's power to regulate particular businesses or activities. Therefore, like the merchandise processing fee, the user fees are classified as nonexchange revenue.

256. Deposits of earnings, Federal Reserve System.—The Federal Reserve System consists of the Board of Governors of the Federal Reserve System and twelve regional Federal Reserve Banks. Under Federal accounting concepts, it is not considered to be part of the Government-wide reporting entity. Therefore, payments made to or collections received from the Federal Reserve System would be reported in the financial statements of the Federal Government and its component reporting entities.[51] The Federal Reserve earns large amounts of interest on its portfolio of Treasury securities and deposits to the Treasury all net income after deducting dividends and the amount necessary to bring the surplus of the Federal Reserve Banks to the level of capital paid-in.

257. The Federal Reserve was established by Act of Congress pursuant to the Government's sovereign power over the nation's money, and its investment in Treasury securities is necessary for carrying out its monetary function. It does not receive anything of value from the Government in exchange for its deposit of earnings, and on occasion it has been required by law to make extra payments. The revenue from the deposits is therefore nonexchange.

[51]SFFAC No. 2, Entity and Display, para. 47.

258. Donations: except types of property, plant, and equipment that are expensed.—Donations are contributions to the Government, i.e., voluntary gifts of resources to a Government entity by a non-Federal entity.[52] The Government does not give anything of value to the donor, and the donor receives only personal satisfaction. The donation of cash, other financial resources, or nonfinancial resources (except stewardship property, plant, and equipment) is therefore a nonexchange revenue.

259. The exception, stewardship PP&E, consists of Federal mission PP&E, heritage assets, and stewardship land. Such PP&E is expensed if purchased, but no amount is recognized if it is received as a donation.[53] Correspondingly, no revenue is recognized for such donations.

260. Fines and penalties.—Fines and penalties are monetary requirements imposed on those who violate laws or administrative rules. The person or other entity that pays a fine or penalty does not receive anything of value in exchange, nor does the Government sacrifice anything of value. The Government collects these amounts through the exercise of its power to compel payment. Fines and penalties are therefore a nonexchange revenue.

261. Fines from judicial proceedings are collected by the entity acting as an agent for the Government as a whole rather than on its own behalf. They are therefore accounted for as a custodial activity of the collecting entity and recognized as a nonexchange revenue in the Government-wide consolidated financial statements.

262. Fines and penalties produced by an entity's operations—such as inspections to ensure compliance with Federal law and with regulations that are the responsibility of the entity (e.g., inspections by the Office of Surface Mining) or compliance with regulations for the conduct of a Federal program—are recognized as nonexchange revenue by whichever entity is legally entitled by law to the revenue. In some cases, but not all, this would be the collecting entity. If the

[52]The term "donations" includes wills disposing of property and judicial proceedings other than forfeitures.

[53]SFFAS No. 6, Accounting for Property, Plant, and Equipment, para. 61 and 71.

collecting entity transfers the nonexchange revenue to the General Fund or another entity, the amount is accounted for as a custodial activity by the collecting entity. If transferred to the General Fund, the penalties are recognized as nonexchange revenue in the Government-wide consolidated financial statements; if transferred to another entity, they are recognized as nonexchange revenue by the entity that receives the transfer.

263. Penalties due to delinquent taxes in connection with custodial activity.—The person or other private entity that pays a penalty on delinquent taxes does not receive anything in exchange, nor does the Government sacrifice anything of value. The Government collects these amounts through its power to compel payment. Penalties on delinquent taxes are therefore a nonexchange revenue. The penalties are accounted for as a custodial activity. If transferred to the General Fund, the penalties are recognized as nonexchange revenue in the Government-wide consolidated financial statements; if transferred to another entity, they are recognized as nonexchange revenue by the entity that receives the transfer.

264. Forfeitures.—Property may be seized as a consequence of various laws and regulations and forfeited to the Government. Forfeited property may be acquired through forfeiture proceedings, be acquired to satisfy a tax liability, or consist of unclaimed and abandoned merchandise. Forfeited property is principally managed by the Asset Forfeiture Fund of the Justice Department and the Treasury Forfeiture Fund of the Treasury Department. Revenue is recognized from forfeited property unless the property is distributed to state or local law enforcement agencies or foreign governments or is received in satisfaction of a previously recognized revenue (e.g., accrued tax receivables).[54]

265. The timing of revenue recognition depends on how the property is forfeited and the nature of the property. In the case of unclaimed and abandoned merchandise, revenue is recognized in the amount of the sales proceeds at the time the property is sold. In the case of property acquired through forfeiture proceedings, the timing of recognition depends on the nature and disposition of the property. For monetary

[54]This amends SFFAS No. 3, Accounting for Inventory and Related Property, with respect to forfeitures related to satisfying tax liabilities.

instruments, the revenue is recognized at the time of obtaining forfeiture judgment; for property that is sold, at the time of sale; and for property that is held for internal use or transferred to another Federal agency, at the time of obtaining approval to use the property internally or transfer it.[55]

266. The method of measuring revenue depends on the nature of the property. The amount of revenue recognized for monetary instruments is the market value when the forfeiture judgment is obtained. For property that is sold, it is the sales proceeds. For property that is held for internal use or transferred to another Federal agency, it is the fair value of the property less a valuation allowance for any liens or third party claims.

267. The revenue from forfeiture is nonexchange revenue, because the Government seizes the property through the exercise of its power. The Government does not sacrifice anything of value in exchange and the entity that forfeits the property does not receive anything of value. More than half of the forfeiture revenue of the two funds mentioned above is from currency and other monetary instruments. Although other types of forfeited property must be sold in order to recognize revenue, or constructively sold (if transferred to another Federal agency or placed into internal use), this is the last step in a process that is inherently nonexchange.

268. The disposition of the revenue from forfeiture is determined by law. Revenue or the property itself may ultimately be distributed to the seizing entity, state or local law enforcement agencies, foreign governments, or the general fund. Revenue is recognized as nonexchange revenue by the entity that is legally entitled to use the revenue or to use the property itself. If the property is distributed to a state or local law enforcement agency or a foreign government, revenue is not recognized by a Federal Government reporting entity. If the revenue is transferred to the General Fund, it is recognized as

[55]SFFAS No. 3, para. 57-78. The standard also requires deferred revenue to be recognized when a forfeiture judgment is obtained, but the deferred revenue is reversed when revenue is recognized. The amount of revenue ordinarily differs from the amount of deferred revenue. In some cases, an adjustment subsequent to the original forfeiture judgment may be necessary when it is later determined that a portion of the forfeiture is to be distributed to state or local law enforcement agencies or foreign governments.

nonexchange revenue in the Government-wide consolidated financial statements.

269. Some entities may be involved in the management and liquidation of forfeited property but not themselves be entitled to the revenue or to the use of the property. For example, a central fund created to support the seizure activities of multiple entities may manage forfeited property and the collection and disposition of the revenue from that property. These entities should account for the property as a custodial activity. Revenue is shown when it is recognized, and it is shown as transferred to others when the cash is disbursed or the property is delivered. The disposition of property to an entity outside the Federal Government is also accounted for.

Exchange transactions with the public: revenue

270. Sales of goods and services.—The cost of production for goods and services such as electricity, mail delivery, and maps is defrayed in whole or in part by revenue from selling the goods or services provided. The sales may be made by a public enterprise revolving fund (such as the Bonneville Power Administration), an intragovernmental revolving fund (such as the Government Printing Office), or a fund that is not a revolving fund (such as the Geological Survey). Each party receives and sacrifices something of value. The sale is therefore an exchange transaction, and the revenue is exchange revenue for the entity making the sale.

271. Sales of goods and services in undercover operations.—The cost of the Government's undercover operations is defrayed in whole or in part from the proceeds of sales of goods that have been purchased (as opposed to goods that have been forfeited). Each party receives and sacrifices something of value. These characteristics of the transaction are not affected by whether the sale is illegal. The sale is therefore an exchange transactions, and the revenue is exchange revenue of the entity making the sale.

272. Interest (unless classified elsewhere), dividends, and rents (except for mineral rights) on Government property.—Each party receives and sacrifices something of value, so the inflow of resources is an exchange transaction.

273. Interest is classified as exchange revenue notwithstanding the fact that the entity may not be charged a cost of capital for the assets that yield these inflows; or, if the entity borrowed from Treasury to acquire

the assets, it may have been charged a below-market interest rate. The gross cost of the entity is understated in such cases; and to recognize an exchange revenue is to recognize a revenue without some or all of the related costs, and hence to understate the entity's net cost of operations. Nevertheless, in some cases the entity does pay the Treasury at least some interest; and the Government's cost of borrowing to acquire the assets is recognized as a cost of the Government as a whole. Since some cost is recognized, even if not always the full cost of the entity,[56] an exchange revenue is recognized for the entity that receives the inflow of interest.

274. Rents, royalties, and bonuses on Outer Continental Shelf (OCS) and other petroleum and mineral rights.—Rents, royalties, and bonuses are exchange revenues, because each party receives and sacrifices something of value. The amounts are earned by sales in the market and therefore are exchange revenue. They are collected by the Minerals Management Service (MMS) of the Department of the Interior, which manages the energy and minerals resources on the OCS and collects the amounts due the Government and Indian tribes from minerals produced on the OCS and other Federal and Indian lands.

275. MMS does not recognize a depletion cost for various reasons, including the fact that under present accounting standards natural resources are not recognized as an asset and depletion is not recognized as a cost. As a result, this exchange revenue bears little relationship to the recognized cost of MMS and cannot be matched against its gross cost of operations. Therefore, although the inflows are exchange revenue, they should not be subtracted from MMS's gross cost in determining its net cost of operations.

276. MMS should instead account for the exchange revenue as a custodial activity. MMS collects rents, royalties, and bonuses acting as an agent on behalf of the recipients designated by law: the General Fund, certain entities within the Government to which amounts are earmarked, the states, and Indian tribes and allottees. The amounts of revenue should be recognized and measured under the exchange

[56]The partial recognition of associated cost distinguishes interest from rents, royalties, and bonuses on the Outer Continental Shelf and the auction of the radio spectrum. For the latter transactions, see the subsequent paragraphs.

revenue standards when they are due pursuant to the contractual agreement.

277. The rents, royalties, and bonuses transferred to Treasury for the General Fund, or to other Government reporting entities, should be recognized by them as exchange revenue. However, neither the Government as a whole nor the other recipient entities recognize the natural resources as an asset and depletion as a cost. Therefore, this exchange revenue should not offset their gross cost in determining their net cost of operations. It should instead be a financing source in determining their operating results and change in net position.

278. Proceeds from the auction of the radio spectrum.—The proceeds from auctioning the right to use the radio spectrum are exchange revenues, because each party receives and sacrifices something of value. The amount of revenue is earned by sales in the market at auctions. It bears little relationship to the costs recognized by the Federal Communications Commission (FCC), which collects the revenue, or to the costs recognized by the U.S. Government as a whole. Therefore, it should not be offset against the costs of the FCC in determining its net cost of operations or against the costs of the Government as a whole in Government-wide consolidated financial statements.

279. The FCC should therefore account for this exchange revenue as a custodial activity, acting as an agent on behalf of the General Fund; and it should be included as exchange revenue in the Government-wide consolidated financial statements.

280. Interest on post-1991[57] direct loans.[58]—Interest on direct loans is an exchange transaction, because it is part of a broader exchange transaction in which the entity makes a loan to the borrower and the entity and borrower each receives and sacrifices something of value.

[57]Post-1991 direct loans consist of direct loans that were obligated after September 30, 1991, whereas pre-1992 direct loans consist of direct loans that were obligated before October 1, 1991. The same accounting that is used for post-1991 direct loans is also used for pre-1992 direct loans that were modified and transferred to financing accounts; loans receivable arising from defaulted post-1991 guaranteed loans; and loans receivable arising from defaulted pre-1992 guaranteed loans that were modified and transferred to financing accounts.

[58]For interest on pre-1992 direct loans, see the preceding section on "interest (unless classified elsewhere) . . ."

Interest on direct loans that are budgeted according to the provisions of the Federal Credit Reform Act of 1990 consists of two components: the nominal interest (the stated interest rate times the nominal principal) and the amortized interest (change in present value of the loans receivable due to the passage of time). The combined effect of these components equals the effective interest, which is directly defined as the present value of the loans receivable times the Treasury interest rate applicable to the particular loans (i.e., the interest rate used to calculate the present value of the direct loans when the direct loans were disbursed). The effective interest causes an equal increase in the aggregate value of the assets on the balance sheet, and therefore the effective interest is the amount recognized as exchange revenue.[59]

281. Interest on delinquent taxes and other receivables that arise as the result of custodial operations.—Receivables that arise as the result of custodial operations are custodial (or non-entity) assets, held by the IRS or another entity as an agent for the Government as a whole rather than on its own behalf (e.g., IRS tax receivables on which the delinquent taxpayer must pay interest). The interest is an exchange revenue, because each party receives and sacrifices something of value, but it is not related to the costs incurred by the collecting entity. The interest is accounted for as a custodial activity by the collecting entity. If transferred to the General Fund, the interest is recognized as exchange revenue in the Government-wide consolidated financial statements because it is related to the government's cost of borrowing; if transferred to another entity, it is recognized as nonexchange revenue by the entity that receives the transfer.

282. Regulatory user fees such as patent and copyright fees; immigration and consular fees; SEC registration and filing fees; and Nuclear Regulatory Commission fees.—Regulatory user fees are charges based on the Government's power to regulate particular businesses or activities. The revenue is related to the cost in one of two ways. Special benefits may be provided to identifiable recipients who pay the fees, beyond the benefits, if any, that accrue to the general public (e.g., passport fees); or the Government may incur costs in order to regulate an identifiable entity for the benefit of the general public or some other group, in which case the user charge compensates the

[59]See SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees, paragraphs 30-31 and 37; for an illustrative case study, also see Appendix B.

Government for its regulatory costs that were caused by the activity of the party that pays the charge (e.g., SEC and Nuclear Regulatory Commission fees). Because in general the revenue is closely related to the cost of operations, these fees are classified as exchange transactions and the revenue is an exchange revenue of the entity that charges the fee.

283. Diversion fees, Department of Justice.—Registrants in the Diversion Control Program (e.g., physicians) pay fees to the Drug Enforcement Administration, in exchange for which the DEA provides the registrants with the authority to prescribe controlled substances. The diversion fees are intended to cover the costs of the Diversion Control Program. Because the revenue is related to the cost and the registrants both receive and sacrifice value, the payment of these fees is an exchange revenue of the Diversion Control Program.

284. Premiums for SMI (Supplementary Medical Insurance), bank deposit insurance, pension benefit guarantees, crop insurance, life insurance, and other insurance.—In exchange for a premium and other considerations, the Government promises to make payments to program participants if specified events occur. The premium offsets the cost of the program in whole or in part. The degree to which participation is voluntary differs from program to program. Because the revenue is related to the cost of the providing service, it is an exchange revenue of the insurance program.

285. Federal employee contributions to pension and other retirement benefit plans.[60]—Employees of the Federal Government provide service to their employer in exchange for compensation, of which some is received currently (the salary) and some is deferred (pensions, retirement health benefits, and other retirement benefits). This is an exchange transaction, because each party sacrifices value and receives value in return. As part of this exchange transaction, the Government promises a pension to its employees after they retire. The Government also promises other retirement benefits, notably health benefits. In return, the employee provides services and, under some plans, makes a contribution to the retirement fund out of his or her

[60]Federal employee retirement plans do not include social insurance, such as Social Security and Medicare.

salary. The financing of these benefits may include contributions paid by the employee to the retirement fund.

286. In broad terms, the employee contribution is an inflow of resources to the retirement fund as part of this exchange transaction. More narrowly, it is a payment by the employee as part of an exchange of money and services for a future pension or other retirement benefit. Therefore, it is an exchange revenue of the entity that administers the retirement plan and thus is an offset to that entity's gross cost in calculating its net cost of operations.[61]

287. Federal employee contributions to health benefits plan for current coverage.—Employees of the Federal Government provide services to their employer in exchange for compensation, of which some is received currently in the form of money (the salary); some is received currently in the form of payments to a third party (the employer entity contribution to the medical insurance plan for current coverage of its employees); and some is deferred (pensions and other retirement benefits). This is an exchange transaction, because each party sacrifices value and receives value in return. As part of this exchange transaction, the Government and its employees both contribute to a medical insurance plan that provides current coverage of the employees.

288. In broad terms, the employee contribution out of his or her salary is an inflow of resources to the health benefits plan as part of this exchange transaction. More narrowly, it is a payment in exchange for current coverage by a health benefits plan. Therefore, it is an exchange revenue of the entity that administers the health benefits plan and thus is an offset to that entity's gross cost in calculating its net cost of operations.

289. Reimbursement for collecting revenue.—The Customs Service collects duties on goods imported by Puerto Rico and the Virgin Islands. The Customs Service retains an amount equal to the estimated cost of collecting these duties, including all costs of operations in Puerto Rico

[61]For further discussion of the accounting standards for pensions and other retirement benefits of Federal employees, see SFFAS No. 5, Accounting for Liabilities of the Federal Government, para. 56-93 and 148-181. The standards do not cover accounting for the plan per se as distinct from the administering entity. Nor do they cover defined contribution plans, or administrative entities that are not Federal reporting entities.

and the Virgin Islands and an allocation of overhead; it transfers the remainder to the Treasury, which, in turn, transfers the collections to Puerto Rico or the Virgin Islands.

290. The total amount of duties collected on these goods should be accounted for as a custodial activity by the Customs Service. Notwithstanding that duties are a nonexchange revenue, these particular duties are a nonexchange revenue of an entity other than the United States and therefore are not recognized as a nonexchange revenue of the U.S. Government.

291. The method of disposing of these collections combines two distinct transactions into one. The entire amount of the duties could be transferred to Puerto Rico and the Virgin Islands, and these governments could then pay the Customs Service to reimburse it for its services of collecting duties. The payment to Customs would be exchange revenue of the Customs Service. The actual procedure for reimbursement, whereby Customs retains an amount equal to the estimated cost, is simpler but equivalent in substance. Hence, the custodial transfer to Treasury (for Puerto Rico and the Virgin Islands) and the amount retained by Customs should be shown as separate components of the disposition of the revenue from customs duties. The amount retained by Customs to reimburse itself for its costs is exchange revenue of the Customs Service and is offset against its gross cost in calculating its net cost of operations.

292. Reimbursement for cleanup costs.—The Coast Guard or other Federal entities may incur costs to clean up environmental hazards caused by private parties and, in some cases, require these private parties to reimburse it for the costs incurred. Notwithstanding that the Government demands the revenue under its power to compel payment, the revenue arises from the action of the private parties and is closely related to the cost of operations incurred as a result of that action. Therefore, the revenue is an exchange revenue of the entity that incurs the cost.

Exchange transactions with the public: gains and losses

293. **Note:** As explained in the introduction to this appendix, transactions that are classified as producing gains or losses should instead be classified as producing revenue or expense if they are usual and recurring for a particular reporting entity.

294. Sales of Government assets: other than property, plant, and equipment and forfeited and foreclosed property.—The sale of Government assets (other than property, plant, and equipment and forfeited and foreclosed property) is an exchange transaction, because each party receives and sacrifices something of value. If the sales price equals book value, there is no gain or loss, because a cash inflow equal to book value is the exchange of one asset for another of equal recorded value and therefore not a net inflow of resources. If the sales price is more or less than the book value of the property, a gain or loss, respectively, is recognized to the extent of the difference. The amount of the difference between sales price and book value is ordinarily a gain or loss rather than a revenue or expense, because sales of property are ordinarily an unusual or nonrecurring inflow of resources.

295. Sales of property, plant, and equipment.— The transaction is an exchange transaction, because each party receives and sacrifices something of value. If the sales price[62] equals book value, there is no gain or loss, because a cash inflow equal to book value is the exchange of one asset for another of equal recorded value and therefore not a net inflow of resources. If the sales price is more or less than book value, a gain or loss, respectively, is recognized to the extent of the difference. The amount of the difference is ordinarily a gain or loss rather than a revenue or an expense, because sales of property, plant, and equipment are ordinarily an unusual or nonrecurring inflow of resources.

296. The entire sales price is a gain if the book value of the asset is zero. The book value is zero (a) if the asset is general property, plant, and equipment (PP&E) that is fully depreciated or written-off or (b) if the asset is stewardship PP&E, for which the entire cost is expensed when the asset is purchased.[63]

[62]The sales price may include the fair value of items received in exchange.

[63]SFFAS No. 6, Accounting for Property, Plant, and Equipment, has divided property, plant, and equipment (PP&E) into two basic categories: general PP&E and stewardship PP&E (which consists of federal mission PP&E, heritage assets, and stewardship land). General PP&E is capitalized and recognized on the balance sheet; stewardship PP&E is expensed and thus has no book value. (Stewardship PP&E is presented in a stewardship statement.)

297. Acquisition of property, plant, and equipment through exchange.—The cost of property, plant, and equipment (PP&E) acquired through an exchange of assets with the public is the fair value of the PP&E surrendered at the time of exchange. If the fair value of the PP&E acquired is more readily determinable than that of the PP&E surrendered, the cost is the fair value of the PP&E acquired. If neither fair value is determinable, the cost of the PP&E acquired is the cost recorded for the PP&E surrendered net of any accumulated depreciation or amortization. In the event that cash consideration is included in the exchange, the cost of PP&E acquired is increased (or decreased) by the amount of the cash surrendered (or received).

298. Any difference between the cost of the PP&E acquired and the book value of the PP&E surrendered is recognized as a gain or loss.[64] It is a gain or loss rather than a revenue or expense, because ordinarily the amount would be an unusual or nonrecurring inflow of resources.

299. If the fair value of the PP&E acquired is less than the fair value of the PP&E surrendered, the PP&E acquired is recognized at its cost and subsequently reduced to its fair value. The difference between the cost of the PP&E acquired and its fair value is recognized as a loss.[65]

300. Sales of foreclosed property: associated with pre-1992 direct loans and loan guarantees.—Foreclosed property associated with pre-1992 direct loans and loan guarantees is recognized as an asset at net realizable value. The sale is an exchange transaction, and any difference between the sales proceeds and book value is recognized as a gain or loss.[66]

301. Sales of receivables: except direct loans.—The transaction is an exchange transaction, because each party receives and sacrifices something of value. Upon sale, any difference between the sales proceeds and book value is recognized as a gain or loss. If the sales price equals book value, there is no gain or loss, because the exchange of one asset for another of equal value is not a net inflow of resources.

[64]See SFFAS No. 6, Accounting for Property, Plant, and Equipment, para. 32.

[65]Ibid., footnote 38.

[66]See SFFAS No. 3, Accounting for Inventory and Related Property, para. 79-91.

302. Sales of direct loans.—The sale of a direct loan is a modification according to the Federal Credit Reform Act of 1990, regardless of whether the loan being sold was obligated after FY 1991 or before FY 1992. The book value loss (or gain) on a sale of direct loans equals the book value of the loans sold (prior to sale) minus the net proceeds of the sale. It normally differs from the cost of modification, which is recognized as an expense.[67] Any difference between the book value loss (or gain) and the cost of modification is recognized as a gain or loss.[68]

303. Retirement of debt securities prior to maturity.—Debt securities may be retired prior to maturity if they have a call feature or if they are eligible for redemption by the holder on demand. Many Treasury bonds issued before 1985 are callable; savings bonds, the Government account series, the foreign series, and the state and local series of Treasury securities are redeemable on demand, although sometimes with a penalty or other adjustment or only after a specified period of time.

304. Each party receives and sacrifices something of value in buying and selling debt securities that may be retired prior to maturity. The sales price reflects such features. Therefore, the transaction is an exchange transaction. The difference, if any, between the reacquisition price and the net carrying value of the extinguished debt is recognized as a loss or gain.[69]

Other financing sources from the public

305. Seigniorage.—Seigniorage is the face value of newly minted coins less the cost of production (which includes the cost of the metal, manufacturing, and transportation). It results from the sovereign power of the Government to directly create money and, although not an inflow of resources from the public, does increase the Government's net position in the same manner as an inflow of

[67]This difference is due to the different interest rates used to discount future cash flows for calculating the subsidy cost (and subsidy allowance) when the loan is made and for calculating the cost of modification at a later time. If the sale is with recourse, the present value of the estimated loss from the recourse is also recognized as an expense.

[68]See SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees, para. 53-55 and Appendix B, Part II(B).

[69]SFFAS No. 5, Accounting for Liabilities of the Federal Government, para. 54.

resources. Because it is not demanded, earned, or donated, it is an other financing source rather than revenue. It should be recognized as an other financing source when coins are delivered to the Federal Reserve Banks in return for deposits.

Intragovernmental Transactions

Nonexchange transactions—intragovernmental: revenue

306. Interest on Treasury securities held by trust funds and special funds (except trust revolving funds).—Many trust funds and special funds hold Treasury securities on which they receive interest. In most cases the invested balances of these funds derive predominantly from the funds' earmarked taxes, which are nonexchange transactions with the public (e.g., employment taxes and gasoline taxes), and to a lesser extent from other financing sources received from other government entities (e.g., the General Fund payment appropriated to the Supplementary Medical Insurance fund). The balances are not earned in exchange transactions by the entity's operations. Most fundamentally, they are not produced by operations in which the entity incurs a cost.

307. Therefore, in such cases, the interest on Treasury securities should not be deducted from the gross costs of the trust fund (or special fund), or the organization in which it is administered, in determining its net cost of operations. As a result, that interest should not be classified as exchange revenue. It should instead have the same classification as the predominant source of the invested balances, which for most trust funds (and special funds) is nonexchange revenue. The interest received from invested balances of trust funds and special funds (except trust revolving funds) is therefore normally a nonexchange revenue.

308. The source of balances for some trust funds and special funds may not be predominantly nonexchange revenue. For example, the main source of balances for two major trust funds, the Civil Service Retirement and Disability fund and the Military Retirement fund, consists of exchange revenue and other financing sources. In such exceptional cases, as explained in the Basis for Conclusions, the interest should be classified in the same way as the predominant

source of balances—in these cases, as exchange revenue—rather than according to the normal rule.

309. Interest received by one fund from another.—One fund within the Government may borrow from another. For example, in 1983 the Old-Age and Survivors Insurance trust fund borrowed from the Disability Insurance and Hospital Insurance trust funds. When that occurs, the lending fund sacrifices interest from Treasury securities on its invested balances and instead receives interest from the borrowing fund on the amount of the loan. Since the predominant source of balances to the lending fund is the same regardless of whether it invests in Treasury securities or lends to another fund, the interest received from the other fund should be classified in the same way—as nonexchange or exchange revenue—as the interest received on Treasury securities.

310. Employer entity contributions to social insurance programs.[70]—Federal employees may be covered by social insurance programs such as Social Security[71] and Medicare under the same terms and conditions as the rest of the covered population. Intragovernmental contributions to social insurance programs such as Social Security and Medicare are nonexchange transactions, just as payments made by private employers to these programs are nonexchange transactions. Contributions by private employers are in the nature of taxes; i.e., compulsory payments demanded by the Government through the exercise of its power to compel payment. Insofar as the social insurance program applies to Federal employees, the terms and conditions are generally the same as the program for private employees. The employer and employee contributions are generally calculated in the same way; the employer entity contribution is not earned by the social insurance program; and the benefits are generally calculated in the same way. The employee does not obtain particular benefits under the plan from rendering service in Federal employment, because he or she would have been similarly covered by the program if privately employed and would have received similar benefits. For these reasons, the employer entity contribution should have the same

[70]"Social insurance" does not include programs established solely or primarily for Federal employees, such as pension and other retirement plans.

[71]Most Federal civilian employees hired before 1984 are not covered by Social Security.

classification as private employer contributions, which is nonexchange revenue.

Nonexchange transactions—intragovernmental: gains and losses

311. Retirement of debt securities prior to maturity: trust funds and special funds (except trust revolving funds).—Treasury securities held by trust funds and special funds are primarily issued in the Government account series, which can generally be redeemed on demand. Other Treasury securities held by these funds may also be callable or redeemable on demand. If these debt securities are retired before maturity, the difference, if any, between the reacquisition price and the net carrying value of the extinguished debt should be recognized as a gain or loss by the fund that owned the securities. The gain or loss should be accounted for as a nonexchange gain or loss if the interest on the associated debt securities is classified as nonexchange revenue, and it should be accounted for as an exchange gain or loss if the interest on the associated debt securities is classified as exchange revenue. For trust funds (except trust revolving funds) and special funds, as explained elsewhere, the interest is normally but not always a nonexchange revenue.

312. The difference, if any, between the reacquisition price and the net carrying value of the extinguished debt should be recognized as a loss or gain in accounting for interest on Treasury debt. The amount should be equal in absolute value but with the opposite sign to the gain or loss recognized by the trust fund or special fund. The amount should be recognized as a gain or loss from exchange in order to offset it against the gross interest on Treasury debt in the Government-wide consolidated financial statements.

313. Cancellation of debt.—The debt that an entity owes Treasury (or other agency) may be canceled by Act of Congress. The amount of debt that is canceled (including the amount of capitalized interest that is canceled, if any) is a gain to the entity whose debt is canceled and a loss to Treasury (or other agency). The purpose of borrowing authority is generally to provide an entity with capital rather than to finance its operations. Therefore, the cancellation of debt is not earned by the entity's operations and is not directly related to the entity's costs of providing goods and services. As a result, the cancellation is a nonexchange gain to the entity that owed the debt and a nonexchange loss to the lender.

Exchange transactions—intragovernmental: revenue

314. Intragovernmental sales of goods and services by a revolving fund.—The cost of providing goods or services by a revolving fund is defrayed in whole or in part by selling the goods or services provided. Intragovernmental sales may be made by an organization that maintains either an intragovernmental revolving fund (such as the Defense Business Operations Fund) or a public enterprise revolving fund (such as the Postal Service). Each party receives and sacrifices something of value. The proceeds are an exchange revenue.

315. Intragovernmental sales of goods and services by a fund other than a revolving fund.—The cost of providing goods or services is defrayed in whole or in part by selling the goods or services provided. Each party receives and sacrifices something of value. The proceeds are an exchange revenue.

316. Employer entity contributions to pension and other retirement benefit plans for Federal employees.—Employees of the Federal Government provide service to their employer in exchange for compensation, of which some is received currently (the salary); and some is deferred (pensions, retirement health benefits, and other retirement benefits). This is an exchange transaction, because each party sacrifices value and receives value in return. As part of this transaction, the Government promises a pension and other retirement benefits (especially health benefits) to the employees after they retire. The financing of these benefits may include contributions paid by the employer entity to the retirement fund.

317. In broad terms, the employer entity contribution is an inflow of resources to the retirement fund as part of this exchange transaction. More narrowly, it is a payment by the employer entity in exchange for the future provision of a pension or other retirement benefit to its employees. Therefore, it is an exchange revenue of the entity that administers the retirement plan and thus is an offset to that entity's gross cost in calculating its net cost of operations.[72]

[72]For further discussion of the accounting standards for pensions and other retirement benefits for federal employees, see SFFAS No. 5, Accounting for Liabilities of the Federal Government, para. 56-93 and 148-181. The standards do not cover accounting for the plan per se as distinct from the administering entity. Nor do they cover defined contribution plans, or administrative entities that are not Federal reporting entities.

318. Employer entity contributions to health benefit plans for current coverage of Federal employees.—Employees of the Federal Government provide services to their employer in exchange for compensation, of which some is received currently in the form of money (the salary); some is received currently in the form of payments to a third party (the employer entity contribution to the medical insurance plan for current coverage of the employees); and some is deferred (pensions and other retirement benefits). This is an exchange transaction, because each party sacrifices value and receives value in return. As part of this exchange transaction, the Government and its employees both contribute to a medical insurance plan that provides current coverage of its employees.

319. In broad terms, the employer entity contribution is an inflow of resources to the health benefits plan as part of this exchange transaction. More narrowly, it is a payment in exchange for current coverage of the employer entity's employees by a health benefits plan. Therefore, it is an exchange revenue of the entity that operates the health benefits plan and thus is an offset to that entity's gross cost in determining its net cost of operations.

320. Employer entity payments for unemployment benefits and workers compensation.—The employer entity recognizes a liability and an expense for Federal employees who are laid-off or injured on the job and are entitled under law to unemployment benefits or workers compensation, respectively.[73] The payment to the former or current employee is made by the unemployment trust fund (Department of Labor) in the case of unemployment benefits and by the special benefits fund (Department of Labor) in the case of workers compensation. Unemployment benefits are reimbursed by the former employer entity; and workers compensation costs are mostly charged back to the employer entity.

321. Since the costs are recognized by the employer entity and its payment to the unemployment trust fund or the special benefits fund reimburses these funds for the costs they incur, the amounts these funds receive from the employer entity are exchange revenues.

[73]See SFFAS No. 5, Accounting for Liabilities of the Federal Government, para. 96 and para. 181, footnote 70.

322. Interest on Treasury securities held by revolving funds.—A revolving fund conducts a cycle of business-type operations in which the expenses are incurred to produce goods and services that generate revenue, and the revenue, in turn, finances expenses. Revolving funds need capital in their operations and may invest some of that capital in Treasury securities. Since their holding of invested balances and the sale of goods and services are both integral to the funds' operations, the interest on the funds' securities is related to the funds' cost of operations just as is the revenue earned from selling goods and services. Furthermore, the source of the invested balances is predominantly revenue earned from their sales of goods and services, for which the funds incurred costs of operations when that revenue was earned. The interest they receive should therefore be classified in the same way as their revenue earned from selling goods and services and should likewise be deducted from gross cost in determining the net cost of operations. For this reason, interest earned by revolving funds should normally be classified as exchange revenue.

323. The source of balances for some revolving funds may not be predominantly exchange revenue. For such exceptions, as explained in the Basis for Conclusions, the interest should be classified in the same way as the predominant source of balances rather than according to the normal rule.

324. Interest on Treasury securities held by trust revolving funds.—A trust revolving fund is a revolving fund that is also classified by law as a trust fund. Like other revolving funds, it earns exchange revenue, which is an offset to its gross cost. For example, the revenue that the Employees Health Benefit fund earns from contributions by Federal employees, annuitants, employer entities, and the Office of Personnel Management (OPM) is an offset to the insurance premiums that it pays to private firms. Trust revolving funds need capital in their operations, just like other revolving funds, the source of which is predominantly the revenue they have earned. When some of their capital is invested in Treasury securities, the interest is related to their cost of operations in the same way as the revenue earned from selling services. Furthermore, the source of the invested balances is predominantly revenue earned from the sales of services, for which they incurred costs of operations when the revenue was earned. The interest they receive should therefore be classified in the same way as the interest received by other revolving funds, which is exchange revenue.

325. The source of balances for some trust revolving funds may not be predominantly exchange revenue. For such exceptions, as explained in the Basis for Conclusions, the interest should be classified in the same way as the predominant source of balances rather than according to the normal rule.

326. Interest on uninvested funds received by direct loan and guaranteed loan financing accounts.—A guaranteed loan financing account holds uninvested balances as reserves against its loan guarantee liabilities and earns interest on these balances that adds to its resources to pay these liabilities. A direct loan financing account may hold uninvested balances to bridge transactions that are integral to its operations, such as when it borrows from Treasury to disburse direct loans prior to the time of disbursement; it earns interest on these balances to reflect the time value of money and thereby finance the interest it pays on its debt to Treasury. Thus, in both cases, the interest received by the financing account is earned through exchange transactions with Treasury and is an offset to the financing account's related costs of operations. The interest is therefore an exchange revenue of the financing account.

327. Interest received by Treasury.—Accounts or funds (including direct loan and guaranteed loan financing accounts) may be authorized to borrow from the Treasury or from the Federal Financing Bank (an entity within Treasury) or other sources. The interest that the entity pays on its borrowings is a cost to the entity and an inflow of resources to the Treasury. The Treasury may be deemed to have borrowed from the public to finance the outlays for which the entity borrowed, and thus to have incurred a corresponding interest cost of its own. The interest received by Treasury from the entity is therefore related to Treasury's cost of borrowing from the public and should be classified as an exchange revenue.

Exchange transactions—intragovernmental: gains and losses

328. **Note:** As explained in the introduction to this appendix, transactions that are classified as producing gains or losses should instead be classified as producing revenue or expense if they are usual and recurring for a particular reporting entity.

329. Retirement of debt securities prior to maturity: revolving funds and trust revolving funds.—Treasury securities held by revolving funds and trust revolving funds are primarily issued in the Government account series, which can generally be redeemed on demand. Other Treasury securities held by these funds may also be callable or

redeemable on demand. If these debt securities are retired before maturity, the difference, if any, between the reacquisition price and the net carrying value of the extinguished debt should be recognized as a gain or loss by the fund that owned the securities. The gain or loss should be accounted for as a nonexchange gain or loss if the interest on the associated debt securities is classified as nonexchange revenue, and it should be accounted for as an exchange gain or loss if the interest on the associated debt securities is classified as exchange revenue. For revolving funds and trust revolving funds, as explained elsewhere, the interest is normally but not always an exchange revenue.

330. The difference, if any, between the reacquisition price and the net carrying value of the extinguished debt should be recognized as a loss or gain in accounting for interest on Treasury debt. The amount should be equal in absolute value but with the opposite sign to the gain or loss recognized by the revolving fund or trust revolving fund. The amount should be recognized as a gain or loss from exchange in order to offset it against the gross interest on Treasury debt in the Government-wide consolidated financial statements.

Other financing sources—intragovernmental

331. Appropriations.—Appropriations—a form of budget authority—permit an entity to incur obligations and make payments and thus are a means of financing the entity's cost. They are not otherwise related to the entity's cost and therefore are not an offset to its gross cost in determining its net cost of operations. They are not earned by the entity's activities, demanded by the entity, or donated to the entity. Therefore, appropriations provide an other financing source instead of a revenue.

332. More precisely, "appropriations used" is recognized as an other financing source in determining the entity's operating results when the entity receives goods and services or provides benefits, grants, or other transfer payments. To avoid double counting, appropriations used are **not** recognized for the appropriation of earmarked revenues or other financing sources, which are already counted in determining the entity's operating results. Appropriations that have been made available for apportionment but have not been used are recognized as "unexpended appropriations" in the entity's capital.

333. Cost subsidies: difference between internal sales price (reimbursement) and full cost.—One entity may receive goods or

services from another entity without paying the full cost of the goods or services or without paying any cost at all. Other Federal accounting standards may require the receiving entity to recognize the full cost as an expense (or, if appropriate, as an asset). In these cases the difference between full cost and the internal sales price or reimbursement (sometimes called a "transfer price") is an imputed cost to the receiving entity.[74]

334. The financing of the imputed cost is also imputed to the receiving entity. Imputed financing is necessary so that the imputed cost does not reduce the entity's operating results and net position. The imputed financing equals the imputed cost and is recognized as an other financing source. It is not a revenue, because the receiving entity does not earn the amount imputed or demand its payment.

335. Cost subsidies: difference between the service cost of pensions (and other retirement benefits), less the employee contributions, if any, and the employer entity contributions.—The service cost of pensions (and other retirement benefits) to the employer entity, less the employee contributions, if any, is recognized as a cost to the employer entity. The difference between the employer entity's cost and its contributions, if any, is imputed to the employer entity as part of its recognized cost. For pensions, the cost recognized by the employer entity is more than its contribution for employees who are covered by the Civil Service Retirement System and several minor systems (in a few of which the employer entity does not make any contributions toward the service cost). For retirement health care benefits, neither the employees nor the employer entity make any contributions while the employee is working.[75] Therefore, the entire service cost is recognized as a cost to the employer entity and imputed to it.

336. The financing of the imputed cost is also imputed to the employer entity.[76] The imputed financing is necessary so that the imputed cost

[74]See SFFAS No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, para. 105-115.

[75]Retired employees do pay premiums, however, and the service cost to the employer entity is defined net of the actuarial present value of those future premiums.

[76]The employer entity's own contribution, if any, is generally financed by an appropriation but could be financed by earned revenue or other sources.

does not reduce the employer entity's operating results and net position. The imputed financing equals the imputed cost and is recognized as an other financing source. It is not a revenue, because the employer entity does not earn the amount imputed or demand its payment.[77]

337. (This transaction differs from the immediately preceding transaction, in which an entity does not pay the full cost of the goods or services it receives from another entity. In the present case, the employer entity acquires the services of the employees itself, but another entity pays part of their cost.)

338. Contribution by the General Fund to the SMI trust fund.—The General Fund makes a contribution to the SMI (Supplementary Medical Insurance) trust fund. This appropriated payment is separate from the transfer of earmarked premiums and is not a transfer of earmarked taxes or other income. It does not arise from an exchange transaction, because SMI does not sacrifice any value to the General Fund in exchange for the payment, and the General Fund does not receive anything of value from SMI. Instead, the payment constitutes a General Fund subsidy of the SMI trust fund. Since the payment is not demanded or earned, it is an other financing source to SMI rather than a revenue.

339. Examples of other payments of a similar nature (and also classified as other financing sources) are the payment by the General Fund to the social security trust funds for military service credits and for certain uninsured persons at least 72 years old; and the payment by the General Fund to the Railroad Retirement Board for the vested dual benefit payments received by certain retirees under both the railroad retirement and the social security systems. The quinquennial military service credit adjustment paid between the General Fund and the social security trust funds is likewise an other financing source to the social security trust funds but one that may be either positive or negative.

[77]For further discussion of the accounting standards for pensions and other retirement benefits for federal employees, see SFFAS No. 5, Accounting for Liabilities of the Federal Government, para. 56-93 and 148-181. The standards do not cover accounting for the plan per se as distinct from the administering entity. Nor do they cover defined contribution plans, or administrative entities that are not Federal reporting entities.

340. Transfer by CCC to Federal Crop Insurance Corporation.—The Commodity Credit Corporation (CCC) makes transfers to the Federal Crop Insurance Corporation (FCIC), which it finances by an appropriation. This payment does not arise from an exchange transaction, because FCIC does not sacrifice anything of value to CCC, and CCC does not receive anything of value from FCIC. It differs from the contribution to SMI primarily in that it is paid by another program entity (the CCC) rather than directly by the General Fund. Since the payment is not demanded or earned, it is an other financing source to FCIC rather than a revenue.

341. Interchange between the Railroad Retirement Board and the Social Security and Hospital Insurance trust funds.—The Railroad Retirement Board pays benefits equivalent to the amounts that would have been paid if railroad workers had been covered under Social Security since its inception, plus additional amounts unique to that program. The railroad retirement program is partly financed by an annual financial interchange that takes place between the Railroad Social Security Equivalent Benefit Account (a trust fund) and the trust funds for old-age and survivors insurance, disability insurance, and hospital insurance (OASDHI). The interchange is designed to place each of the OASDHI trust funds in the same position as it would have been if railroad employment had been covered under Social Security since its inception.

342. The amount of the payment reflects the difference between (a) the benefits that the OASDHI trust funds would have paid to railroad workers and their families if railroad employment had been covered by OASDHI and (b) the payroll taxes that the OASDHI trust funds would have received if railroad employment had been covered by OASDHI. If benefits would have exceeded taxes, the OASDHI trust funds make a payment to the Railroad Social Security Equivalent Benefit Account; if benefits would have been less, the OASDHI trust funds receive a payment. Currently OASI and DI make payments to that Account, and HI receives payment. The interchange differs from the examples in the previous cases primarily in that (a) the payment is between two trust funds and (b) the payment may be made in either direction.

343. The financial interchange does not arise from an exchange transaction, because it is a reallocation of resources among funds, all of which are financed primarily from nonexchange revenue.

Furthermore, the nature of this reallocation is such that the transferring entity does not receive anything of value and the recipient entity does not sacrifice anything of value. Therefore, the recipient entity recognizes the transfer-in as an other financing source, and the transferring entity recognizes the transfer-out as a negative financing source.

344. Transfer of cash and other capitalized assets without reimbursement.—Cash and other capitalized assets may be transferred without reimbursement from one Government entity to another. Cash may include exchange revenue that is recognized by the transferring entity in determining its net cost of operations but is required to be transferred to the General Fund or another entity; other capitalized assets may include general property, plant, and equipment. The receiving entity does not sacrifice anything of value, and the transferring entity does not acquire anything of value. Therefore, the transfer is not an exchange transaction. The receiving entity recognizes the transfer-in as an other financing source; the transferring entity recognizes the transfer-out as a negative financing source. The amount recorded by both entities is the transferring entity's book value of the asset.

345. Transfer of property, plant, and equipment without reimbursement: types that are expensed.—Property, plant, and equipment (PP&E) of types that are expensed (i.e., stewardship PP&E) may be transferred from one Government entity to another. If the asset was classified as stewardship PP&E in its entirety by both the transferring entity and the recipient entity, the transfer does not affect the net cost of operations or net position of either entity and therefore in such a case it is not a revenue, a gain or loss, or other financing source.

346. However, if the asset that is transferred was classified as general PP&E for the transferring entity but stewardship PP&E for the recipient entity, it is recognized as a transfer-out (a negative other financing source) of capitalized assets by the transferring entity.

Revaluations

347. Revaluation of capitalized property, plant, and equipment.—Capitalized property, plant, and equipment (PP&E) may be removed from the general PP&E accounts if it no longer provides service in the operations of the entity because it has suffered damage, become obsolete in advance of expectations, or is identified as excess. It is

recorded as an asset at its expected net realizable value. Any difference between the book value and the expected net realizable value is recognized as a gain or loss in determining the net cost of operations, because the revaluation results from the entity's operations. The expected net realizable value is adjusted at the end of each period, and any further revaluation is also recognized as a gain or loss in determining the net cost of operations.[78]

348. Since the revaluation does not affect obligations incurred but does affect net cost, an amount equal to the revaluation is recognized in determining the reconciliation between obligations incurred and net cost of operations. A reconciliation is not needed in determining the change in net position, because the revaluation affects net cost and net position equally.

349. Revaluation of inventory and related property.—Inventory and related property may be revalued for such reasons as determination that the property is excess, obsolete, or unserviceable; that stockpile materials have decayed or been damaged; that a loss is estimated on commodity purchase agreements; or that a change has occurred in the net realizable value of commodities valued at the lower of cost or net realizable value. The amount of revaluation is recognized as a loss or a gain in determining the net cost of operations, because it results from the entity's operations. Assets are correspondingly reduced or increased.[79]

350. Since the revaluation does not affect obligations incurred, but does affect net cost, an amount equal to the revaluation is recognized in determining the reconciliation between obligations incurred and net cost of operations. A reconciliation is not needed in determining the change in net position, because the revaluation affects net cost and net position equally.

[78]SFFAS No. 6, Accounting for Property, Plant, and Equipment, para. 39.

[79]See SFFAS No. 3, Accounting for Inventory and Related Property, para. 29-30, 47-48, 54, 97, and 107.

Transactions Not Recognized As Revenues, Gains, Or Other Financing Sources

351. Borrowing from the public.—Borrowing from the public is a means of financing the Government's outlays. However, it is not a net inflow of resources to the Treasury or other borrowing entity, because the asset received (cash) is offset by an equal liability (debt). Therefore, it is not revenue or an other financing source.

352. Borrowing from Treasury, the Federal Financing Bank, or other Government accounts.— An entity may be provided the authority to borrow from Treasury, the Federal Financing Bank, or other Government accounts. Intragovernmental borrowing is a means of financing the entity's outlays. However, it is not a net inflow of resources to the entity, because the asset received (cash) is offset by an equal liability (debt). Therefore, it is not revenue or an other financing source.

353. Disposition of revenue to other entities: custodial transfers.—Revenue, primarily nonexchange revenue, may be collected by an entity acting on behalf of the General Fund or another entity within the Government on whose behalf it was collected. The collecting entity accounts for the disposition of revenue as part of its custodial activity. These custodial transfers, by definition, do not affect the collecting entity's net cost of operations or operating results, nor are they part of the reconciliation between its obligations and net cost of operations. (The receiving entity recognizes the revenue as nonexchange or exchange revenue, depending on its nature, according to the applicable revenue standards.)

354. Sales of different types of Government assets.—The sale of Government assets (other than forfeited property) is an exchange transaction, because each party receives and sacrifices something of value. As a general rule, any difference between the sales proceeds and book value is recognized as a gain or loss when the asset is sold. The remainder of the transaction does not provide a net inflow of resources, so no gain, revenue, or other financing source is recognized. If the sales proceeds equal book value, there is no gain or loss, because the exchange of one asset for another of equal recorded value is not a net inflow of resources.

355. This general rule applies to property, plant, and equipment, receivables (other than direct loans), foreclosed property associated with pre-1992 direct loans and loan guarantees, and miscellaneous assets. It does not apply to inventory, nor does it apply to forfeited property (as explained

in the previous section on nonexchange revenue). It also does not apply to the sale of direct loans and the sale of foreclosed property associated with post-1991 direct loans and loan guarantees. The latter transactions are discussed in subsequent paragraphs.

356. Acquisition of property, plant, and equipment through exchange.—The cost of property, plant, and equipment (PP&E) acquired through an exchange of assets with the public is the fair value of the PP&E surrendered at the time of exchange. If the fair value of the PP&E acquired is more readily determinable than that of the PP&E surrendered, the cost is the fair value of the PP&E acquired. If neither fair value is determinable, the cost of the PP&E acquired is the cost recorded for the PP&E surrendered net of any accumulated depreciation or amortization. In the event that cash consideration is included in the exchange, the cost of PP&E acquired is increased (or decreased) by the amount of the cash surrendered (or received).[80]

357. Any difference between the cost of the PP&E acquired and the book value of the PP&E surrendered is recognized as a gain or loss. If the cost of the PP&E acquired equals the book value of the PP&E surrendered, there is no gain or loss (nor a revenue or other financing source), because the exchange of one asset for another of equal value does not provide a net inflow of resources. Therefore, the amount of the transaction equal to the book value of the PP&E surrendered is not recognized as a gain, a revenue, or an other financing source.

358. Transfer of property, plant, and equipment without reimbursement: types that are expensed.—Property, plant, and equipment (PP&E) of types that are expensed (i.e., stewardship PP&E) may be transferred from one Government entity to another. If the asset was classified as stewardship PP&E in its entirety by both the transferring entity and the recipient entity, the transfer does not affect the net cost of operations or net position of either entity and therefore in such a case it is not a revenue, a gain or loss, or other financing source.

359. However, if the asset that is transferred was classified as general PP&E for the transferring entity but stewardship PP&E for the recipient entity, it is recognized as a transfer-out (a negative other financing source) of capitalized assets by the transferring entity.

[80]See SFFAS No. 6, Accounting for Property, Plant, and Equipment, para. 32.

360. If multi-use heritage assets are transferred and some cost was recognized for them on the books of the transferring entity, that cost is recognized as a transfer-out (a negative other financing source) of capitalized assets. No amount is recognized by the entity that receives the asset.[81]

361. Donation of property, plant, and equipment: types that are expensed.—The acquisition cost of stewardship property, plant, and equipment (PP&E) is recognized as a cost when incurred. Such PP&E consists of Federal mission PP&E, heritage assets, and stewardship land. When such PP&E is donated to the Government, however, no amount is recognized as a cost.[82] Since the donation of such PP&E does not affect the net cost or net position of the recipient entity, it is not a revenue, a gain, or an other financing source.

362. Negative subsidies on post-1991 direct loans and loan guarantees.—A negative subsidy means that the direct loans or loan guarantees are estimated to make a profit, apart from administrative costs (which are excluded from the subsidy calculation by law). The amount of the subsidy cost is recognized as an expense when the direct loan or guaranteed loan is disbursed. A negative subsidy is recognized as a direct reduction in expense, not as a revenue, gain, or other financing source.[83]

363. Downward subsidy reestimates for post-1991 direct loans and loan guarantees.—A downward subsidy reestimate means that the subsidy cost of direct loans or loan guarantees is estimated to be less than had previously been estimated. The initial subsidy cost is recognized as an expense; a positive subsidy reestimate is recognized as an expense; and a downward subsidy reestimate is recognized as a direct reduction in expense, not as a revenue, gain, or other financing source.

364. Fees on post-1991 direct loans and loan guarantees.—The present value of estimated fees is included as an offset in calculating the

[81]SFFAS No. 6, Accounting for Property, Plant, and Equipment, para. 61 and 72.

[82]Ibid.

[83]For standards on direct loans and loan guarantees, see SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees. The accounting for negative subsidy costs is symmetrical to the accounting for positive subsidy costs.

subsidy cost of direct loans and loan guarantees, which is recognized as an expense when the loans are disbursed. The present value of estimated fees is likewise included as one component in calculating the value of loans receivable or loan guarantee liabilities. When cash is received in payment of fees, the loans receivable decrease by an equal amount (or the loan guarantee liabilities increase by an equal amount). The increase in one asset is offset by an equal decrease in another asset (or by an equal increase in liabilities). Therefore, fees are not recognized as a revenue, a gain, or an other financing source.[84]

365. Repayment of post-1991 direct loans.—The present value of estimated loan repayments is included in the calculation of the subsidy cost of direct loans, and this subsidy cost is recognized as an expense when the loans are disbursed. The present value of estimated loan repayments is likewise included in the value of the loans receivable. When cash is received for the repayment of loans, the loans receivable decrease by an equal amount. The increase in one asset is offset by an equal decrease in another asset. Therefore, cash inflow from the repayment is not recognized as a revenue, a gain, or an other financing source.[85]

366. Repayment of pre-1992 direct loans.—When pre-1992 direct loans are repaid in whole or in part, the entity exchanges one asset (loans receivable) for another (cash) with equal value. There is no net inflow of resources. Therefore, the amount of cash inflow equal to book value is not recognized as a revenue, a gain, or an other financing source.[86]

367. Repayment of receivables: except direct loans.—When receivables other than direct loans are paid or repaid in whole or in part, the entity exchanges one asset (loans receivable) for another (cash) with equal value. There is no net inflow of resources. Therefore, the amount of

[84]The fee component of the subsidy cost is required to be disclosed separately.

[85]If the actual repayment is different from the previous estimate, the present value of the difference between cash inflows and outflows over the term of the loan—calculated as of the date of disbursement—is reestimated and is recognized as a subsidy expense or a reduction in subsidy expense.

[86]If the loan is not repaid, the unpaid amount is recognized as an adjustment to the bad debt allowance and does not affect revenue, gains, or other financing sources.

cash inflow equal to book value is not recognized as a revenue, a gain, or an other financing source.[87]

368. Sales of direct loans.—The sale of a direct loan is a modification according to the Federal Credit Reform Act of 1990 regardless of whether the loan being sold was obligated after FY 1991 or before FY 1992. The book value loss (or gain) on a sale of direct loans equals the book value of the loans sold (prior to sale) minus the net proceeds of the sale. It normally differs from the cost of modification, which is recognized as an expense.[88] Any difference between the book value loss (or gain) and the cost of modification is recognized as a gain or loss.[89] The amount of cash inflow equal to book value is not a net inflow of resources to the entity, because it is an exchange of one asset for another of equal recorded value. Therefore, the amount of cash inflow equal to book value is not recognized as a revenue, a gain, or an other financing source.

369. Sales of foreclosed property: associated with post-1991 direct loans and loan guarantees.—The net present value of the cash flow from the estimated sales of foreclosed property is included in calculating the subsidy cost of post-1991 direct loans and loan guarantees. This subsidy cost is recognized as an expense when the loans are disbursed. When property is foreclosed, the property is recognized as an asset at the net present value of its estimated net cash flows. When the foreclosed property is sold, any difference between the sales proceeds and the book value (i.e., the net present value as of the time of sale) requires a reestimate of the subsidy expense, which is recognized as a subsidy expense or a reduction in subsidy expense. The amount of cash flow equal to book value is an exchange of one

[87]If the receivable is not repaid, the unpaid amount is recognized as an adjustment to the bad debt allowance and does not affect revenue, gains, or other financing sources.

[88]This difference is due to the different interest rates used to discount future cash flows for calculating the subsidy cost (and subsidy allowance) when the loan is disbursed and for calculating the cost of modification at a later time. If the sale is with recourse, the present value of the estimated loss from the recourse is also recognized as an expense.

[89]SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees, para. 53-55 and Appendix B, Part II(B).

asset for another of equal recorded value and therefore is not recognized as a gain, a revenue, or an other financing source.[90]

370. Deposit fund transactions.—Deposit funds are accounts outside the budget that record amounts that the Government (a) holds temporarily until ownership is determined or (b) holds as an agent for others. The standards and guidance in this Statement do not apply to deposit funds except insofar as a particular deposit fund may be classified as part of a Federal reporting entity or a disclosure may be required due to a fiduciary relationship on the part of a Federal reporting entity toward a deposit fund.

[90]See SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees, para. 57-60 and Appendix B, Part III(E); and SFFAS No. 3, Accounting for Inventory and Related Property, para. 79-91 and 154-158.

Appendix C: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273.

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Transfer of property, plant, and equipment without reimbursement: types that are expensed (677)
User fees, Harbor Maintenance trust fund (647)

List of Abbreviations

See Consolidated List of Acronyms in “Appendix F: Consolidated List of Abbreviations” on page 1327.

Statement of Federal Financial Accounting Standards No. 8: Supplementary Stewardship Reporting

Status

Issued	June 11, 1996
Effective Date	For fiscal years beginning after September 30, 1997 except for the consolidated financial report of the Federal Government (CFR). For the CFR: Chapters 2 through 7 are not effective until further action by the Board and its principals; Chapter 8, Current Services Assessments, is effective for fiscal years beginning after September 30, 1997.
Volume I References	• SFFAS No. 6, *Accounting for Property, Plant and Equipment* (for additional PP&E discussion and cleanup cost standards) • SFFAS No. 7, *Accounting for Revenue and Other Financing Sources* (for classifications of transactions involving asset transfers, donations, sales, and exchanges) • SFFAS No. 14, *Amendments to Deferred Maintenance Reporting* • SFFAS No. 16, *Amendments to Accounting for Property, Plant, and Equipment--Measurement and Reporting for Multiuse Heritage Assets* • SFFAS No. 17, *Accounting for Social Insurance* • SFFAS No. 23, *Eliminating the Category National Defense Property, Plant, and Equipment* • SFFAS No. 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*
Volume II References	Heritage Assets (H20), Human Capital (H60), Nonfederal Physical Property (N60), Research and Development (R20), Stewardship Land (S60), Stewardship Reporting (S70)
Interpretations and Technical Releases	None.
Affects	
Affected by	• SFFAS No. 14, paragraphs 10-11, replace phrases in SFFAS No. 8, paragraphs. 50, 68, and 81 and footnote 15. • SFFAS No. 16, paragraphs 6-15 replace paragraphs 48-49 in SFFAS No. 8; SFFAS No.16, paragraph 18 is added as a reporting requirement to paragraph 50 in SFFAS No. 8. • SFFAS No. 17 provides standards for accounting for social insurance. SFFAS No. 8, paragraphs 116-117 deferred consideration of social insurance. • SFFAS No. 23 affects SFFAS No. 8 by rescinding the prefatory box preceding paragraph 52 and paragraphs 52 through 70. • SFFAS No. 25, paragraph 5 rescinds chapter 8 and paragraphs 14-16 of SFFAS 8, and the associated Illustration of the Current Services Assessment in Appendix B of SFFAS No. 8.

Summary

This Statement establishes standards for reporting on the Federal Government's stewardship over 1) certain resources entrusted to it, identified as stewardship property, plant, and equipment and stewardship investments, and 2) certain responsibilities assumed by it, identified as the current service assessment. The resources and responsibilities do not meet the criteria for assets and liabilities that are required to be reported in the financial statements but are, nonetheless, important to an understanding of the operations and financial condition of the Federal Government at the date of the financial statements and in subsequent periods. Because the Government has been entrusted with, and made accountable for, these resources and responsibilities, they should be recognized in the financial reports of the Federal Government and of its component entities.

Stewardship resources are investments by the Federal Government for the benefit of the Nation. When made, they are treated as expenses in the financial statements. These expenses, however, are intended to provide long-term benefits to the public. Therefore, this Statement requires that information on these resources be reported to highlight their long-term-benefit nature and to demonstrate accountability over them. Depending on the nature of the resources, stewardship reporting could consist of financial and nonfinancial data.

This Statement also establishes a standard for reporting projections that will aid in assessing the sufficiency of future budgetary resources to sustain public services and meet obligations as they come due.

This Statement establishes reporting requirements based on the categories defined below:

a The purpose of this Statement is to establish standards for reporting on the Federal Government's stewardship over 1) certain resources entrusted to it, identified as stewardship property, plant, and equipment and stewardship investments, and 2) certain responsibilities assumed by it, identified as the current service assessment. The resources and responsibilities do not meet the criteria for assets and liabilities that are required to be reported in the financial statements but are, nonetheless, important to an understanding of the operations and financial condition of the Federal Government at the date of the financial statements and in subsequent periods. Because the Government has been entrusted with, and made accountable for, these resources and responsibilities, they should be recognized in the financial reports of the Federal Government and of its component entities. This determination was made to more fully satisfy the stewardship objective defined in the concepts statement, Objectives of Federal Financial Reporting.[1]

b The stewardship objective requires that the Federal Government "report on the broad outcomes of its actions." Such reporting will provide information that could help report users assess the impact of the Government's operations and activities for the period on its financial condition.[2]

[1] *Objectives of Federal Financial Reporting*, SFFAC No. 1, September 1993.

[2] Ibid., pp. 41-42.

c Stewardship resources involve substantial investment by the Federal Government for the benefit of the Nation. When made, they are treated as expenses in the financial statements. These expenses, however, are intended to provide long-term benefits to the public. Therefore, this Statement requires that information on these resources be reported to highlight their long-term-benefit nature and to demonstrate accountability over them. Depending on the nature of the resources, stewardship reporting could consist of financial and nonfinancial data.

d This Statement also establishes a standard for reporting projections that will aid in assessing the sufficiency of future budgetary resources to sustain public services and meet obligations as they come due.

e Given the above purpose, this Statement establishes standards for supplementary stewardship reporting that are on the basis of categories defined in the paragraphs that follow.

f Stewardship Property, Plant, and Equipment (PP&E) - property owned by the Federal Government and meeting the definition of one of the following three categories:

– Heritage Assets - property, plant, and equipment of historical, natural, cultural, educational, or artistic significance.

– Federal Mission PP&E - property, plant, and equipment integral to certain unique Federal missions.

– Stewardship Land - land other than that acquired for or in connection with general PP&E.

g Stewardship Investments - items treated as expenses in calculating net cost but meriting special treatment to highlight their substantial investment and long-term-benefit nature. This includes:

– Nonfederal Physical Property - grants provided for properties financed by the Federal Government, but owned by the state and local governments.

– Costs incurred for education and training programs that are designed to increase or maintain national economic productive capacity and research efforts to provide future benefits or returns. These include:

– Human Capital - education and training programs financed by the Federal Government for the benefit of the public.

– Research and Development - basic and applied research and development.

h Stewardship Responsibilities - the projected financial impact on the Government of sustaining current services that it provides. Projections of current services provided by the Government aid in assessing the

sufficiency of future budgetary resources to sustain public services and meet obligations as they come due. This assessment, termed a Current Services Assessment, provides receipt and outlay data on the basis of projections of future activities.

j All stewardship information is deemed "required supplemental stewardship information" (RSSI). Audit requirements for RSSI will be established in a collaborative effort by the Office of Management and Budget (OMB) and the General Accounting Office (GAO).

k The introduction and background chapter of this standard provides information on the approaches used to develop the standards for supplementary stewardship reporting. Appendices include a basis for the Board's conclusions, sample stewardship reports, and a glossary of terms used in the Statement. First-time use of glossary terms within the body of this document appear in boldface.

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Chapter 1: Introduction And Background

Purpose

1. The purpose of this Statement is to establish standards for reporting on the Federal Government's **stewardship** over certain resources entrusted to it, and certain responsibilities assumed by it. The resources and responsibilities relate to those which do not meet the criteria for assets and liabilities that are required to be reported in the financial statements but that are important to an understanding of the operations and financial condition of the Federal Government at the date of the financial statements and in subsequent periods. Costs of these stewardship-type resources are treated as **expenses** in the financial statements in the year the costs are incurred. However, these costs and resultant resources are intended to provide long-term benefits to the public and are included in stewardship reporting to highlight for the reader their long-term-benefit nature and to demonstrate accountability over them.

2. Specific descriptions of these stewardship-type resources are addressed later in this chapter and in the individual standards (chapters 2-7) in this Statement. Generally, stewardship reporting on these resources includes:

   - Information on investment in physical capital other than that used to support Federal operations to provide goods and services to the public, that is, investment in other than general property, plant, and equipment (PP&E).[3]
   - Information on investment in other than physical capital. Such information, as well as the information called for in the paragraph above, will be reported for stewardship purposes on an investment basis (that is, as benefitting more than the current reporting period) rather than a consumption basis (that is, benefitting only the current reporting period). Such a

[3]Physical assets supporting Federal operations to provide goods and services to the public, referred to as general property , plant and equipment (PP&E), are addressed in *Accounting for Property, Plant and Equipment*, SFFAS No. 8.

presentation could help users analyze all Federal investment on an equal basis, and make decisions among competing investments, such as when allocating Federal resources or deciding whether to authorize new programs or modify ongoing programs.

- Information that could assist in measuring the success of certain programs. The measurement of the benefits received for the dollars invested and the evaluation of program performance could appear with other stewardship information as part of the financial statements, or in other financial reports, for example, in a report on program performance.

3. This Statement also established standards for providing information on stewardship responsibilities (chapter 8) through projections for the Government as a whole. The projections will aid in assessing the Government's financial condition and the sufficiency of future budgetary resources to sustain public services and meet obligations as they come due.

4. Each standard is summarized briefly in a box followed by a detailed explanation of the standard. However, the standards comprise the summaries in the boxes and the entire text of the explanations.

Background And Rationale

5. The Concepts Statement, *Objectives of Federal Financial Reporting* was developed on the basis of an in-depth assessment of user needs and is used to guide the Board in developing Federal accounting and reporting standards. The objectives cover four areas: budgetary integrity, operating performance, stewardship, and systems and control.

6. This Statement of accounting standards addresses the objective of reporting on stewardship over certain resources entrusted to the Federal Government and responsibilities assumed by it. The need for a report on the Federal Government's stewardship over the resources entrusted to it and the responsibilities it has assumed, arises because of the unique nature of the Federal Government, as described in the following section.

Stewardship And The Reporting Objectives

7. "Financial position" is a representation of an entity's economic resources and the claims on those resources as of a particular date. In the private sector, the principal objective of reporting on financial position is to assess the viability of the entity, the business firm, and its potential profitability.

8. Assessing the overall performance of the Federal Government is not exclusively a matter of comparing revenue and expense, or its accumulated assets and liabilities.

9. The Federal Government's viability and perpetuity are assumed. It has unique access to financial resources and financing, and the power to tax, to borrow, and to create money. For the Federal Government, financial performance is a vital issue, but traditional financial measures provide data that are appropriate for assessing only some, not all, of the responsibilities for which the Government should be held accountable. Since it exists not to make a profit but to serve the needs of the citizens and to promote the general welfare of the Nation, other measures of accountability need to be used. Measures of accountability are to be reported for elements that are defined as stewardship property, plant, and equipment (PP&E); stewardship investments; and stewardship responsibilities. These elements of stewardship exist because the Federal Government is dissimilar to industrial and commercial entities.

Financial Condition

10. The measures of accountability mentioned above help to portray the Government's "financial condition." Financial condition is a broader and more forward-looking concept than is financial position. Financial condition allows an assessment of an entity on the basis of additional data that could include financial and nonfinancial information about current conditions. These additional data provide a more complete indication of performance. In some cases, it may be necessary to present and characterize financial data in ways that differ from traditional financial reporting and to supplement traditional data with nonfinancial data. In other cases, it may be necessary to rely almost entirely on nonfinancial data to provide a more complete presentation of entity performance. Moreover, assessment of financial condition

could include analysis of trends, demands, commitments, events, and uncertainties.[4]

Stewardship PP&E

11. "Stewardship PP&E" consists of items whose physical properties resemble those of general PP&E traditionally capitalized in financial statements. However, the nature of these Federal physical assets that are classified as stewardship PP&E differ from general PP&E in that their values may be indeterminable or may have little meaning (for example, museum collections, monuments, assets acquired in the formation of the nation) or that allocating the cost of such assets (for example, military weapons systems and space exploration hardware) [see SFFAS 11] to accounting periods that benefit from the ownership of such assets is meaningless. However, the Federal Government should be able to demonstrate accountability for stewardship PP&E by reporting on its existence and on its condition by a reference to deferred maintenance reported in the financial statements. Stewardship PP&E would include stewardship land (that is, land not acquired for or in connection with general property, plant, and equipment); heritage assets (for example, Federal monuments and memorials and historically or culturally significant property); and ... [National Defense] property, plant, and equipment (for example, ... military weapons systems. [See SFFAS 11].

Stewardship Investments

12. "Stewardship investments" are substantial investments made by the Federal Government for the benefit of the nation. When incurred, they are treated as expenses in determining the net costs of operations. However, these items merit special treatment so that readers of Government financial reports know the extent of these investments that are made for long-term benefit. Such investments will be measured in terms of expenses incurred for certain education and training programs; federally financed research and development; and federally financed but not federally owned property, such as bridges and roads.

13. Because the Government has been entrusted with and made accountable for these resources, they should be reported in the financial reports of the Government and of its component entities. This will help satisfy the stewardship objective defined in the concepts

[4]Chapter 7 of the *Objectives of Federal Financial Reporting* provides a full discussion of financial position and financial condition.

statement, *Objectives of Federal Financial Reporting*, SFFAC No. 1. The goal of the stewardship objective is that the Federal Government "report on the broad outcomes of its actions." Such reporting may provide information that could help report users assess the impact of the Government's operations and investments for the period.[5]

Stewardship Responsibilities

14. A key aspect of the stewardship objective requires that Federal reporting provide information that helps users determine (1) whether the Government's financial condition improved or deteriorated over the period and (2) whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due.[6]

15. Information on "stewardship responsibilities" will aid in these determinations. It will provide an essential perspective on the Government's commitment to discretionary and mandatory programs.

16. Reporting on this stewardship responsibility may be accomplished in a stewardship section in the consolidated financial report of the Federal Government. [See SFFAS 17]

Stewardship Categories Or Elements

17. In defining the specific categories of items, or elements, that would appear as stewardship information, the Board decided on the following:

    - Property owned by the Federal Government and meeting the definition of one of the following three categories:
        - Property, plant, and equipment of historical, natural, cultural, educational or artistic significance, referred to as heritage assets, for example, the Washington Monument and the Lincoln Memorial; ...[7]
        - ... [See SFFAS 14 for the explanation of deletion and change to "National defense PP&E"] and

[5]See SFFAC No. 1, pp. 41-42.

[6]Ibid., pp. 42-44.

[7]... [see SFFAS No. 14]

- Investments in stewardship land,[8] that is, land not acquired for or in connection with general property, plant, and equipment, for example, national forests, parks, and historic sites. Some investments in stewardship land, for example national parks, will be reported by both 1) the number of acres used as a park or an historic site in the stewardship land category, and 2) by the number of physical units identified as national parks in the heritage assets category. Such reporting would not be considered duplication, as the type of information reported on an item would be different for each category of stewardship asset.

- Properties financed by the Federal Government but owned by state and local governments, referred to as nonfederal physical property, for example, highways and bridges.
- Expenses that are incurred for education and training that are intended to increase national economic productive capacity or for research and development that are intended to provide future benefits or returns. This includes:
  - Investments in human capital, that is, education and training programs provided by the Federal Government, for example, job training programs, and grants for higher education.
  - Investments in research and development, for example, research on the effects of early medical intervention in delaying the onset of AIDs symptoms in HIV-positive individuals, and Federal investment in genetic code research to advance national medical research.
- Information on the projected financial impact on the Government of providing current services, assuming a continuation of current programs. This information will be in the form of a current services assessment providing future receipt and outlay data on the basis of projections of future activities for the Government as a whole and will include both discretionary and mandatory programs and interest on debt.

[8]The Board is including only surface land as supplementary stewardship information because the issues associated with other than surface land, i.e., the natural resources on and under that land, are complex. The Board is researching these complex issues and will publish a separate exposure draft on a proposed accounting standard for natural resources at a later date.

18. The previous categories of items or elements result from or exist largely because of the Federal Government's role as a sovereign power. The components that they include are defined and discussed in detail in their respective chapters of this standard.

The Nature of Stewardship Reporting

19. The Board, recognizing the Federal Government's size, complexity, diversity, and impact on others, has determined that the aforementioned information is needed in addition to that included in financial statements.

20. Such information may not link directly with the basic financial statements because the data to be reported may be other than financial, for example, physical units or projections. It will supplement the basic financial statements.

21. This information, as indicated in each of the standards, will be designated as required supplementary stewardship information (RSSI) for the consolidated financial statements of the Federal Government and of the entities who have stewardship responsibilities over resources identified earlier in this document. The Board has chosen to call this RSSI to distinguish it from "required supplementary information" (RSI), for which audit responsibilities are prescribed in existing professional literature. The Board believes that OMB and GAO should establish and cause the implementation of the audit responsibilities for RSSI.

Stewardship Information

22. Stewardship information may be presented in varying formats depending on the nature of the Federal investments or claims to Federal resources controlled by an entity. Such information is required for those entities (1) that control stewardship resources and (2) whose financial statements purport to be in accordance with Federal accounting principles as recommended by FASAB, and approved by the Secretary of the Treasury, the Director of OMB and the Comptroller General.

23. Examples of selected portions of stewardship report sections are included at Appendix B.

Measurement

24. The separate standards for each stewardship element contain specific guidance for that element. In general, however, stewardship

investments shall be measured on the same basis of accounting as used for financial statements, including appropriate accrual adjustments, general and administrative overhead, and a share of the cost of facilities (for example, depreciation).[9]

25. For investments that are intended to maintain or increase the economic productive capacity of the Nation, that is, investments in human capital, research and development, and nonfederal physical property, trend data shall be presented. Trend data should reflect the full cost (including allocation of facility and administrative costs) of the investment.

26. For stewardship land and heritage assets, measurement will be done on other than a financial basis. For example, measurement may be on the basis of physical units, such as acres of land. Specific data requirements are addressed in the individual stewardship standards.

27. Generally, amounts shall be reported in nominal dollars. If trend data that span many years are reported and the entity believes that constant dollar information would be meaningful for data interpretation, constant dollar data may be provided in addition to nominal dollar data.

28. **Split Grants.** Frequently, stewardship elements are financed by grants. In some cases, the grants may have more than one purpose.[10] For such grants, the investment shall be allocated among stewardship elements on the basis of an estimate of the proportionate funding of the various grant objectives. If allocation is not feasible, the investment shall be reported on the basis of the predominant use of the grant.

29. **Performance Indicators.** For some stewardship elements, categorization of these elements as investments is predicated on producing outputs and outcomes. The specific procedures, including a phasing-in process for requiring such justification, is contained in the individual respective standards.

[9]See *Managerial Cost Accounting Concepts and Standards*, SFFAS No. 4, for a discussion of Federal cost accounting principles and standards.

[10]An example of a grant with a split purpose is a grant issued to a teaching hospital to perform both medical education and medical research.

30. **Reporting Program Expenses.** Trend data reported on stewardship investment elements should reflect the full cost[11] of the investment for the year being reported upon and the preceding 4 years. Additional years' data also may be reported if such data would better indicate the investment nature of an item.

31. In some cases, before the issuance of Federal accounting standards, entities have maintained records on the basis of outlays rather than expenses. It may be impracticable for such entities to reconstruct their accounts on the basis of expense. In such cases, entities may report data on an outlay basis for any years for which expense data are not available. At the end of 5 years, entities should have sufficient expense data to be able to report expenses rather than outlays.

32. **Reporting Deferred Maintenance.** Many state and local governments, members of Congressional oversight committees, and national groups, have raised the issue of the deteriorating condition of federally-owned PP&E because of deferred maintenance associated with these assets. The issue was addressed in association with PP&E. As a result, a deferred maintenance standard in *Accounting for Property, Plant, and Equipment*, SFFAS No. 6, establishes reporting requirements related to the condition and future maintenance requirements for PP&E.

33. These requirements are flexible since different conditions may be considered acceptable by different entities, as well as for different items of PP&E held by the same entity. The deferred maintenance standard is applicable to all PP&E whether the PP&E is reported as general PP&E or stewardship PP&E.

Reporting Requirements

34. Within each of the standards, minimum required and, in some cases, recommended reporting is described. These requirements and recommendations, including a phasing-in process for entities who may not have required data available at the implementation of the standards, are contained in the individual standards. These requirements describe the nature of items to be reported by Federal entities; guidance on the form and content of agency financial reports,

[11]See *Managerial Cost Accounting Concepts and Standards*, SFFAS No. 4, for a discussion of Federal cost accounting principles and standards.

including the specific guidance on the format in which items addressed in this Statement will be reported, will be prescribed by OMB.

35. Reporting should be at the major program or category level; individual transactions need not be reported unless significant. Additional reporting is encouraged when preparers believe such information would make the financial report more meaningful or understandable.

Social Insurance

36. The Board first considered accounting and reporting for social insurance programs while considering SFFAS No. 5, *Accounting for Liabilities of the Federal Government*. The Board concluded, at that time, that the topic should be made part of the Supplementary Stewardship Reporting project.

37. Research and deliberations regarding social insurance have continued as part of the Supplementary Stewardship Reporting project. However, the Board, recognizing the magnitude and complexity of these programs, the strength of the views on the accounting and reporting issues, the significant attention being focused on these programs at the present time, and the potential for change to the programs, has again concluded that additional consideration is appropriate before issuing final guidance. Accordingly, the Board has not included guidance on social insurance in this Statement and has added a Social Insurance Accounting project to its agenda. [see SFFAS 17]

Applicability

38. This standard requires that the consolidated financial reports[12] of the Federal Government and the financial reports of its component units contain RSSI relating to:

[12]The terms "financial statements" and "consolidated financial statements" are used throughout this document to refer to the basic financial statements of a reporting entity; the basic financial statements normally include: the balance sheet, the statements of net cost, changes in financial position, financing, budgetary resources, and custodial activities and the notes to the financial statements. The terms "financial reports" and "consolidated financial reports" are used to refer to a document which would include the financial statements but which would also include items such as: a management discussion and analysis section, a statement of program performance measures, required supplemental information or required supplementary stewardship information not included in the financial statements or other supplemental financial and management information.

- amounts invested in human capital, research and development, and nonfederal physical property; and
- quantities (stated in terms of physical units or dollars) of land, heritage assets, ... [See SFFAS 11 for the explanation of deletion and change to "National Defense"] property.

Although FASAB's sponsors do not set accounting standards for the legislative or judicial branches, Federal accounting standards would be appropriate for them.

39. Because the financial reports of the Federal Government present the aggregation of information about stewardship investments and assets related to varied agencies and programs, further deliberations by the Board are needed to reach a decision on the amount and nature of information to be required under this standard for reporting in the consolidated financial report. Accordingly, except for the standard described in Chapter 8, "Current Service Assessment," the effective date of the stewardship standards as they apply to the consolidated financial report, is deferred pending that decision. The effective date of the standard in Chapter 8 is for fiscal periods beginning after September 30, 1997. In the interim, the consolidated financial reports should include such summary or selected information as is feasible. Experimentation is encouraged, as is the reporting of such additional information as will enhance the financial report.

40. Some Federal entities, including those government corporations listed in the Government Corporation Control Act and certain others, such as the US Postal Service, are required by law or policy to publish financial statements pursuant to the standards issued by the Financial Accounting Standards Board (FASB). (Some entities also may be required to prepare statements pursuant to standards set by a regulatory agency. That practice would not be affected by this statement of standards.) For such entities, this standard provides the following general principles:

    - *Applying Applicable Accounting Principles* - Separately issued (stand-alone) general-purpose financial statements on such entities should apply applicable accounting principles that will best meet user needs and comply with any relevant statutory requirements. This principle would continue to be true for separately issued statements even if, pursuant to the provisions below, other information about these entities might need to be

presented when their financial statements are included within reports of a larger Federal entity.

- *Reporting Additional or Supplementary Information* - When financial information on such entities is included in general-purpose financial reports of a larger Federal reporting entity (including Treasury's consolidated financial report), any applicable standards recommended by the FASAB and issued by OMB and the General Accounting Office (GAO) that call for additional reporting or supplementary information should be applied.
- *Applying Applicable Standards When Differences Arise* - When financial information on such entities is included in general purpose financial reports of a larger Federal reporting entity (including Treasury's consolidated financial report), standards recommended by FASAB and issued by OMB and GAO should be used if the difference arising from differences between Federal accounting standards and FASB's would be material to users of the report of the larger entity.

Materiality

41. The provisions of this Statement need not be applied to immaterial items. The determination of whether an item is material depends on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement.

Effective Date

42. The accounting standards in this statement, except for the standards described in Chapters 2-7 to the extent that they related to the consolidated financial report of the Federal Government, are effective for fiscal periods beginning after September 30, 1997. Earlier implementation is encouraged. See paragraph 39 for the effective date of standards in Chapters 2-7 relating to the consolidated financial report.

Chapter 2: Heritage Assets

Heritage Assets

Heritage assets shall be reported as required supplementary stewardship information accompanying the financial statements of the Federal

Government and the component units of the Federal Government responsible for such assets. Heritage assets shall be reported in terms of physical units rather than cost, fair value, or other monetary values.

Definition

43. "Heritage assets" are PP&E that are unique for one or more of the following reasons:

    - historical or natural significance;
    - cultural, educational or artistic (for example, aesthetic) importance; or
    - significant architectural characteristics.

44. Heritage assets are generally expected to be preserved indefinitely. One example of evidence that a particular asset is heritage in nature is that it is listed on the National Register of Historic Places.

45. Some investments in heritage assets, for example national parks, will be reported by both 1) the number of physical units identified as national parks in the heritage assets category, and by 2) the number of acres used as a park or an historic site in the stewardship land category (see Chapter 4 of this document). Such reporting would not be considered duplication, as the type of information reported on an item would be different for each category of stewardship asset.

Measurement

46. Heritage assets shall be quantified in terms of physical units (for example, number of items in collections or the number of national parks). No asset amount shall be shown on the balance sheet of the Federal financial statements for heritage assets.

47. The costs of acquiring, constructing, improving, reconstructing, or renovating heritage assets shall be considered an expense in the period incurred when determining the net cost of operations.[13] The

[13]For guidance in measuring and reporting the cost of heritage assets transferred from other federal entities, and heritage assets acquired through donation or devise, see the general PP&E standard contained in *Accounting for Property, Plant, and Equipment*, SFFAS No. 6.

cost shall include all costs incurred to bring the heritage asset to its current condition and location. [see SFFAS 16]

Multi-use Heritage Assets

48. ... [See SFFAS 16 for explanation of the deletion]

49. ... [See SFFAS 16 for explanation of the deletion]

Minimum Reporting

50. The determination of the most relevant information to be presented should be made by the preparer; however, reporting at the entity level shall be more specific than at the governmentwide level. The following are examples of information that should be considered for presentation:

- Description of each major category of heritage asset.
- The number of physical units added and withdrawn from the heritage asset records during the year and the end-of-year number of physical units for each type of heritage asset. Heritage assets consist of (1) collection-type heritage assets, such as objects gathered and maintained for exhibition, for example, museum collections, art collections, and library collections; and (2) noncollection-type heritage assets, such as, parks, memorials, monuments, and buildings.
- Description of the methods of acquisition and withdrawal of heritage assets.
- *Condition[14] of the assets, unless it is already reported in ... [See SFFAS 14 for the explanation of the deletion and change to "deferred maintenance information included elsewhere in the report, in which case a reference to the information will suffice"].
- *A reference to [the information] ... [See SFFAS 14 for the explanation of deletion and change to "the information"] if deferred maintenance is reported for the assets.[15]

[14]Examples of condition information include, among others, (1) averages of standardized condition rating codes; (2) percentage of assets above, at, or below acceptable condition; or (3) narrative information.

[15]For guidance relating to deferred maintenance reporting, see the Deferred Maintenance standard in *Accounting for Property, Plant, and Equipment*, SFFAS No. 6.

Implementation Guidance

51. For guidance on heritage assets that were previously recognized as assets for balance sheet reporting, see Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant and Equipment*, paragraphs 63, 64, and 65.

Chapter 3: ... [National Defense PP&E] [See Sffas 14 For The Explanation Of The Deletion And Change To "National Defense PP&E"]

... [National Defense PPE]

... [National Defense PP&E] shall be reported as required supplementary stewardship information accompanying the financial statements of the Federal Government and the component units of the Federal Government responsible for such PP&E. ... [National Defense] shall be valued and reported using either the total cost or the latest acquisition cost valuation method.

Definition

52. ... [See SFFAS 14 for the explanation of deletion][16, 17, 18, 19]

53. ... [See SFFAS 14 for the explanation of deletion]

54. ... [See SFFAS 14 for the explanation of deletion]

55. ... [See SFFAS 14 for the explanation of deletion]

56. ... [See SFFAS 14 for the explanation of deletion]

57. ... [See SFFAS 14 for the explanation of deletion]

58. ... [See SFFAS 14 for the explanation of deletion]

[16]... [see SFFAS 14]

[17]... [see SFFAS 14]

[18]... [see SFFAS 14]

[19]... [see SFFAS 14]

59. ... [See SFFAS 14 for the explanation of deletion]

Measurement

60. ... [See SFFAS 14 for the explanation for the deletion and change to "National Defense PP&E"] [National Defense] PP&E shall be valued using either the total cost or the latest acquisition cost valuation method.

61. There is a presumption that the valuation method previously used by the entity was appropriate for the circumstances and, therefore, should be applied on a consistent basis. Accordingly, the preparer shall justify any changes in the use of a valuation method.

62. For purposes of this standard, the "total cost method" is defined to include the actual acquisition cost of each item held plus the costs of any additions, improvements, alterations, rehabilitations, or replacements that extend the useful life of the Federal mission PP&E.

63. Under the latest acquisition cost method, all like units that are held are valued at the invoice price of the most recent like item purchased, less any discounts, plus additional costs described in the following paragraphs.

64. Using either cost valuation method, the cost assigned to an item of PP&E shall include all costs incurred to bring the Federal mission PP&E to a form and location suitable for its intended use. For example, the cost of acquiring Federal mission PP&E may include:

- amounts paid for vendors;
- transportation charges for the point of initial use
- handling and storage costs;
- labor and other direct or indirect production costs (for assets produced or constructed);
- engineering, architectural, and other outside services for designs, plans, specifications, and surveys;
- acquisition and preparation costs of buildings and other facilities;
- an appropriate share of the cost of the equipment and the facilities used in construction work;
- fixed equipment and related installation costs required for activities in a building or a facility;
- direct costs of inspection, supervision, and administration of construction contracts and construction work;

- legal and recording fees and damage claims;
- fair value of facilities and equipment donated to the government; and
- material amounts of interest costs paid.[20]

65. No asset amount shall be shown on the balance sheet for Federal mission PP&E.

66. The acquisition cost of Federal mission PP&E shall be considered an expense in determining the net costs of operations in the period acquired. The cost of constructing, improving, reconstructing, or renovating Federal mission PP&E also shall be considered an expense in determining net costs in the period incurred.

67. For acquisitions of Federal mission PP&E where costs are incurred over a number of years, the portion of the cost incurred during the reporting period shall be considered an expense in the period incurred in determining the net cost of operations and the total cost to date considered an acquisition-in-process cost in the required supplementary stewardship information.

Minimum Reporting

68. Federal Mission PP&E shall be reported as required supplementary stewardship information. Reporting at the entity level for Federal mission PP&E shall be more specific than at the governmentwide level. At a minimum, the following information shall be reported:

- A description of major types of Federal mission PP&E by the holding entity and the values assigned under the valuation method used.
- The value of Federal mission PP&E added and withdrawn during the year, the increase or the decrease in value resulting from revaluations of assets held to latest acquisition cost, and the end-of-year value for each major type of property using the entity's valuation method.
- A description of the methods of acquisition and withdrawal of Federal mission PP&E. This should be reported at the major

[20]"Interest costs" include any reimbursable interest paid by the reporting entity directly to providers of goods or services related to the acquisition or construction of Federal mission PP&E. It excludes any interest costs paid by a reporting entity in financing its own debt.

program or category level; individual transactions, unless significant, need not be reported.

- *Condition[21] of the assets, unless it is already reported in ... [deferred maintenance information included elsewhere in the report, in which case a reference to the information will suffice]. [See SFFAS 14 for the explanation for deletion and changes.]
- *A reference to [the information] if deferred maintenance is reported for the assets. [See SFFAS 14 for the explanation for the deletion and change to "the information".]

Implementation Guidance

69. For guidance on ... [See SFFAS 14 for the explanation of deletion] PP&E previously recognized as assets for balance sheet reporting, see SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, paragraphs 55 and 56.

70. For guidance on deferred maintenance reporting, see SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, paragraphs 77 through 84.

Chapter 4: Stewardship Land

Stewardship Land

Land not acquired for or in connection with[22] items of general PP&E, that is, stewardship land, shall be reported as required supplementary stewardship information accompanying the financial statements of the Federal Government and the separate reports of component units of the Federal Government responsible for such land. Stewardship land shall be reported in terms of physical units rather than cost, fair value, or other monetary values.

[21]Examples of condition information include, among others, (1) averages of standardized condition rating codes; (2) percentage of assets above, at, or below acceptable condition; or (3) narrative information.

[22]"Acquired for or in connection with" is defined as including land acquired with the intent to construct general PP&E and land acquired in combination with general PP&E, including not only land used as the foundation, but also adjacent land considered to be the general PP&E's common grounds.

Definition

71. "Land" is defined as the solid part of the surface of the earth. Excluded from the definition are the natural resources (that is, depletable resources, such as mineral deposits and petroleum; renewable resources, such as timber; and the outer-continental shelf resources) related to land.

72. Although the Federal Government holds vast amounts of "proven" and inferred" natural resources, the major reasons for addressing only surface land in this project were (1) the allotted time frame within which to complete this standard; (2) existing studies that point out the difficulties and the complexities of accurately estimating and valuing natural resources; and (3) disputes regarding the boundaries of the outer-continental shelf.[23]

73. Land and land rights[24] owned by the Federal Government and acquired for or in connection with items of general PP&E shall be accounted for and reported as general PP&E.

74. Land and land rights owned by the Federal Government and not acquired for or in connection with items of general PP&E will be reported as stewardship land. Examples of stewardship land include land used as forests and parks, and land used for wildlife and grazing.

Measurement

75. Stewardship land shall be quantified in terms of physical units (for example, acres) rather than in monetary terms.

76. No asset amount shall be shown on the balance sheet of the Federal financial statements for stewardship land.

77. The acquisition cost of stewardship land shall be considered an expense in the period acquired when determining the net cost of operations.

[23]The Board presently has an active project to address standards for natural resources.

[24]"Land rights" are interests and privileges held by the entity in land owned by others, such as leaseholds, easements, water and water power rights, diversion rights, submersion rights, rights-of-way, mineral rights, and other like interests in land.

78. In some cases, land may be acquired along with existing structures. The following treatments may apply:

- if the structure, which would be deemed a heritage asset, is significant in and of itself, the entity shall use its judgement as to whether the acquisition cost shall be treated as the cost of stewardship land, heritage asset, or both;
- if the structure is to be used in operations (for example, as general PP&E) but 1) the value of the structure is insignificant, or 2) its acquisition is merely a by-product of the acquisition of the land, the cost in its entirety shall be treated as an acquisition of stewardship land; or
- only significant structures that have an operating use (such as, a recently constructed hotel or employee housing block) shall be treated as general PP&E by identifying the cost attributable to general PP&E and segregating it from the cost of the stewardship land acquired.

79. However, no amounts for stewardship land acquired through donation or devise[25] shall be recognized as a cost in calculating net cost. The fair value of the property, if known and material, shall be disclosed in notes to the financial statements. If fair value is not estimable, information related to the type and quantity of assets received shall be disclosed in the year received.

80. Any costs to prepare stewardship land for its intended use (for example, razing a building) shall be expensed as a part of the cost of stewardship land.

Minimum Reporting

81. Reporting at the entity level for stewardship land shall be more specific than at the governmentwide level. Minimum reporting shall include the following:

- The number of physical units of stewardship land by category of major use, broken down within that category by principal holding agency.
- Where parcels of stewardship land have more than one use, the predominant use of the land shall be considered the major use.

[25]A will or clause of a will disposing of property.

Examples of major uses of stewardship land include forests and wildlife, grazing, parks, recreation, and historic sites. In cases where land has multiple uses, none of which is predominant, a description of the multiple uses shall be presented.

- Acquisitions, withdrawals, and ending balance should be shown by major categories of use, and methods of acquisition and withdrawal identified. Reporting should be at the major category level; individual transactions, unless significant, need not be reported.
- The condition[26] of the stewardship land, unless it is already reported in a note to the financial statement, in which case a reference to the note will suffice. [see SFFAS 14]
- A reference to the note to the financial statements if deferred maintenance is reported for the assets.[27] [see SFFAS 14]

Implementation Guidance

82. For guidance relating to stewardship land that was previously recognized as assets for balance sheet reporting, see SFFAS No. 6, *Accounting for Property, Plant and Equipment*, paragraphs 75 and 76.

Chapter 5: Nonfederal Physical Property Standard

Nonfederal Physical Property

Expenses included in calculating net cost for nonfederal physical property programs shall be reported as investments in required supplementary stewardship information accompanying the financial statements of the Federal Government and the separate reports of component units of the Federal Government responsible for such investments. Reporting will include data, in nominal dollars, on investment for the year being reported upon and the preceding 4 years. Additional years' data also may be reported if such data would provide a better indication of the nature of the investment.

[26]Examples of condition information include, among others, (1) averages of standardized condition rating codes; (2) percentage of assets above, at, or below acceptable condition; or (3) narrative information.

[27]For guidance on deferred maintenance reporting, see the Deferred Maintenance standard *Accounting for Property, Plant, and Equipment*, SFFAS No. 6.

Definition

83. "Investment in nonfederal physical property" refers to those expenses incurred by the Federal Government for the purchase, the construction, or the major renovation of physical property owned by state and local governments, including major additions, alterations, and replacements; the purchase of major equipment; and the purchase or improvement of other physical assets. Grants for maintenance and operations are not considered investments.

Measurement

84. "Expenses incurred" - The financial investment shall be measured on the same basis of accounting as used for financial statement purposes, including appropriate accrual adjustments, general and administrative overhead, and costs of facilities.[28] Amounts shall be reported in nominal dollars.

85. Cash grants related to nonfederal physical property programs are recognized and reported as expenses in arriving at the net cost of operations.

86. Expenses incurred for program costs, contracts, or grants with split purposes[29] shall be reported on the basis of an allocation of the expenses. If allocation is not feasible, the investment shall be reported on the basis of the predominant application of the expense or transfer.

Minimum Reporting

87. Minimum reporting shall include the following:

- Annual investment[30] shall be reported, including a description of Federally-owned physical property transferred to state and local governments. This information will be provided for the year ended on the balance sheet date as well as for each of the 4 years

[28]See *Managerial Cost Accounting Concepts and Standards*, SFFAS No. 4, for a full discussion of Federal cost accounting principles and standards.

[29]An example of an investment with a split purpose is a grant issued to a state to construct segments of the National Highway System and to conduct highway research.

[30]As defined in this standard, "annual investment" includes more than the annual expenditure reported by character class for budget execution. "Annual investment" is the full cost of the investment. Full cost shall be measured and accounted for in accordance with *Managerial Cost Accounting Concepts and Standards*, SFFAS No. 4.

preceding that year. If data for additional years would provide a better indication of investment, reporting of the additional years' data is encouraged. In those unusual instances when entities have no historical data, only current reporting year data need be reported.

- Reporting shall be at a meaningful category or level, for example, a major program or department. Reporting of major investments at the entity level shall be more specific than at the governmentwide level.
- In some cases, the information called for above is not available because entities have maintained records on the basis of outlays rather than expenses. For such entities to reconstruct their accounts on the basis of expense data may be impracticable. Agencies in this situation will continue to report historical data on an outlay basis for any years for which reporting is required and for which expense data are not available. If neither historical expense nor outlay data are available for each of the 5 years, entities need report only expense data for the current reporting year and such other years as available. At the end of 5 years, however, the agency will be able to report the expenses to be categorized as investments for nonfederal physical property rather than the outlays for each of the preceding 5 years.
- Reporting shall include a description of major programs involving Federal investments in nonfederal physical property including a description of programs or policies under which non-cash assets are transferred to state and local governments.

Recommended Reporting

88. Reporting of the amount of significant state and local total contributions to shared or joint programs is encouraged but is not required. If it is known, however, that other contributions in a significant amount were made, that fact (for example, expressed as a percentage of the total program) shall be reported even if the exact amount of the contribution is not known.

Chapter 6: Human Capital

Human Capital

Expenses included in calculating net cost for education and training programs that are intended to increase or maintain national economic productive capacity shall be reported as investments in human capital as required supplementary stewardship information accompanying the

financial statements of the Federal Government and its component units. Continued categorization of expenses as investments for stewardship purposes is predicated on demonstrated outputs and outcomes consistent with the intent of the program. Reporting will ordinarily include data in nominal dollars on investment for the year being reported upon and the preceding 4 years. Additional years' data also may be reported if such data would provide a better indication of the investment.

Definition

89. "Investment in human capital" refers to those expenses incurred for programs for education and training of the public that are intended to maintain or increase national productive capacity and that produce outputs and outcomes that provide evidence of maintaining or increasing national productive capacity.

90. The definition excludes education and training expenses for Federal civilian and military personnel. It also excludes education and training expenses whose purpose is not maintaining or enhancing national productive capacity.

Measurement

91. "Expenses incurred" - The investment shall be measured on the same basis of accounting as used for financial statements, including appropriate accrual adjustments, general and administrative overhead, and costs of facilities.[31] Amounts shall be reported in nominal dollars.

92. Expenses incurred for programs, contracts, or grants with split purposes[32] shall be reported on the basis of an allocation of the investment expenses. If allocation is not feasible, the investment shall be reported on the basis of the predominant application of the expenses incurred.

93. By no later than the third year after the effective date of this standard, managers of the investment program should be able to provide information on the outcomes for the programs for which the

[31]See *Managerial Cost Accounting Concepts and Standards*, SFFAS No. 4, for a full discussion of Federal cost accounting principles and standards.

[32]An example of an investment with a split purpose is a grant issued to a teaching hospital to perform both medical education and medical research.

investments are reported. If outcome data are not available (for example, the agency has not agreed on outcome measures for the program, the agency is unable to collect reliable outcome data or the outcomes will not occur for several years), output data that best provide indications of the intended program outcomes shall be used to justify continued treatment of expenses as investments until outcome data are available. Definitions and characteristics of outputs and outcomes are provided in the paragraphs that follow.[33]

- "Output" - A tabulation, calculation, or recording of activity or effort that can be expressed in a quantitative or qualitative manner. Outputs shall have two key characteristics: (1) they shall be systematically or periodically captured through an accounting or management information system, and (2) there shall be a logical connection between the reported measures and the program's purpose. Examples of human capital output are high school and college graduates as a percentage of population over 25.
- "Outcome" - An assessment of the results of a program compared to its intended purpose. Outcomes shall: (1) be capable of being described in financial, economic, or quantitative terms and (2) provide a plausible basis for concluding that the program has had or will have its intended effect. Examples of human capital outcomes are program graduates obtaining jobs within 2 months of program completion or program graduates obtaining jobs making more money than they previously received on Federal aid.

Minimum Reporting

94. Minimum reporting shall consist of:

- The annual investment[34] made in the year ended on the balance sheet date as well as in each of the 4 years preceding that year

[33]The human capital outputs and outcomes should be the same as those measured for the Government Performance and Results Act (GPRA) and the budget and could be reported in a Statement of Program Performance Measures as described in Appendix 1-F to the concepts statement entitled, *Entity and Display*, SFFAC No. 2.

[34]As defined in this standard, "annual investment" includes more than the annual expenditure reported by character class for budget execution. "Annual investment" is the full cost of the investment. Full cost shall be measured and accounted for in accordance with *Managerial Cost Accounting Concepts and Standards*, SFFAS No. 4.

shall be reported. If data for additional years would provide a better indication of investment, reporting of the additional years' data is encouraged. In those unusual instances when entities have no historical data, only current reporting year data need be reported. Reporting shall be at a meaningful category or level, for example, a major program or department. Reporting of major efforts at the entity level shall be more specific than at the governmentwide level.

- In some cases, the information called for above will not be available because entities have maintained records on the basis of outlays rather than expenses. For such entities to reconstruct their accounts on the basis of expense data may be impracticable. Agencies in this situation will continue to report historical data on an outlay basis for any years for which reporting is required and for which expense data are not available. If neither historical expense nor outlay data are available for each of the 5 years, entities need report expense data for only the current reporting year and such other years as available. At the end of 5 years, however, the agency will be able to report the expenses to be categorized as investments for human capital rather than the outlays for each of the preceding 5 years.
- A narrative description of major education and training programs considered Federal investments in human capital shall be included.

Recommended Reporting

95. Reporting of the amount of significant state, local, private, or foreign total contributions to shared or joint programs is encouraged, but is not required. If it is known, however, that other contributions in a significant amount were made, that fact (for example, expressed as a percentage of the total program) may be reported even if the exact amount of the contribution is not known.

Chapter 7: Research & Development

Research and Development

Expenses included in calculating net cost for research and development programs that are intended to increase or maintain national economic productive capacity or yield other future benefits shall be reported as investments in research and development in required supplementary stewardship information accompanying the financial statements of the Federal Government and its component units. Continued categorization

of program expenses as investment is predicated on output and outcome data consistent with the program's intent. Reporting ordinarily will include data in nominal dollars on investment for the year being reported upon and the preceding 4 years. Additional years' data also may be reported if such data would provide a better indication of the investment.

Definition

96. "Investment in research and development" refers to those expenses incurred to support the search for new or refined knowledge and ideas and for the application or use of such knowledge and ideas for the development of new or improved products and processes with the expectation of maintaining or increasing national economic productive capacity or yielding other future benefits. Research and development is composed of

- Basic research: systematic study to gain knowledge or understanding of the fundamental aspects of phenomena and of observable facts without specific applications toward processes or products in mind;
- Applied research: systematic study to gain knowledge or understanding necessary for determining the means by which a recognized and specific need may be met; and
- Development: systematic use of the knowledge and understanding gained from research for the production of useful materials, devices, systems, or methods, including the design and development of prototypes and processes.[35]

Measurement

97. "Expenses incurred" - The investment shall be measured on the same basis of accounting as used for financial statements, including appropriate accrual adjustments, general and administrative overhead, and costs of facilities.[36] Amounts shall be reported in nominal dollars.

[35]See OMB Circular A-11, section 44.

[36]See *Managerial Cost Accounting Concepts and Standards*, SFFAS No. 4, for a full discussion of Federal cost accounting principles and standards.

98. Expenses incurred for programs, contracts, or grants with split purposes[37] shall be reported on the basis of an allocation of the investment expenses. If allocation is not feasible, the investment shall be reported on the basis of the predominant application of the expenses incurred.

99. By no later than the third year after the effective date of this standard, managers of the investment program should be able to provide information on the outcomes for the programs for which the investments are reported.[38] If outcome data are not available (for example, the agency has not agreed on outcome measures for the program, the agency is unable to collect reliable outcome data, or the outcomes will not occur for several years), the outputs that best provide indications of the intended program outcomes shall be used to justify continued treatment of expenses as investments until outcome data are available. Definitions and characteristics of outputs and outcomes follow.

- "Output" - A tabulation, calculation, or recording of activity or effort that can be expressed in a quantitative or qualitative manner. They shall have two key characteristics: (1) they shall be systematically or periodically captured through an accounting or management information system, and (2) there shall be a logical connection between the reported measures and the program's purpose. In research and development programs, this might consist of data for the year concerning the number of new projects initiated, the number continued from the prior year, the number completed and the number terminated. It also might consist of such quantitative measures as bibliometrics (for example, publication counts, citation counts and analysis, and peer evaluation); patent counts and analysis; and science "indicators" that assess the ongoing vitality of the research (for

[37]An example of an investment with a split purpose is a grant issued to a teaching hospital to perform both medical education and medical research.

[38]The research and development outputs and outcomes should be the same as those measured for the Government Performance and Results Act (GPRA) and the budget and will be reported in a Statement of Program Performance Measures as described in Appendix 1-F to *Entity and Display*, SFFAC No. 2.

example, statistics on scientific and engineering personnel, graduate students and degree recipients by field and sector).[39]

- "Outcome" - An assessment of the results of a program compared to its intended purpose. Because of the difficulty of measuring such results for research and development programs in financial, economic, or quantitative terms, outcome data for such programs are expected to consist typically of a narrative discussion of the major results achieved by the program during the year, along the following lines:
  - *Basic Researc*h - an identification of any major new discoveries that were made during the year;
  - *Applied Research* - an identification of any major new applications that were developed during the year; or
  - *Development* - the progress of major developmental projects including the results with respect to projects completed or otherwise terminated during the year and the status of projects that will continue.

The information provided concerning outcomes should be chosen to provide, in concise form, a plausible basis for judging the extent to which the program is achieving its purpose.

Minimum Reporting

100. Minimum reporting shall consist of the following:

- The annual investment[40] made in the year ended on the balance sheet date as well as in each of the 4 years preceding that year shall be reported. If data for additional years would provide a better indication of investment, reporting of the additional years' data is encouraged. In those unusual instances when entities have no historical data, only current reporting year data need be reported. Reporting shall be at a meaningful category or level, for example, a major program or department. Reporting of major investments at the entity level shall be more specific than at the governmentwide level.

[39]*Research Funding as an Investment: Can We Measure the Returns?*, A Technical Memorandum, Congress of the United States, Office of Technology Assessment (Apr. 1986).

[40]As defined in this standard, "annual investment" includes more than the annual expenditure reported by character class for budget execution. "Annual investment" is the full cost of the investment. Full cost shall be measured and accounted for in accordance with *Managerial Cost Accounting Concepts and Standards*, SFFAS No. 4.

- In some cases, the information called for above will not be available because certain entities have maintained records on the basis of outlays rather than expenses. For such entities to reconstruct their accounts on the basis of expense data may be impracticable. Agencies in this situation will continue to report historical data on an outlay basis for any years for which reporting is required and for which expense data are not available. If neither historical expense nor outlay data are available for each of the 5 years, entities need report expense data for only the current reporting year and such other years as available. At the end of 5 years, however, the agency will be able to report the expenses to be categorized as research and development rather than the outlays for each of the preceding 5 years.
- A narrative description of major research and development programs shall be included.

Recommended Reporting

101. Reporting of the amount of significant state, local, private, or foreign total contributions to shared or joint programs is encouraged, but is not required. If it is known, however, that other contributions in a significant amount were made, that fact (for example, expressed as a percentage of the total program) may be reported even if the exact amount of the contribution is not known.

Chapter 8: Current Services Assessment

[Chapter 8, par. 102-108, rescinded by SFFAS No. 25]

Appendix A: Basis For Conclusions

109. This appendix provides a discussion of the more significant comments that the Board received from respondents to the exposure draft, *Supplementary Stewardship Reporting*, dated August 1995 and from testimony at a public hearing on the exposure draft that was held December 5, 1995.

110. Responses overall were generally favorable to the concept of reporting stewardship information. In some cases, respondents had questions about the specific reporting requirements or requested clarification on particular items. Where feasible, these areas were addressed or clarified in the final standards in this Statement. In the case of issues raised by the respondents, this appendix explains the basis of the Board's conclusions.

The Nature Of Stewardship Reporting

111. The exposure draft presented the Board's approach to reporting in a manner other than is done in the basic financial statements for those items that it has categorized as stewardship items. As the Board stated in the Introduction and Background chapter of this Statement, it believes that these stewardship items warrant specialized reporting to highlight their importance and to portray them in additional ways than provided by financial accounting. The Board designated a new category of reporting to highlight the unique nature of stewardship reporting, Required Supplemental Stewardship Information (RSSI).

112. Some respondents believed that, although reporting on stewardship items might be warranted, a separate manner of reporting might not. They believed that stewardship reporting could be accommodated either within the basic financial statements, for example, as a note, or as Required Supplemental Information (RSI). They did not see the need for the separate category of RSSI.

113. The Board, however, believes that a new category for reporting on stewardship items is more appropriate. If stewardship information were required to be reported in a note to the basic financial statements, it would be subject to the same level of audit scrutiny as that of the basic financial statements. Since some of the stewardship information is non-financial, for example, physical units, and other data is based on projections or assumptions, the same degree of audit coverage as that of the basic financial statements for these items may not be appropriate. Such data is not drawn directly from the financial

records. Thus reliance on financial records for audit backup would not be feasible.

114. On the other hand, the Board believes that certain stewardship information should receive more audit scrutiny than it would if it were RSI. For RSI, the auditor reviews the data for overall compliance with associated guidance and for consonance with the basic financial statements. The auditor usually provides in-depth review of the RSI only if there appears to be some problem with the data. If he or she believes that the data is not fairly presented, the auditor still may issue a clean opinion on the basic financial statements while noting that there are problems with the RSI.

115. Therefore, the Board has proposed that a new category, RSSI, be designated to cover stewardship reporting. By developing this new category, it is anticipated that audit standards will be developed to address the specific items in that category. Although the Board does not have authority to set audit standards, it established RSSI with the expectation that OMB and GAO will, in collaboration, determine appropriate audit procedures for this information.

Social Insurance

116. Consideration of guidance for the recognition, measurement and display of obligations for social insurance programs has continued to present the Board with significant, vexing theoretical and practical problems. The Board notes the strength of feelings of respondents and commentators, some of whom believe a liability should be recognized for amounts that will be paid in future periods to or on behalf of current or future program beneficiaries and others who believe that there is no obligation associated with these programs that meets the definition of a liability, other than amounts due and payable at the end of an accounting period; additionally, some favor disclosure of projected data relating to the magnitude of the present value of future net benefit payments at a particular date while others favor cash flow information for a long period of time. The Board notes too the magnitude and complexity of these programs and the extreme sensitivity of projections relating to the programs to assumptions whose range of possibilities is large. More importantly, the Board notes that social insurance programs are presently being studied and discussed frequently and seriously within government and by the public; a report and recommendations are expected shortly from the 1994-95 Quadrennial Advisory Council on Social Security. The

prospects of significant changes to the programs are reasonably high. [SFFAS 17]

117. After deliberating the issue, the Board has concluded that additional investigation and further deliberation is required and has directed the FASAB staff to continue to research social insurance issues focusing especially on: identifying the characteristics of programs which should cause them to be subject to the guidance provided in a Statement on Social Insurance; the appropriate display of information in the financial statements; the identification of additional information, if any, which should be required for social insurance programs; the means for measurement of financial data included in such additional information; and, the desirability of nonfinancial indicators (ratios of data to GDP or "covered payroll") to describe the status of programs or the implications of potential changes to or needs of the programs. The Board has instructed the staff to be mindful of all current developments in structuring its research and its recommendations.

Expensing Stewardship PP&E

118. Echoing their earlier comments to the Board's Exposure Draft, *Accounting for Property, Plant, and Equipment*, some respondents expressed concern that expensing rather than capitalizing costs associated with stewardship PP&E would lessen the value of the operating statement as a tool for performance measurement since it would overstate the cost in the year an asset is acquired.

119. The Board, however, believes that capitalizing and depreciating stewardship PP&E provides information that is of little usefulness. Stewardship PP&E includes heritage assets, Federal mission PP&E, and stewardship land. Period costs related to stewardship PP&E are of diminished usefulness because of uncertain useful life (e.g., heritage assets, Federal mission PP&E), uncertain historical cost basis (e.g., stewardship land), or probability of being destroyed in use (e.g., Federal mission PP&E). Therefore, the Board believes that attempting to capitalize and depreciate stewardship PP&E is not warranted. It believes that reporting on information related to the existence and the condition of the stewardship PP&E has more relevance to decision-makers and other users of the financial report.

Costing Of Federal Mission PP&E [SFFAS 11]

120. Respondents to the Board's question on whether the alternatives of presenting costs of Federal mission PP&E in terms of either total (historical) or latest acquisition cost generally believed that both options should not be allowed. Some believed that use of alternative methods would not ensure consistency in reporting. Others believed that only total (historical) costs should be used. Still others believed that total (historical) cost should be the long-term goal, with the use of latest acquisition cost allowed only until such historical cost data would be available.

121. The Board, however, recognizes that significant practical problems may arise if an agency is compelled to adopt a specified costing approach for reporting stewardship assets, and that such cost approach would not be used for computing the net cost of operations. Therefore, it believes that its decision to accept either the historical cost or latest acquisition cost method is appropriate. However, it also emphasizes that once a method is chosen, an entity should switch to the other method only with appropriate justification.

Reporting Expense Or Outlay Data

122. The standards require that expense data be reported for investments in human capital, research and development, and nonfederal physical property. The standards also provide for a period of 5 years to transition to reporting expense data for those agencies that currently maintain only outlay data. Some Board members suggested that since some agencies currently maintain only outlay data, requiring that only outlay data be reported might be more practical. However, the responses reflected a clear consensus for reporting expenses, with little or no support for reporting outlays only, and a minority preferring to report both expenses and outlays. Therefore, the standards, as proposed, remain unchanged.

Request For More Specificity In Reporting Requirements

123. When the Board developed the standards for stewardship reporting, its intention was to provide overall guidance on definitions, recognition, measurement, and minimum and recommended reporting. This broad guidance was intended to provide the basic reporting requirements while allowing each entity maximum flexibility in such areas as determining what constitutes the individual stewardship items for that entity, which costs are directly attributable to the stewardship item, and how best to report on multi-use items so

that users will gain the best picture of the entity's financial and performance information.

124. The Board believes that the desire for more specific guidance expressed by several respondents stems from the belief that without such guidance, an entity's determination of how to apply the standards could be questioned. Nevertheless, the Board reiterates its position that entities should be provided maximum flexibility when applying the stewardship standards. However, entities should make the determination of how best to apply the stewardship standards based on a thorough analysis of their individual entity, including its mission, financial practices, and the impact of its mission and operation on financial report users and on the Nation. Finally, all entity determinations of the applicability of stewardship standards should be thoroughly documented.

Issues For Which Changes Were Made To The Proposed Standards

125. **Multiple Category Reporting.** Some respondents were concerned that there would be double counting if, as proposed by the standards, some stewardship items would be reported in two separate categories; for example, Yellowstone National Park would be reported as a heritage asset and as stewardship land.

126. Reporting supplementary stewardship information in two categories will not be deemed double counting. This is because where multiple reporting is required, the units of measure are different for each of the stewardship categories. In the example above, Yellowstone National Park would be reported under a category, such as "National Parks," as *one of the total number* of heritage assets under the auspices of the Department of the Interior; it also would be reported by the *number of acres* that it occupies under the stewardship land category for the Department. To clarify this point, the discussion of the process of multiple reporting was expanded in the statement to explain that the Board does not consider this reporting as double counting.

127. **Reporting the Fair Value for Stewardship PP&E Transferred to State or Local Governments.** Many respondents questioned the need for, and the cost/benefit of, requiring that the fair value of stewardship PP&E transferred to state and local governments be reported. They stated that monetary values for stewardship PP&E are not required to be reported because such values are either difficult to obtain (e.g., lack of historical cost data on land acquired at the birth of

the Nation) or not meaningful (e.g., the historical cost to build the Washington Monument). Therefore, they questioned the cost/benefit of requiring that the fair value of stewardship property transferred to state and local governments be determined and reported.

128. The Board agreed that the fair value of stewardship property transferred to state and local governments need not be determined and reported. The standards have been revised to require a description of the property transfer transaction; if the fair value is known, nothing would preclude reporting it.

Effective Date For Consolidated Financial Statements

129. In considering required reporting of stewardship information, the Board became increasingly aware of the need to be highly selective in proposing requirements for the consolidated financial report of the Federal Government. It recognized the potential for implementation problems in the first few years after the effective date of this statement. In addition to the normal problems associated with adapting to new standards, several of these standards provide for a transition period during which agencies may or, in some cases, may not report investments in human capital, research and development and nonfederal physical property; if investments are reported for each of five years as called for in this statement, they may be reported for earlier years during the transition period on the basis of either outlays or expense. The merit of reporting the aggregate of information prepared on different bases is questionable.

130. Further, the information required to be reported by these standards goes beyond that customarily accompanying financial reports of governments or commercial enterprises. Standards related to heritage assets and stewardship land call for reporting in terms of physical units (e.g., number of parks or acres of land) rather than in terms of historical cost. Implementation problems are foreseen at the consolidated statement level because of differing measures. Also, the Board is concerned with the possibility of establishing requirements so detailed as to render the consolidated financial report unwieldy, unfriendly to the potential user and obfuscating of important information.

131. Because of these possible implementation problems and the need to consider other disclosures or presentations, the Board expressed a

desire for further deliberations relative to the consolidated financial report of the Federal Government.

132. Accordingly, the effective date of this statement will be for fiscal years beginning after September 30, 1997 as it relates to financial statements of component units of the Federal Government; this same effective date applies to chapter 8 as it relates to the consolidated financial statements of the Federal Government. The effective date of the statement as it applies to the consolidated financial statements, except for chapter 8, is deferred pending further deliberations of the Board. In the interim, the consolidated financial reports should include such summary or selected information as is feasible. Experimentation is encouraged, as is the reporting of such additional information as will enhance the financial report.

Reporting Of Information Not Specifically Addressed In The Standards

133. Some respondents requested that the standards provide for reporting additional information, such as transfers of stewardship property to foreign governments, stewardship land sold to the private sector, the Federal Government's interest in such things as property held by nonfederal entities or patents generated through Federal research and development funds, and foreign contributions to Federal programs.

134. In developing the standards for stewardship reporting, the Board concentrated on providing guidance in the principal areas of stewardship resources that have materiality for the majority of Federal entities and for the consolidated financial reporting for the Nation. The Board's intent was to ensure that these significant areas, if material for an entity, would be reported regularly and in a consistent manner.

135. In some cases, an entity may have other resources or obligations that were not specifically addressed in the stewardship standards, but that the entity believes may be material to the presentation of its stewardship information. In such cases, if the reporting of such additional data would be useful and relevant to readers, and would provide a better indication of the resources and obligations of the entity, the Board encourages such reporting.

Appendix B: Sample Reports

NOTE: The sample report sections in Appendix B are intended to illustrate the type of reporting contemplated by the Board. Certain data are taken from various reports for one or more recent years and are "actual data." Other data have been estimated by judgmentally extrapolating from "actual data." Still other data and program references have been fabricated and are hypothetical. Therefore, readers should not rely on the validity of the data in the sample reports.

Specific form and content guidance on financial reports will be provided by OMB.

Heritage Assets

Annual Stewardship Information

Heritage assets are PP&E that possess one or more of the following characteristics: historical or natural significance; cultural, educational or aesthetic value; or significant architectural characteristics. The cost of heritage assets is not often relevant or determinable. In addition, the useful life of heritage assets is generally not reasonably estimable for depreciation purposes. The most relevant information about heritage assets is their existence and condition. Therefore, heritage assets are reported in terms of physical units.

Various agencies operate and maintain heritage assets. During the period, maintenance expense is recognized as incurred. However, certain maintenance was deferred over the past several years. Below is information on deferred maintenance on stewardship assets.

Summary of Deferred Maintenance as of September 30, 199Z

Dollars in millions

Category	Method	Asset condition	Cost to Return to Acceptable Condition
Buildings	CAS[a]	4	$350-$450
Memorials/Monuments	CAS	4	$100-$150
Parks	CAS	4	$200-$300
Collection-type Heritage Assets	CAS	5	$25-$30

[a] Condition Assessment Survey (CAS).

Heritage Assets[b] Annual Stewardship Information for the Fiscal Years Ended September 30, 199Y and 199Z

	Balance[c] 9/30/9X	Additions[d]	Deletions	Balance 9/30/9Y	Additions	Deletions	Balance 9/30/9Z
Collection-type (in thousands)							
Museum Collections	859	8	N/A[e]	867	11	N/A	878
Art Collections	327	4	N/A	331	7	N/A	338
Library Collections	96,473	2,718	554	98,637	3,180	421	101,395
Total	**97,659**	**2,730**	**554**	**99,835**	**3,198**	**421**	**102,611**
Noncollection-type							
Buildings and Structures	3,155	95	0	3,250	65	0	3,315
Memorials	22	1	0	23	1	0	24
Monuments	76	0	0	76	2	1	77
Parks	129	2	0	131	1	0	132
Battlefields	11	0	0	11	0	0	11
Preserves	10	0	0	10	2	0	12
Sea/Lakeshores	13	0	0	13	1	0	14
Parkways	4	0	0	4	0	0	4
Rivers and Systems	31	0	0	31	0	0	31
Recreational Areas	19	0	0	19	1	0	20
Other Historical Areas	27	1	0	28	2	0	30
Total	**3,497**	**99**	**0**	**3,596**	**75**	**1**	**3,670**

[b]See accompanying notes to the financial statement for the reporting of condition of Heritage Assets.

[c]Many paintings were refurbished at a cost of $5 million. Refurbishment was required because of deficient climate-control equipment.

[d]During the fiscal year, three complete collections of manuscripts and historical papers with an estimated value of $17 million were donated to the library collection.

[e]The number of deletions was negligible.

Federal Mission Property, Plant, And Equipment

[SFFAS No. 23 eliminated this category.]

Stewardship Land

Annual Stewardship Information

"Land" is defined as the solid part of the surface of the earth. Excluded from the definition of land for reporting purposes here are materials beneath the surface (that is, depletable resources such as mineral deposits and petroleum), the space above the surface (that is, renewable resources such as timber), and the outer-continental shelf resources. These materials will be addressed in a future standard.

The Federal Government holds approximately 650 million acres of land. Land that is acquired for or in connection with items of general PP&E are reported on the balance sheet. Land that is not acquired for or in connection with items of general PP&E is considered stewardship land. Of the total amount of land held by the Federal Government, about 617 million acres are considered stewardship land.

The cost or value of stewardship land is often not determinable. The most relevant information about stewardship land is its existence, condition, and use. Therefore, stewardship land is reported in terms of physical units rather than cost, fair value, or other monetary values.

The major uses of stewardship land are for forests, wildlife, grazing, parks, recreation, and historic sites. Where parcels of stewardship land have more than one use, the predominant use of the land is considered the major use. Two Federal agencies are responsible for maintaining virtually all stewardship land held by the Federal Government: the Departments of the Interior and Agriculture.

Virtually all stewardship land is usable for its purposes at September 30, 1994. In some cases, however, scheduled maintenance has been deferred. Estimates of costs to complete critical maintenance range from $ 40 to $ 50 million. "Critical maintenance" refers to maintenance that, if not performed, could lead to irreparable damage to the assets or to unusability. On the basis of engineering estimates, the estimated cost of deferred maintenance ranges from $ 75 to $ 100 million in 199Z.

On the following page is a summary of the stewardship land by category of major use, broken down within each category by principal holding agency, at September 30, 199Z.

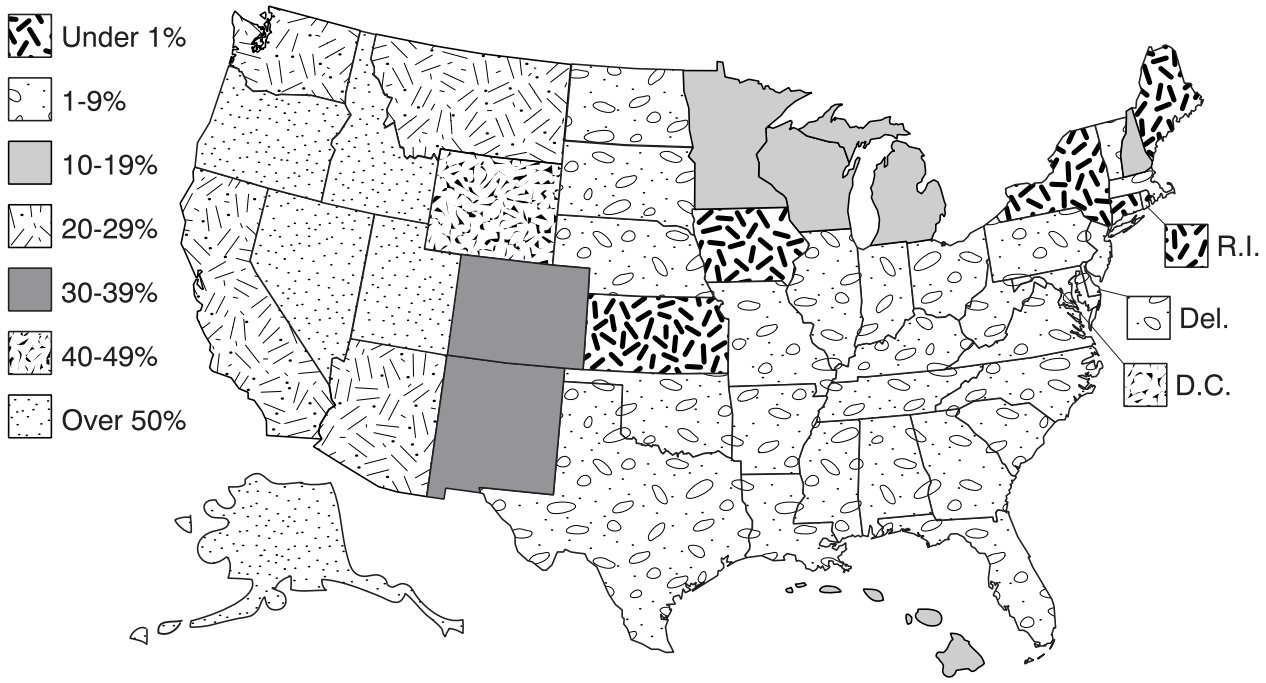
Stewardship Land[j] Annual Stewardship Information For the Fiscal Year Ended September 30, 199Z

Major Uses of Land by Holding Agency[k] (Within the 50 States)		
Use and Agency	**Acres (in millions)**	**Percentage of Stewardship Land**
Forest and Wildlife:		
The Interior	193.6	31.4
Agriculture	174.0	28.2
Total	**367.6**	**59.6**
Grazing		
The Interior	145.1	23.5
Agriculture	8.5	1.4
Total	**153.6**	**24.9**
Parks and Historic Sites		
The Interior	95.9	15.5
Grand Total	**617.1**	**100**

[j]See accompanying notes to the financial statements for the condition of stewardship land.

[k]Figures are based on information from the Summary Report of Real Property Owned by the United States Throughout the World as of September 30, 1991, December 1993.

Percent of Federally Owned Land In Each State[1]



Acres (in millsions)	Federally Owned	Area/State Acreage	Percent Federally Owned
Area/State			
Alaska	248.0	365.5	67.86
Western	354.2	752.9	47.00
South Atlantic, South Central, DC	21.2	561.2	3.75
Northeastern, North Central	25.7	587.6	4.38
Hawaii	0.6	4.1	15.45
Total	**649.8**	**2271.3**	**28.59**

1/ Negligible

[1]Summary of Real Property Owned by the United States Throughout the World as of September 30, 1991, US General Services Administration (Dec. 1993).

Nonfederal Physical Property

Annual Stewardship Information For The Fiscal Year Ended September 30, 199Z

Annually, the Federal Government provides funding to state and local governments for the purchase, the construction, or the major renovation of physical property owned by state and local governments; additionally, from time to time, the Federal Government transfers PP&E to these governments in exchange for less than fair value. These grants and transfers relate to roads and transportation systems, clean water and environmental projects, and other projects for the common good.

The investments in nonfederal physical property in the 5 years from 199V to 199Z were as follows:

Nonfederal Physical Property Annual Stewardship Information for the Fiscal Year Ended September 30, 199Z

Dollars in billions

	199V	199W	199X	199Y	199Z[m]
Transportation	$19.0	$20.0	$20.0	$22.0	$23.0
Natural Resources and Environment	3.7	4.0	3.9	3.7	4.2
Community and Regional Development	4.9	4.3	4.5	5.6	6.3
Administration[n]	2.2	2.3	2.4	2.5	2.7
Total	**$29.8**	**$30.6**	**30.8**	**$33.8**	**$36.2**

[m]Included as expenses in calculating net cost.

[n]Expenses of administration include an appropriate allocation of agency overhead costs.

In addition to the transfers shown above in the "Community and Regional Development" category, the fair value of land and facilities associated with former military installations that were transferred to local governments approximated $40 million in 199Y and $52 million in 199Z.

Certain transportation and environmental programs involving Federal investments of $22 billion and $4 billion, respectively, in 199Z required matching support by local governments of about 20 percent and 80 percent of the Federal grants.

Human Capital

Annual Stewardship Information For the Fiscal Year Ended September 30, 199Z

Federal investment in human capital comprises those expenses for education and training programs for the general public that are intended to increase or maintain national economic productive capacity. It does not include expenses for internal Federal education and training. Expense data are expressed in nominal dollars for the fiscal year being reported upon and the preceding 4 fiscal years.

Following is a summary of stewardship data for the program entitled, Transition Training for Former Navy Contractor Personnel[41], for the 5 fiscal years ending September 30, 199V through 199Z:

Program: Transition Training for Former Navy Contractor Personnel

	199V	199W	199X	199Y	199Z[o]
Program Expenses ($000s)[p]					
Counseling	$ 373	$ 508	$ 740	$ 980	1,053
Education	786	2,381	3,860	5,621	7,053
Administration[q]	847	1,165	1,224	1,367	1,584
Total	**$ 2,005**	**$ 4,054**	**$ 5,824**	**$ 7,968**	**9,690**
Program Outputs					
Participants Counseled	310	415	592	784	823
Participant Years of Training Delivered	162	486	787	1,147	1,432

[o]Included as expenses in calculating net cost.

[p]Expenses are reported on an accrual basis, including contractual amounts due for counseling services delivered and educational costs incurred by participants.

[q]Expenses of administration include an appropriate allocation of agency overhead costs.

[41]This hypothetical program is for illustration only.

Program Outcomes

Preliminary data appear to confirm that the services provided by the program accelerate the transition of participants into alternative employment; some savings are realized in the Unemployment Insurance Fund. A follow-up survey of the 415 participants in the year 199W showed that 80% were earning at least as much as they were earning in their Navy contractor positions. A more extensive evaluation, including an assessment of effects on long-term earnings, is currently planned for completion in 1999.

Narrative Discussion

This program was authorized in 19XX (by P.L. XX-XXX) to ease the transition into other civilian positions of skilled technical, administrative, and managerial personnel who are no longer needed in certain shipyards because of declining orders for Navy ship construction.

Eligibility is limited to those who have been employed at designated shipyards for at least 5 years, but who are not yet eligible for retirement benefits. Participants receive intensive counseling to help them develop individual transition plans. This counseling is provided by a private job placement service under contract. Participants are then reimbursed up to $5,000 per year for up to 2 years, not to exceed 80 percent of the cost of the cost of tuition, fees, books, and other student materials required for attendance at approved educational institutions.

An additional increment of education or technical training is expected to reduce the period of transitional unemployment and increase the subsequent earnings of participants.

Research and Development

Annual Stewardship Information For the Fiscal Year Ended September 30, 199Z

Federal investment in research and development comprises those expenses for basic research, applied research, and development that are intended to increase or maintain national economic productive capacity or yield other benefits. Expense data are expressed in nominal dollars for the fiscal year being reported upon and the preceding 4 FYs.

Following is a summary of stewardship data for the Ceramic Materials Research Program[42] for the 5 fiscal years ending September 30, 199V through 199Z:

Program: Ceramic Materials Research Program

Dollars in millions					
	199V	**199W**	**199X**	**199Y**	**199Z**[r]
Program Expenses[s]					
Basic Research	$ 106	$ 124	$136	$ 132	$ 143
Applied Research	93	101	107	118	121
Development[t]	46	62	73	68	82
Administration	14	16	17	19	21
Total	**$ 259**	**$ 303**	**$ 333**	**$ 337**	**$ 367**

[r]Included as expenses in calculating net cost.

[s]Expenses are reported on an accrual basis and include an allocation of overhead costs.

[t]Development grants are for a fixed amount, not to exceed 50 percent of the cost of the project.

Program: Outputs and Outcomes

	199V	**199W**	**199X**	**199Y**	**199Z**
Interagency Agreements and Contracts					
New	45	38	41	37	44
Continuation	28	52	55	61	68
Articles in Journals	9	12	23	34	41
Patents funded R&D	3	8	14	18	21
Rights to Inventions from funded R&D[u]	0	1	0	3	2

[u]Indicated inventions financed with federal funds to which the government has patent rights, in accordance with the Bayh-Dole Act.

[42]This hypothetical program is for illustration only.

RESEARCH AND DEVELOPMENT SAMPLE REPORT (continued)

Programs Outcomes:

The increasing number of articles published on the basis of funded research, including announcements of several newly discovered properties of certain composite ceramics, is evidence of the utility of this part of the program. The number of patents emerging from the program is also increasing, primarily from the development component of the program.

Narrative Discussion:

This program was authorized in 19XX (by P.L. XX-XXX) to accelerate the development of this industry in the United States. The research element of the program operates through interagency agreements with the Federal laboratories and grants to university researchers. The researchers are selected through peer review procedures. The development component provides grants to private firms to develop improved manufacturing procedures for ceramic materials-based products and to accelerate the development of marketable products incorporating advanced ceramic materials.

Current Services Assessment Annual Stewardship Information

A Current Services Assessment (CSA) provides receipt and outlay data on the basis of projections of future activities. It is relevant for assessing the sustainability of programs established by current law. CSA focuses on the totality of government operations rather than on individual programs. It provides an analytical perspective on the Government because it shows the short- and long-term directions of current programs.

The following display presents CSA data for all programs for 6 years subsequent to the base year. The data are identical to projected data prepared for the President's Budget for the same period; the economic and program assumptions are the same as used in that document.

See display on next page.

Current Services Assessment - Annual Stewardship Information

	Estimates						
	1995-Base Year	1996	1997	1998	1999	2000	2001
Receipts							
Individual Income Taxes	590.2	632.2	662.3	696.6	730.9	769.4	811.9
Corporate Income Taxes	157.0	167.0	181.6	197.0	207.3	219.9	231.3
Social Insurance Taxes and Contributions	484.5	507.4	535.9	560.5	587.9	616.8	645.0
Excise Taxes	57.5	53.2	52.0	52.4	53.3	53.8	54.5
Other	66.0	68.1	69.6	72.1	75.0	78.6	82.0
Subtotal Receipts	1,355.2	1,427.9	1,501.5	1,587.6	1,654.4	1,738.5	1,824.8
Outlays							
Defense	272.1	265.9	270.3	279.9	285.2	293.5	302.4
Social Security	335.8	350.8	367.7	386.0	404.7	424.4	445.1
Medicare	159.9	177.7	196.3	215.3	235.0	256.3	279.5
Net interest	232.2	241.1	239.1	238.6	240.6	241.1	244.6
Other							
Educ.,Train.,Employ.	54.3	54.5	51.4	50.1	51.4	53.0	54.8
Income Security	220.4	228.5	242.8	252.7	262.5	275.1	280.6
Health	115.4	121.1	129.7	140.5	151.0	163.5	177.1
Veterans Benefits	37.9	37.7	40.1	41.7	42.8	45.4	43.9
Other	91.1	104.2	113.9	118.1	125.6	125.9	127.5
Subtotal	519.1	546.0	577.9	603.1	633.3	662.9	683.9
Total outlays	1,519.1	1,581.5	1,651.3	1,722.9	1,798.8	1,878.2	1955.5
Deficit (-)	(163.9)	(153.6)	(149.8)	(144.3)	(144.4)	(139.7)	(130.7)

Appendix C: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273.

Statement of Federal Financial Accounting Standards No. 9: Deferral of the Effective Date of Managerial Cost Accounting Standards for the Federal Government in SFFAS No. 4

Status

Issued	March 3, 1997
Effective Date	For fiscal years ending September 30, 1998 and thereafter.
Volume I References	SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government* (amends its effective date)
Volume II References	Managerial Cost Accounting (M20)
Interpretations and Technical Releases	
Affects	SFFAS No. 9 changes the effective date of SFFAS No. 4.
Affected by	No other statements.

Summary

I. This statement is issued to amend the effective date of the standards in Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, issued in July 1995. The original effective date was for reporting periods beginning after September 30, 1996. The amended effective date is for periods beginning after September 30, 1997.

II. In July 1997, the Federal Accounting Standards Advisory Board (the Board) received a request from the CFO Council for a two year deferral of the effect date of the managerial cost accounting standards to fiscal year 1999. The CFO Council representatives stated that many agencies have not been able to implement the managerial cost accounting standards during the two years since SFFAS No. 4 was issued, due to the following reasons: (a) the Joint Financial Management Improvement Program (JFMIP) has not issued its Managerial Cost Accounting System Requirements, (b) the CFO Council has not issued its managerial cost accounting guide, and (c) most agencies do not have adequate cost accounting systems in place. After considering the CFO Council's request, the Board reluctantly agreed to propose deferring the effective date of the managerial cost accounting standards for one year to fiscal year 1998 and issued an Exposure Draft (ED) for public comments. Most responses to the ED were in favor of the proposal.

III. After reviewing the comments to the ED, the Board decided to recommend the one year deferral. At the same time, it reemphasizes the importance of managerial cost accounting to Federal program and financial management. The Chief Financial Officers Act of 1990 requires the development of cost information and the systematic measurement of performance. Reliable and relevant cost information is indispensable for implementing the requirements of the Government Performance and Results Act of 1993. The Board urges Federal entities and their CFOs to give priority to implementing the requirements in SFFAS No. 4.

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Introduction

1. This statement is issued to amend the effective date of the managerial cost accounting standards prescribed in Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*,[1] which was issued in July 1995. The standards in SFFAS No. 4 were effective for reporting periods beginning after September 30, 1996. The amended effective date is for reporting periods beginning after September 30, 1997.

2. In August 1997, the Board issued an exposure draft (ED)[2] in which it proposed a deferral of the effective date of managerial cost accounting standards. The ED was issued after considering a request presented to the Board by the CFO Council. (See Attachment: Letter from the CFO Council, dated June 26, 1997.) In their request, the CFO Council representatives stated that most agencies were having difficulties in implementing the cost accounting standards because (a) the Managerial Cost Accounting System Requirements have not yet been issued,[3] (b) the CFO Council has yet to issue a managerial cost accounting guide,[4] and (c) most agencies do not have adequate cost systems in place. The CFO Council representatives requested that the effective date of SFFAS No. 4 be deferred for two years to reporting periods that begin after September 30, 1998. They also requested that "relevant portions" of SFFAS 7, *Accounting for Revenue and Other Financing Sources*, be delayed to that same date.

3. After considering the reasons presented by the CFO Council, the Board reluctantly proposed a one year delay for SFFAS No. 4, to reporting periods beginning after September 30, 1997, and issued the ED for that proposal. No delay was proposed for any part of SFFAS

[1]In addition to managerial cost accounting standards, SFFAS No. 4 also contains managerial cost accounting concepts which provide general guidance for managerial cost accounting but do not constitute specific requirements. The effective date does not apply to those concepts.

[2]The ED was published in FASAB News issue No. 45, August 1997.

[3]In April 1997, JFMIP issued an Exposure Draft on Managerial Cost Accounting System Requirements, which is yet to be finalized as of this date.

[4]The CFO Council's Governmentwide Cost Accounting Work Group issued an Exposure Draft of the Managerial Cost Accounting Implementation Guide on June 30, 1997, which has not been finalized as of this date.

No. 7, which is effective for reporting periods beginning after September 30, 1997. The Board noted that cost accounting is required by the Chief Financial Officers Act of 1990 (the CFO Act), and reliable cost information is necessary for implementing the Government Performance and Results Act (GPRA) of 1993. The Board also observed that the cost accounting standards allow Federal entities without a sophisticated cost accounting system to use cost studies or cost finding techniques to meet the requirements of the cost accounting standards. The Board further observed that during the past two years since SFFAS No. 4 was issued, most agencies should have had sufficient time to develop at least the basic cost accounting processes as described in paragraph 71, SFFAS No. 4.

4. The Board received 26 responses to the ED. Most respondents supported the Board's proposal for a one year deferral of the cost accounting standards in SFFAS No. 4 to fiscal year 1998. After considering the comments, including those opposed to any delay and those favoring a two year delay, the Board decided to recommend the one year deferral to the FASAB principals.

The Amended Effective Date

5. The effective date of the managerial cost accounting standards provided in paragraph 30, SFFAS No. 4, is amended as follows:

> "The managerial cost accounting standards prescribed in SFFAS No. 4 shall be effective for fiscal periods beginning after September 30, 1997. Earlier implementation is encouraged."

Basis For Conclusion

Reasons for the Delay

6. After considering the CFO Council's presentation and the responses to the ED, the Board is convinced that as of the end of fiscal year 1997, most agencies were not ready to produce cost information as required in the cost accounting standards. As described in CFO Council's request and in the responses to FASAB's ED, many agencies need more time and guidance to define responsibility segments and to develop procedures for accumulating and assigning costs. They also said that they need more time to upgrade or expand their accounting

systems, and to promote the use of cost measures among program and financial managers.

7. Most respondents stated that the one year delay should not significantly affect implementation of the Government Performance and Results Act of 1993 (GPRA). With regard to the GPRA requirement that Federal agencies measure and report outputs, outcomes, and related costs by segments for fiscal year 1999 and thereafter, the respondents stated that with the one year deferral of the cost accounting standards, agencies will have time to align their cost accounting structures with the GPRA measures.

8. Under these circumstances, the Board concluded that a one year deferral would be appropriate. The deferral would provide the Federal entities with an opportunity to engage top-level agency officials, budget analysts, and program and financial managers in the processes of developing, collecting and using cost information.

9. Several respondents reiterated the CFO Council's original request for a two year delay to fiscal year 1999, on the grounds that their systems would not be ready within fiscal year 1998. The Board cannot agree with this request. It believes that cost accounting capability must be developed in time to fully support the GPRA reporting. The Board thus urges Federal entities to give implementation of SFFAS No. 4 a high priority and take immediate actions to define and structure responsibility segments and develop costing methodologies.

10. Several respondents said that, after the effective date, Federal entities should be given a transitional period in which they could have flexibility to develop and improve their cost accounting systems and procedures gradually. The Board disagrees with this approach for two reasons: (a) such a transitional period would add uncertainty to the required implementation, (b) a degree of flexibility for developing cost accounting systems and procedures is already built in the standards, and thus a transitional provision is not necessary.

11. The Board notes that the standards already provide a sufficient degree of flexibility to Federal entities. For example, paragraph 70, SFFAS No. 4, provides that managerial cost accounting processes can be accomplished through the use of a cost accounting system or the use of cost finding techniques or other cost studies and analyses. Paragraph 266 further provides that "Federal agencies can take a

gradual approach to the development of cost systems, if necessary, while developing basic cost information through other means in the short run." Federal agencies are expected to refine and improve their costing procedures, methods, and systems, as they gain experience in using cost information (paragraph 24, SFFAS No. 4). Those who are not familiar with the criteria of implementation should review the standard on "Requirement for Cost Accounting" in paragraphs 67 through 76, SFFAS No. 4.

12. Several respondents were opposed to any deferral. They pointed out that the original effective date was more than two years after SFFAS No. 4 was issued, and it provided enough lead time for agencies to implement the cost accounting standards. They stated that if the delay in implementing the standards was caused by a lack of action, a mere deferral could only cause continued inaction. The Board recognizes that many agencies have made significant progress in improving general accounting and financial reporting. The Board anticipates that the one year deferral will bring similar progress in implementing the cost accounting standards.

The Status of Interpretation No. 2

13. In January 1997, FASAB issued Interpretation No. 2, *Accounting for Treasury Judgment Fund Transactions*. The Treasury Judgment Fund was established by Congress to pay, in whole or part, the court judgments or settlements negotiated by the Justice Department on behalf of Federal agencies. Interpretation No. 2 requires that if a loss in litigation is probable and estimable, the reporting entity in the litigation should recognize an expense and liability for the full amount of the estimated loss, although the loss may be paid by the Treasury Judgment Fund. The Interpretation reflects the cost principle in SFFAS No. 4, and is based on the principle of recognizing contingent liabilities in SFFAS No. 5, *Accounting for Liabilities of the Federal Government*. The Interpretation was made effective for reporting periods beginning after September 30, 1996, the same as SFFAS No. 4 and No. 5.

14. The ED raised a question: If SFFAS No. 4 were deferred as proposed, should Interpretation No. 2 be deferred as well? Some respondents believed that Interpretation No. 2 should be deferred to fiscal year 1998. They were concerned with difficulties in collecting reliable information to estimate the probable litigation losses. Other respondents, however, did not believe that Interpretation No. 2 should

be delayed for the following reasons: (1) the recognition of litigation losses and liabilities is not dependent on cost accounting capabilities, and (2) the recognition of contingent liabilities and losses is required by SFFAS No. 5, which is not deferred.

15. The Board agrees with the view that Interpretation No. 2 is based on the principle provided in SFFAS No. 5 of recognizing contingent liabilities, and that its implementation should not be deferred. As with all matters in litigation, the data should come from agencies' management and their legal offices and the Department of Justice. Deferring the Interpretation is not a positive solution to the data gathering problem.

The Status of SFFAS No. 7

16. Those respondents who preferred a two year delay for SFFAS No. 4 also reiterated the CFO Council's original request to defer certain cost-related portions of SFFAS No. 7, *Accounting for Revenue and Other Financing Sources* to fiscal year 1999. While no specific paragraphs were mentioned, they were concerned with the requirements for matching costs with revenues by sub-organizations (equivalent to responsibility segments). (See, for example, paragraphs 116 through 126, SFFAS No. 7.) They stated that they are modifying their systems to accommodate those requirements, but their systems work could not be completed in fiscal year 1998.

17. With the effective date of SFFAS No. 4 deferred to fiscal year 1998, the cost accounting standards should be implemented and the necessary cost information should be accumulated to support implementation of SFFAS No. 7 for that year. Thus, the Board is not convinced that SFFAS No. 7 needs to be deferred. The Board believes that it is highly important to relate SFFAS No. 4 and No. 7 to measuring program performance and results. While the standards in SFFAS No. 4 provide more detail in cost concepts, procedures, and methodologies, SFFAS No. 7 brings cost information into focus in measuring the net results of programs and activities. The integrated implementation of those two statements is crucial for meeting the objectives of financial reporting by Federal entities and for implementing the GPRA requirements.

Attachment: Letter From CFO Council

United States Government
Chief Financial Officers Council

Jun 26, 1997

Mr. Dave Mosso, Chairman
Financial Accounting Standards Advisory Board
441 G Street, N. W.
Washington, D.C. 20548

Dear Mr. Mosso:

The Chief Financial Officers Council (CFOC) recognizes the importance for Federal agencies to move forward and implement the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government. We believe this standard, effective for reporting periods after September 30,1996, is essential to support the cost effectiveness of mission performance and to provide full accountability to taxpayers over our resources.

The Council is concerned, however, over the impediments and difficulties most agencies are having in implementing this standard. These difficulties exist due to the following:

- The Managerial Cost Accounting System Requirements have not yet been issued;
- The Managerial Cost Accounting Guidance, which will help agencies in implementing SFFAS No.4, will not be issued until later this Summer;
- Adequate cost Systems are not in place to meet the requirements of the Results Act to provide program cost and performance information in an agency's annual performance report. Agency Performance Reports required under the Results Act are not due until March 2000. It will be several years before agencies will have the necessary cost systems in place.

For the above reasons, the Council requests FASAB to change the effective date for SFFAS No. 4, and in relevant portions of its companion, SFFAS No. 7, Accounting for Revenue and Other Financial Sources (effective for reporting periods after September 30,1997), to the "revised effective date"

for reporting periods after September 30, 1998. Given that the systems and cost accounting guidance needed by agencies have not been issued and only 4 months remain in this fiscal year, we feel this request is justified. Additionally, this request is further supported by the fact that the Results Act Performance Report requirements are not statutorily required until FY 1999.

While we recommend a change in the effective implementation date, we fully acknowledge and support the critical importance of the cost and revenue standards. Based on the importance and usefulness of anticipated cost information for internal agency management and other purpose, in addition to the significant benefits that are often derived from early implementation of Federal accounting standards, we nevertheless encourage Federal agencies to implement these standards as soon as practicable based on the capabilities of agency systems and the maturity of agency cost accounting practices. While such early, voluntary implementation is encouraged, the Council requests that the Board change the mandatory implementation date to fiscal periods after September 30, 1998.

Specific questions regarding this request may be directed to Frank M. Sullivan, Chair, CFOC Cost Accounting Committee, at (202) 273-5504 or via E-Mail at “fs@mail.va.gov”.

Sincerely,

(SIGNED)

Arnold G. Holz
Executive Vice-Chair
Chief Financial Officers Council

Statement of Federal Financial Accounting Standards No. 10: Accounting for Internal Use Software

Status

Issued	June 1998
Effective Date	For fiscal years beginning after September 30, 2000
Volume I References	SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government* (provides information on cost allocation) SFFAS No. 5, *Accounting for Liabilities of the Federal Government* (provides information on accounting for leases) SFFAS No. 6, *Accounting for Property, Plant, and Equipment* (provides information on other PP&E)
Volume II References	Software (S50)
Interpretations and Technical Releases	None.
Affects	SFFAS No. 10, paragraph 7, rescinds SFFAS No. 6, paragraphs 27-28, and provides a comprehensive standard for accounting for internal use software.
Affected by	No other statements.

Summary

This statement provides accounting standards for internal use software. Under the provisions of this statement, internal use software is classified as "general property, plant, and equipment" (PP&E) as defined in Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment*. This statement includes software used to operate a federal entity's programs (e.g., financial and administrative software, including that used for project management) and software used to produce the entity's goods and services (e.g., air traffic control and loan servicing).

Internal use software can be purchased off-the-shelf from commercial vendors and can be developed by contractors with little technical supervision by the federal entity or developed internally by the federal entity. SFFAS No. 6 specified treatment for internally developed software different from that for commercial off-the-shelf (COTS) software and contractor-developed software. SFFAS No. 6 addressed COTS and contractor-developed software generally, providing that they were "subject to its provisions." On the other hand, specific provision was made for internally developed software.

SFFAS No. 6 prohibited the capitalization of the cost of internally developed software unless management intended to recover the cost through user charges, and the software was to be used as general PP&E. For capitalizable software, capitalization would begin after the entity completed all planning, designing, coding, and testing activities that are necessary to establish that the software can meet the design specifications.

At the conclusion of the PP&E project the Federal Accounting Standards Advisory Board discussed whether the standard for internally developed software should also apply to contractor-developed software. Also, some users of SFFAS No. 6 were unsure how to apply it to COTS and contractor-developed software. The

Board decided, in December 1996, to review the issue and develop a separate standard for internal use software.

This standard requires the capitalization of the cost of internal use software whether it is COTS, contractor-developed, or internally developed. Such software serves the same purposes as other general PP&E and functions as a long-lived operating asset. This standard provides guidance regarding the types of cost elements to capitalize, the timing and thresholds of capitalization, amortization periods, accounting for impairment, and other guidance.

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Introduction

Purpose

1. This statement provides accounting standards for internal use software[1] used by federal entities. Federal entities purchase commercial "off-the-shelf" (COTS) software, hire contractors to develop substantially all of the desired software (contractor-developed), or develop software internally using their own employees, with or without a contractor's assistance (internally developed).

Scope

2. This statement establishes accounting standards for the cost of software developed or obtained for internal use. These include the cost of

   - software used to operate an entity's programs (e.g., financial and administrative software, including that used for project management),
   - software used to produce the entity's goods and to provide services (e.g., air traffic control and loan servicing), and
   - software that is developed or obtained for internal use and subsequently provided to other federal entities with or without reimbursement.

3. This statement provides standards on accounting for software consisting of one or more components or modules. For example, an entity may develop an accounting software system containing three elements: a general ledger, an accounts payable subledger, and an accounts receivable subledger. Each element might be viewed as a component or module of the entire accounting software system. This standard may be applied to the total cost of the software or, when appropriate, to individual components or modules. For example, one software module may be implemented before others, in which case, the provisions of this standard for capitalization, amortization, etc., would apply to it separately.

[1]The terms defined in the glossary will be in boldface when they firs appear in the body of this document [see Appendix E, Consolidated Glossary]

Background

4. At the conclusion of the general property, plant, and equipment (PP&E) project, the Federal Accounting Standards Advisory Board (Board) discussed whether the standard for internally developed software should also apply to contractor-developed software. Also, some users of Statement of Federal Financial Accounting Standards (SFFAS) No. 6 were unsure of how to apply it to COTS and contractor-developed software. The Board decided in December 1996 to review the issue and develop a separate standard for internal use software.

5. In June 1997, the Board issued an exposure draft entitled *Accounting for Internal Use Software*. The Board received comments from 26 respondents and held a public hearing on December 18, 1997.

Materiality

6. The provisions of this statement need not be applied to immaterial items.

Effective Date

7. The provisions of this statement are effective for reporting periods that begin after September 30, 2000. Paragraphs 27 and 28 of SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, which pertain to internally developed software, are rescinded upon this standard's issuance. Federal entities may continue their current accounting practices for internal use software for accounting periods beginning before October 1, 2000. Early implementation of this statement is encouraged.

Internal Use Software Accounting Standard

Definitions

8. Software includes the application and operating system programs, procedures, rules, and any associated documentation pertaining to the operation of a computer system or program. "Internal use software" means software that is purchased from commercial vendors "off-the-shelf," internally developed, or contractor-developed solely to meet

the entity's internal or operational needs. Normally software is an integral part of an overall system(s) having interrelationships between software, hardware, personnel, procedures, controls, and data.

9. This definition of internal use software encompasses the following:

   a. Commercial off-the-shelf (COTS) software: COTS software refers to software that is purchased from a vendor and is ready for use with little or no changes.

   b. Developed software

      (1) Internally developed software refers to software that employees of the entity are actively developing, including new software and existing or purchased software that are being modified with or without a contractor's assistance.

      (2) Contractor-developed software refers to software that a federal entity is paying a contractor to design, program, install, and implement, including new software and the modification of existing or purchased software.

Software Development Phases

10. Software's life-cycle phases[2] include planning, development, and operations. This standard provides a framework for identifying software development phases and processes to help isolate the capitalization period for internal use software that the federal entity is developing.

[2]There are no federal requirements regarding the phases that each software project must follow. The **life-cycle** phases of a software application described here are compatible with and generally reflect those in the Office of Management and Budget's (OMB) Circular A-130, *Management of Information Resources*, and *Capital Programming Guidance*; the General Accounting Office's (GAO), *Measuring Performance and Demonstrating Results of Information Technology Investments* (*GAO/AIMD-98-89*, Mar. 1998); and the American Institute of CPA's Statement of Position No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (Mar. 4, 1998). Successful software projects normally would have at least an initial design phase, an application development phase, and a post-implementation/operational phase. Also, software eventually would become obsolete or otherwise be replaced and therefore have a termination phase. Circular A-130 acknowledges that the "life cycle varies by the nature of the **information system**. Only two phases are common to all information systems—a beginning and an end. As a result, life cycle management techniques that agencies can use may vary depending on the complexity and risk inherent in the project." (A-130, "Analysis of Key Sections," p. 63).

11. The following table illustrates the various software phases and related processes. The steps within each phase of internal use software development may not follow the exact order shown below. This standard should be applied on the basis of the nature of the cost incurred, not the exact sequence of the work within each phase.

Preliminary design phase	Software development phase	Post-Implementation/ operational phase
Conceptual formulation of alternatives[2]	Design of chosen path, including software configuration and software interfaces[3]	Data conversion
Evaluation and testing of alternatives	Coding	Application maintenance
Determination of existence of needed technology	Installation to hardware	
Final selection of alternatives	Testing, including parallel processing phase	

12. In the *preliminary design phase*, federal entities will likely do the following:

    a. Make strategic decisions to allocate resources between alternative projects at a given time. For example, should programmers develop new software or direct their efforts toward correcting problems in existing software?

    b. Determine performance requirements (i.e., what it is that they need the software to do).

    c. Invite vendors to perform demonstrations of how their software will fulfill a federal entity's needs.

    d. Explore alternative means of achieving specified performance requirements. For example, should a federal entity make or buy

[3]See OMB Circular A-11, *Planning, Budgeting, and Acquisition of Capital Assets;* Supplement to Circular A-11, *Capital Programming Guide* (July 1997); and Circular A-109, *Major Systems Acquisitions*, par. 11, "Alternative Systems."

[4]See OMB Circular A-109, *Major Systems Acquisitions*, par. 13, "Full-Scale Development and Production."

the software? Should the software run on a mainframe or a client server system?

e. Determine that the technology needed to achieve performance requirements exists.

f. Select a vendor if a federal entity chooses to obtain COTS software.

g. Select a consultant to assist in the software's development or installation.

13. In the *software development phase*, federal entities will likely do the following:

    a. Use a system to manage the project.

    b. Track and accumulate life-cycle cost and compare it with performance indicators.

    c. Determine the reasons for any deviations from the performance plan and take corrective action.

    d. Test the deliverables to verify that they meet the specifications.

14. In the *post-implementation/operational phase*, federal entities will likely do the following:

    a. Operate the software, undertake preventive maintenance, and provide ongoing training for users.

    b. Convert data from the old to the new system.

    c. Undertake post-implementation review comparing asset usage with the original plan.

    d. Track and accumulate life-cycle cost and compare it with the original plan.

Recognition, Measurement, And Disclosure

Software Used As General PP&E

15. Entities should capitalize the cost of software when such software meets the criteria for general property, plant, and equipment (PP&E). General PP&E is any property, plant, and equipment used in providing goods and services.[5]

Capitalizable Cost

16. For internally developed software, capitalized cost should include the full cost (direct and indirect cost) incurred during the software development stage.[6] Such cost should be limited to cost incurred after

    (1) management authorizes and commits to a computer software project and believes that it is more likely than not that the project will be completed and the software will be used to perform the intended function with an estimated service life of 2 years or more and

    (2) the completion of conceptual formulation, design, and testing of possible software project alternatives (the preliminary design stage).

17. Such costs include those for new software (e.g., salaries of programmers, systems analysts, project managers, and administrative personnel; associated employee benefits; outside consultants' fees; rent; and supplies) and documentation manuals.

18. For COTS software, capitalized cost should include the amount paid to the vendor for the software. For contractor-developed software, capitalized cost should include the amount paid to a contractor to design, program, install, and implement the software. Material internal cost incurred by the federal entity to implement the COTS or

[5]General PP&E, as distinguished from **stewardship PP&E**, is defined in pars. 23-25, in SFFAS No. 6, *Accounting for Property, Plant, and Equipment*.

[6]For a full discussion of direct and indirect cost, see SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government* (June 1995), pars. 90-92. Also see pars. 94-95, Statement of Federal Financial Accounting Concepts No. 2, *Entity and Display*.

contractor-developed software and otherwise make it ready for use should be capitalized.

Data Conversion Cost

19. All data conversion costs incurred for internally developed, contractor-developed, or COTS software should be **expensed** as incurred, including the cost to develop or obtain software that allows for access or conversion of existing data to the new software. Such cost may include the purging or cleansing of existing data, reconciliation or balancing of data, and the creation of new/additional data.

Cutoff For Capitalization

20. Costs incurred after final acceptance testing has been successfully completed should be expensed. Where the software is to be installed at multiple sites, capitalization should cease at each site after testing is complete at that site.

Multiuse Software

21. The cost of software that serves both internal uses and stewardship purposes ("multiuse software") should be accounted for as internal use software (e.g., a global positioning system used in connection with national defense activities and general operating activities and services).

Integrated Software

22. Computer software that is integrated into and necessary to operate general PP&E, rather than perform an application, should be considered part of the PP&E of which it is an integral part and capitalized and depreciated accordingly (e.g., airport radar and computer-operated lathes). The aggregate cost of the hardware and software should be used to determine whether to capitalize or expense the costs.

Bundled Products And Services

23. Federal entities may purchase software as part of a package of products and services (e.g., training, maintenance, data conversion, reengineering, site licenses and rights to future upgrades and enhancements). Federal entities should allocate the capitalizable and noncapitalizable cost of the package among individual elements on the basis of a reasonable estimate of their relative fair values. Costs that are not susceptible to allocation between maintenance and relatively minor enhancements should be expensed.

Capitalization Thresholds

24. Each federal entity should establish its own threshold as well as guidance on applying the threshold to bulk purchases of software

programs (e.g., spreadsheets, word-processing programs, etc.) and to modules or components of a total software system. That guidance should consider whether period cost would be distorted or asset values understated by expensing the purchase of numerous copies of a software application or numerous components of a software system and, if so, provide that the collective cost should be capitalized.

Enhancements

25. The acquisition cost of enhancements to existing internal use software (and modules thereof) should be capitalized when it is more likely than not that they will result in significant additional capabilities. For example, in an instance where the federal entity adds a capability or function to existing software for making ad hoc queries, the cost would be capitalized.

26. Enhancements normally require new software specifications and may require a change of all or part of the existing software specifications as well. The cost of minor enhancements resulting from ongoing systems maintenance should be expensed in the period incurred. Also, the purchase of enhanced versions of software for a nominal charge are properly expensed in the period incurred.

27. Cost incurred solely to repair a design flaw or to perform minor upgrades that may extend the useful life of the software without adding capabilities should be expensed.[7]

Impairment

POST-IMPLEMENTATION/OPERATIONAL SOFTWARE

28. Impairment should be recognized and measured when one of the following occurs and is related to post-implementation/operational software and/or modules thereof:

[7]However, in instances where the useful life of the software is extended, the amortization period would be adjusted.

The Board has considered the cost associated with modifying internal use software for the year 2000 (Y2K) and has determined that such cost should be charged to expenses as incurred, since it is a repair of a design flaw that allows existing software to continue being used. However, an enhancement could presumably provide enhanced capabilities and at the same time, as an integral part of the new code and other software enhancements, cure the Y2K problem. The total cost of such an enhancement should be capitalized rather than allocated between the Y2K cost and all other cost.

- the software is no longer expected to provide substantive service potential and will be removed from service or
- a significant reduction occurs in the capabilities, functions, or uses of the software (or a module thereof).

29. If the impaired software is to remain in use, the loss due to impairment should be measured as the difference between the book value and either (1) the cost to acquire software that would perform similar remaining functions (i.e., the unimpaired functions) or, if that is not feasible, (2) the portion of book value attributable to the remaining functional elements of the software. The loss should be recognized upon impairment, and the book value of the asset reduced accordingly. If neither (1) nor (2) above can be determined, the book value should continue to be amortized over the remaining useful life of the software.

30. If the impaired software is to be removed from use, the loss due to impairment should be measured as the difference between the book value and the net realizable value (NRV), if any.[8] The loss should be recognized upon impairment, and the book value of the asset reduced accordingly. The NRV, if any, should be transferred to an appropriate asset account until such time as the software is disposed of and the amount is realized.

DEVELOPMENTAL SOFTWARE

31. In instances where the managers of a federal entity conclude that it is no longer more likely than not that developmental software (or a module thereof) will be completed and placed in service, the related book value accumulated for the software (or the balance in a work in process account, if applicable) should be reduced to reflect the expected NRV, if any, and the loss recognized. The following are indications of this:

    - Expenditures are neither budgeted nor incurred for the project.
    - Programming difficulties cannot be resolved on a timely basis.
    - Major cost overruns occur.

[8]Presumably, NRV will be zero for software. However, in the rare case that it is not zero, NRV should be recognized.

- Information has been obtained indicating that the cost of developing the software will significantly exceed the cost of COTS software available from third party vendors; hence, management intends to obtain the product from those vendors instead of completing the project.
- Technologies that supersede the developing software product are introduced.
- The responsibility unit for which the product was being created is being discontinued.

Amortization

32. Software that is capitalized pursuant to this standard should be amortized in a systematic and rational manner over the estimated useful life of the software. The estimated useful life used for amortization should be consistent with that used for planning the software's acquisition.[9]

33. For each module or component of a software project, amortization should begin when that module or component has been successfully tested. If the use of a module is dependent on completion of another module(s), the amortization of that module should begin when both that module and the other module(s) have successfully completed testing.

34. Any additions to the book value or changes in useful life should be treated prospectively. The change should be accounted for during the period of the change and future periods. No adjustments should be made to previously recorded amortization. When an entity replaces existing internal use software with new software, the unamortized cost of the old software should be expensed when the new software has successfully completed testing.

Disclosures

35. The disclosures required by SFFAS No. 6, paragraph 45, for general PP&E are applicable to general PP&E software. Thus, for material

[9]For example, federal agencies use the following planning guidance: OMB Circulars A-11, *Budget Planning, Budgeting, and Acquisition of Fixed Assets*; A-94, *Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs*; and A-109, *Acquisition of Major Systems*; OMB's *Capital Programming Guide* (July 1997); GAO's *Assessing Risks and Returns: A Guide for Evaluating Federal Agencies' IT Investment Decision-making* (Feb. 1997); and other federal guidance.

amounts, the following should be disclosed in the financial statements regarding the software:

- The cost, associated amortization, and book value.
- The estimated useful life for each major class of software.
- The method(s) of amortization.

Implementation

36. Cost incurred prior to the initial application of this statement, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized, had this statement been in effect when those costs were incurred. However, the provisions of this statement concerning amortization and impairment should be applied to any unamortized cost capitalized prior to the initial application of this statement that continue to be reported as assets after the effective date.

Appendix A: Basis For Conclusions

General Property, Plant, And Equipment

37. As stated in Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment*, paragraph 10, the Federal Accounting Standards Advisory Board (Board) believes that measuring the cost associated with using general property, plant, and equipment (PP&E), and including that cost in a federal entity's operating results will help to achieve the operating performance objective. To meet the operating performance objective, the Board seeks to provide accounting standards that will result in

    - relevant and reliable cost information for decision-making by internal users,
    - comprehensive, comparable cost information for decision-making and program evaluation by Congress and the public, and
    - information to help assess the efficiency and effectiveness of asset management.

38. The Board believes that the cost of software acquired or developed for internal use that meets the SFFAS No. 6 criterion for general PP&E should be capitalized. Internal use software is specifically identifiable, can have determinate lives of 2 years or more, is not intended for sale in the ordinary course of operations, and has been acquired or constructed with the intention of being used by the entity.[10]

39. This standard does not apply to software that is an integral part of stewardship property, plant, and equipment. For example, if software is a part of a weapons systems, it would not be capitalized but included in the cost of investing in that weapons system. On the other hand, software used to accumulate the cost of acquiring that weapons system or to manage and account for that item would meet the criteria for general PP&E and should be capitalized.

40. Regarding any costs of internal use software acquired or developed for stewardship PP&E or stewardship investments, the Board chose to

[10]See SFFAS No. 6, par. 17.

follow SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, and SFFAS No. 8, *Supplementary Stewardship Reporting*, and expense them as incurred. For example, a research project may involve new software applications for computer simulation or modeling and meet the definition of a stewardship investment in research and development. In such cases, that software should be expensed as part of that research and development stewardship investment. However, software used to manage, account for, and report on research and development projects and activities would meet the criteria for general PP&E and should be capitalized.

Comparison With SFFAS No. 6

41. As explained in the following paragraphs and in subsequent sections of the Basis for Conclusions, the accounting standard for internal use software required some tailoring of the provisions in SFFAS No. 6. First, the criteria in this standard for determining when to start amortizing/depreciating differs from SFFAS No. 6. SFFAS No. 6 provides that for constructed PP&E, depreciation begins when the PP&E is "placed in service." However, this standard defines the start of amortization for internal use software as the point when final acceptance testing is successfully completed. This additional criteria is necessary, especially for internally developed software—but also for contractor-developed and commercial off-the-shelf (COTS) software—because (1) testing plays a major role for software assets by demonstrating that the software product can meet the requirements and (2) of the need for clear point for ending the developmental phase.

42. A second area of tailoring involves "enhancements" and other potentially capitalizable expenditures incurred after the software and/or other general PP&E is in service. SFFAS No. 6 provides a criterion for capitalizable cost for general PP&E that is different from that required here for software enhancements. SFFAS No. 6 provides that cost incurred to either extend the useful life of existing general PP&E or to enlarge or improve its capacity should be capitalized.[11]

43. By contrast, this standard, as explained below, takes a different tack for software. It provides that material expenditures to add capability/functionality would be capitalized but expenditures that result in extending useful life or capacity would be expensed.

[11]Par. 37.

44. Finally, it should be noted that this standard provides additional procedures for recognizing and measuring impairment. The provisions in this standard and in SFFAS No. 6 are the same regarding situations where the software/general PP&E is impaired and will be removed from service in its entirety. Both provide that the loss is measured as the difference between the book value and the net realizable value, if any. However, as explained below, this standard also provides for instances where (1) operational software is only partly impaired and (2) developmental software becomes impaired.

Respondent's Comments

45. The respondents to the exposure draft (ED), *Accounting for Internal Use Software*, generally agreed with the principles presented therein. Most of the respondents agreed that the cost of internal use software and enhancements thereto should be capitalized, that capitalized amounts should be written down or off when the software is impaired, and that the guidance in the ED was sufficient to identify capitalizable cost and to recognize impairment. Two-thirds of the respondents agreed with the capitalization point in the ED—after (1) management authorizes and commits to funding a project and believes that it is more likely than not that the project will be successful and (2) the preliminary design stage is complete.

46. Some respondents raised objections and concerns, similar to those expressed in response to the original PP&E exposure draft, about capitalizing software, especially internally developed software. They were concerned that distinguishing between the cost of new and/or enhanced software on the one hand and maintenance and routine improvements that do not benefit future periods on the other hand would be difficult. Other respondents noted the rapidity with which technology changes and current software becomes obsolete, and said that the risky and uncertain nature of software development makes write-off much more likely for software than for general PP&E.

47. Notwithstanding these objections, the Board continues to believe that internal use software is similar to other general PP&E and should be accounted for accordingly. Internal use software and other **information technology** products and services are important resources for government operations. They are subject to similar risks of impairment and write-off and, otherwise, have general PP&E characteristics. Moreover, some respondents said they were already

capitalizing their COTS software, which represents a large and growing percentage of their software portfolio.

48. The Board believes that the difference between internal use software and other general PP&E is not sufficient to justify different accounting treatment. This standard provides guidance for determining when capitalization starts and stops, how to amortize the software, how to determine and measure impairment, and other guidance.

Cost-Benefit

49. Several of the respondents opposed the capitalization of internal use software because they do not believe that the benefits of doing so are worth the cost. The respondents are concerned about the difficulty and cost of evaluating, measuring, and tracking such information. Some respondents point especially to the difficulty of allocating federal employees' salaries and contractors' cost in multiuse contracts (e.g., systems development and maintenance).

50. Some argue (1) that capitalized internal cost related to developing internal use software is often unrelated to the software's actual value or is irrelevant, (2) that capitalization would result in arbitrary values and amortization periods, and (3) that such cost is frequently written-off, causing readers to be misled by the initial capitalization and subsequent write-off.

51. In Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, the Board points out that recommending accounting standards necessarily involves judgments about the cost and benefits of producing information and that standards can have different effects on different users. The Board is concerned that the benefits from standards should exceed the cost of complying with them but realizes that the benefits from standards are very hard to quantify.[12]

52. The Board is persuaded that the benefits from this standard exceed the cost. The Board believes that internal use software meets the

[12]Also, see OMB Circular A-130, *Management of Federal Information Resources*, par. 7d, which establishes the goal of having benefits exceed cost but notes that "the benefits to be derived from government information may not always be quantifiable."

definition of general PP&E and that general PP&E ought to be capitalized as an asset and amortized to the future periods benefited.

53. Capitalizing software contributes to the effective management of federal entities' resources. The careful measurement of the cost to construct capital assets, the matching of such cost to periods and programs benefitted on the federal entity's statement of net cost, and the comparison of cost with other alternatives for achieving the entity's goal comprise good management. Moreover, the regular review of software assets for impairment provides an early warning of problems. In short, such information provides periodic feedback about the quality and competitiveness of software products and services.[13]

54. The Board believes that expensing software costs incurred (1) in the preliminary design stage, (2) for software repairs and improvements that increase efficiency and useful life (see discussion of enhancements below), and (3) under materiality considerations will ease the burden of complying with this standard. Federal entities incur cost in the preliminary design stage exploring design and technical possibilities. Expensing this cost will limit the risk of "over-capitalization."

55. The Board realizes that software—in general—and internally developed internal use software—in particular—present difficult materiality considerations. However, the Board believes that federal entities will be able to use their discretion under the materiality provisions of federal accounting standards to set reasonable limits to capitalization and avoid incurring excessive cost in tracking de minimis items.

56. SFFAS No. 4 calls for the full cost of resources that directly and indirectly contribute to the production of outputs to be assigned to outputs through appropriate costing methodologies. Cost effectiveness is a key consideration in selecting a cost assignment method. As a general rule, directly tracing costs and assigning costs on a cause-and-effect basis are more expensive than cost allocations, because they require detailed analyses and record-keeping for costs

[13]See OMB Circular A-130, par. 8a, "Information Management Policy," and par. 9b, as well as OMB's *Capital Programming Guide*, for detailed guidance on analyzing information technology through the planning, acquisition, and management-in-use phases.

and activities. However, they are preferable because they produce more reliable cost information than cost allocations.[14] In any case, the method used to trace, assign or allocate costs must produce materially correct and complete costs.

57. The Board acknowledges that the service life of software is less predictable than that for other general PP&E. However, the Board is not persuaded that the difficulties of estimation and adjustment justify an accounting treatment different from that for other general PP&E. The Board believes that the additional guidance in the standard versus that in the ED will address the concerns raised by respondents and will be sufficient for federal entities to comply with the standard.

Cost To Be Capitalized—Direct And Indirect Cost

58. Many respondents agreed with the ED position that indirect cost should be expensed. The ED provided that such cost should be expensed because of cost-benefit considerations and the risk of over-capitalization.

59. Several respondents objected to the failure of the ED to require indirect as well as direct costs to be capitalized. Most of these respondents based their objection on the full-cost requirements in SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, believing that the Board would not be consistent with this standard unless full cost accounting were adopted.

60. The Board had reserved final judgment on the issue of capitalizing indirect cost at the time the ED was published. Several of the Board's members had argued that capitalizing only direct cost was inconsistent with SFFAS No. 4. Also, some Board members felt that, if the standard not did require indirect cost to be capitalized, the cost of internally developed internal use software would not be comparable with COTS and contractor-developed software, which would include indirect cost.

61. After reconsidering the issue, the Board is persuaded that SFFAS No. 4 requires both direct and indirect costs to be capitalized. Moreover, the

[14]SFFAS No. 4, par. 143.

new federal capital programming guidelines[15] require full life-cycle cost to be tracked, which is a more extensive requirement than that required by this standard, since it includes cost that would be expensed for accounting purposes.[16] Also, software asset values will be comparable among internally developed, COTS and contractor-developed software.

Commencing Capitalization

62. Two-thirds of the respondents agreed that capitalization should begin as described in par. 21 of the ED (and par. 16 of this standard): that is, when (1) management authorizes and commits to a software project and believes that it is more likely than not that the software will be completed and (2) the preliminary design stage is complete. Two of these respondents noted that the standard was consistent in this regard with the American Institute of Certified Public Accountant's (AICPA) draft Statement of Position (SOP).[17] Six other respondents would begin to capitalize only when "technological feasibility" is demonstrated.[18] Other respondents either would not capitalize internal use software under any circumstances or only COTS software.

63. The Board has added a framework for identifying the stages of a software project. Also, the standard now draws a sharper distinction between internally developed software on the one hand and COTS and contractor-developed software on the other. However, the Board believes that flexibility is needed so that the standard can be applied governmentwide.

[15]The Office of Management and Budget's (OMB) *Capital Programming Guide*, Supplement to OMB Circular A-11, Part 3 (July 1997), integrates the various executive branch and statutory asset management initiatives, including the Government Performance and Results Act, the Clinger-Cohen Act, and the Federal Acquisition Streamlining Act, into a single, integrated capital-programming guide.

[16]"Capital assets are land, structures, equipment, and intellectual property (including software) that ... have an estimated life of two years or more... The cost of a capital asset is its full life-cycle cost, including all direct and indirect cost for planning, procurement ... operations and maintenance, including service contracts and disposal." Capital Programming Guide, version 1.0, definition of capital asset, p. i (July 1997).

[17]Published March 4, 1998 as SOP No. 98-1.

[18]"Technological feasibility" is the criteria that the Financial Accounting Standards Board (FASB) used in Statement of Financial Accounting Standards (SFAS) No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed.*

64. One respondent asked for clarification regarding management's commitment to the software project. This is critical, since it is the starting point for the capitalization of software cost. The Board believes that management's authorization and commitment are a recognizable point for major software projects. A "go/no go" decision should be a visible milestone. Management should use its best judgment to identify when its commitment to a major software project takes place.

65. The Board decided that the "technological feasibility" test in SFFAS No. 6, which follows the Financial Accounting Standard Board's Statement of Financial Accounting Standards No. 86, should be changed. The Board believes that that test is appropriate for software developed for sale or lease or otherwise marketed but is not applicable to internal use software. Federal software should be capitalized because it is a long-lived operating asset rather than inventory to be sold. However, federal entities normally do not develop software for sale. If, in a rare instance, an entity should engage to develop software for another federal entity, SFAS No. 86 would be applicable.

Software Licenses

66. One respondent asked for guidance on accounting for licenses for COTS software. The Board had not discussed software licenses during its deliberations leading up to the publication of the ED. Software licenses can cover periods ranging from the entire estimated service life of the software (a "perpetual" license) to annual or more frequent periods and are similar to leases of general PP&E.

67. The Board believes that it would be appropriate for the federal entity to apply lease accounting concepts[19] and the entity's existing policy for capitalization thresholds and for bulk purchases to licenses. Immaterial costs would be expensed, but the entity should consider whether period costs would be distorted by expensing the license.

Capitalization Thresholds

68. In SFFAS No. 6, the Board carefully considered whether to take a prescriptive approach regarding capitalization thresholds or to permit each entity to set its threshold in light of its own particular operating

[19]See SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, "Capital Leases," pars. 43-46, and SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, par. 20, for federal accounting standards for leases.

environment. The Board decided that federal entities were too diverse to require one threshold for all entities; hence, the Board adopted a materiality approach whereby each entity establishes its own threshold as well as the guidance for bulk purchases. The Board continues to believe that permitting management discretion in establishing capitalization policies will lead to a more cost-effective application of the accounting standards.

Data Conversion Cost

69. The issue of whether to capitalize all, some, or no data conversion cost is a difficult one. Some argue that the cost of converting existing data to a new software system is analogous to the types of cost that the Accounting Principles Board Opinion (APB) No. 17, *Intangible Assets*, requires to be expensed as incurred because they are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole—such as goodwill (APB 17, par. 24). The Board is persuaded that data conversion costs are operating costs and should be expensed.

Amortization Period

70. Most respondents said that no maximum period for amortization should be set in the standard. One respondent asked for clarification regarding the meaning of the general requirement that the amortization period be "consistent with management's plan for use." Another respondent asked whether the amortization period should begin when capitalization stops or when the system is put into use, saying that, often, there can be a significant time lag between these two events. One respondent asked for clarification regarding incremental implementation.

71. The Board has added additional guidance regarding the cessation of capitalization and commencement of amortization. The standard now focuses on the point when testing is complete. The term "operational," which some respondents found vague, is no longer used as a definitive point for cessation of capitalization. Also, provision has been made to treat each location and/or module separately.

Enhancements

72. Several respondents requested additional guidance for distinguishing maintenance from enhancements. The exposure draft proposed capitalizing the cost of changes to the existing system as an enhancement if it is more likely than not that the changes add capabilities or useful life. One respondent asked whether the cost of changes that make the software or system easier to use and users

more efficient, but do not significantly change the capability/functionality (i.e., the system does not do any additional tasks), should be expensed or capitalized. Also, the ED proposed that year 2000 (Y2K) cost be expensed as incurred, even though they extend useful life. Several respondents asked whether Y2K cost were "enhancements."

73. The Board believes that an "enhancement" should be limited to instances where significant new capabilities are being added to the software. Merely making the software more efficient and/or extending its service life should not constitute a capitalizable cost. Software is more fluid and malleable than other PP&E and the Board concludes that a higher threshold for additional capitalization is reasonable.

Impairment

74. Two-thirds of the respondents said that the guidance on impairment was sufficient. Several respondents had questions about how the impairment provisions would apply to particular situations.

75. A respondent asked whether the availability of a new, updated version of COTS software with significantly improved functionality, efficiency, or effectiveness means that the older version is impaired even if the older version is still performing the functions for which it was designed. He asked whether the availability of new technology, whether adapted or not, render existing software "impaired." He asked about the affect of modernizing existing software to take advantage of the new technology. This respondent was concerned that if modernization is included in the definition of "impairment," there will be constant write-downs.

76. The Board believes that none of the situations cited by the respondent would meet the criteria of this standard in paragraphs 28-31. According to the criteria, in order for software to be considered impaired, it would have to have lost its service potential such that the federal entity would plan to remove it from service or the software would have had its capabilities reduced.

77. One respondent asked about the ED's proposal for expensing Y2K cost. Since the implementation date for this standard has been moved back to FY 2001, the issue is largely moot. However, the Board's rationale for recommending that the Y2K cost be expensed is that such cost is incurred to repair a design flaw rather than to add to the

software's capabilities or useful life, although the latter would be affected.

Working Capital Funds

78. At least one respondent was concerned about the impact of capitalizing non-COTS internal use software on the cash flows, billing rates, and performance measurement of working capital funds (WCFs). This respondent said that developing software internally and through contractors could require long lead times during which WCFs would have to finance the project because WCFs could not start to recover the cost from customers until the software project was complete and amortization commences. Also, this respondent said that write-downs or write-offs due to impairment by rapidly changing technology would be difficult to recapture from customers who expect and budget for consistent billing rates. This respondent believes that the capitalization of internally developed or contractor-developed software could result in fluctuating rates depending on when new projects come "on line" and on write-downs or write-offs due to impairment.

79. This respondent said that if write-downs or write-offs cannot be recovered from customers, then capital funds would be unavailable for investment, the WCFs' equity could be seriously impaired, and the WCFs would rapidly become unable to effectively provide the services for which they were established. The respondent said that WCFs are vulnerable to capital shortages because they operate on a break-even basis rather than generate retained earnings, and because they do not have access to private capital markets. This respondent's WCF currently capitalizes COTS software because it is a proven commodity; it becomes operational immediately and the WCF can begin chargingback the cost to customers.

80. Fixed assets usually provide important future benefits but require large amounts of resources up-front and extended periods for planning and acquisition. Making capital planning decisions is often difficult for agencies because full budget authority is required before the acquisition can commence and the entire acquisition has an immediate budgetary impact. This makes capital assets look expensive relative

to, for example, annual lease payments even though the latter may be more expensive in the longrun.[20]

81. Notwithstanding these very real concerns, the Board concludes that the WCFs problem is one of budgetary control and program finance rather than of accounting. Congress has instituted various alternatives for WCFs to acquire capital. The Board's responsibility is to recommend what it considers the best accounting treatment considering all the circumstances and the Board's objectives.

Implementation Date

82. The 23 respondents who addressed the question of the implementation date were almost evenly divided as to the feasibility of an FY 1999 implementation date. Most respondents opposing the FY 1999 date said that federal agencies do not have the cost accounting systems as yet to account for capitalized cost but are developing such capabilities. Some respondents said that most federal agencies have a great deal "on their plate" now, when one considers the many recent initiatives. They said that an FY 2000 or FY 2001 implementation date would be better.

83. One respondent said that the AICPA's SOP is effective for periods beginning after December 15, 1998, and that there is no reason for the federal government to adapt such a standard before the private sector does. The respondent said that federal implementation after the private sector implements its standard would allow the federal government to learn from the private sector's experience.

84. The Board believes that federal entities are striving to meet deadlines for audited financial statements, performance reports, cost accounting, technology management, and other initiatives. Entities resources are under stress to meet these deadlines. Thus, the Board believes that moving the implementation to FY 2001 is reasonable.

[20]See GAO, *Budget Issues: Budgeting for Federal Capital* (GAO/AIMD-97-5 Nov. 1996), for (1) an analysis of capital budgeting problems experienced by WCFs and federal agencies generally and (2) possible solutions.

Appendix B: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273

Statement of Federal Financial Accounting Standards No. 11: Amendments to Accounting for Property, Plant, and Equipment - Definitional Changes - Amending SFFAS No. 6 and SFFAS No. 8 Accounting for Property, Plant, and Equipment and Supplementary Stewardship Reporting

Status

Issued	December 15, 1998
Effective Date	The amendments to SFFAS Nos. 6 and 8 in this statement are effective for periods beginning after September 30, 1998, with earlier implementation encouraged.
Volume I References	
Volume II References	
Interpretations and Technical Releases	None.
Affects	
Affected by	• SFFAS No. 23 rescinds SFFAS No. 11 in its entirety.

Statement of Federal Financial Accounting Standards No. 12: Recognition of Contingent Liabilities Arising from Litigation: An Amendment of SFFAS No. 5, Accounting for Liabilities of the Federal Government

Status

Issued	December 1998
Effective Date	For fiscal years beginning after September 30, 1997
Volume I References	SFFAS No. 5, *Accounting for Liabilities of the Federal Government* provide information on accounting for leases
Volume II References	Liabilities (L40)
Interpretations and Technical Releases	None.
Affects	SFFAS No. 12, affects SFFAS No. 5, paragraphs 33 and 36, by changing the recognition criteria for recognizing liabilities arising from litigation.
Affected by	No other statements.

Summary

This standard amends Statement of Federal Financial Accounting Standards Number 5, Accounting for Liabilities of the Federal Government (SFFAS No. 5). It provides an exception to the contingent liability standard for recognizing loss contingencies on matters of pending or threatened litigation and unasserted claims.

For loss contingencies for matters of pending or threatened litigation and unasserted claims, a contingent liability would be recognized[1] when a future outflow or other sacrifice of resources is "likely to occur," a past event or exchange transaction has occurred, and the future outflow or sacrifice of resources is measurable. Before the amendment, SFFAS No. 5 called for recognition when an outflow is "more likely than not." In addition to recognition, disclosure[2] would be required for loss contingencies on matters of pending or threatened litigation and unasserted claims if it is at least reasonably possible that a loss or an additional loss may have been incurred. The amendment does not affect recognition of other types of contingencies.

[55]The term "recognize" means the formal recording or incorporating of an item into the financial statements of an entity as an asset, liability, revenue, expense, etc. See FASAB Consolidated Glossary

[56]The term "disclosure" means the reporting of information in notes or narrative regarded as an integral part of the basic financial statement. See FASAB Consolidated Glossary.

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Purpose

1. This Statement amends Statement of Federal Financial Accounting Standards Number 5 (SFFAS No. 5), A*ccounting for Liabilities of the Federal Government*, to provide an exception to the contingent liability standard for matters of pending or threatened litigation and unasserted claims. The proposed amendment would affect accounting for contingencies under SFFAS No. 5 by inserting an exception to the definition of "probable" and to the recognition criteria in SFFAS No. 5 (see current paragraphs 33, 36, and 38 of that standard in Appendix C).

Scope

2. This standard applies to evaluations and accounting recognition and disclosure of the future outcome of litigation.

Background

3. The Federal Accounting Standards Advisory Board (FASAB) was asked to clarify the application of the standard for recognizing loss contingencies for pending or threatened litigation and unasserted claims. SFFAS No. 5 provides the definition for "liability" and establishes specific standards for five liability categories, including contingencies.

4. SFFAS No. 5 defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss.[3] SFFAS No. 5 requires a liability to be recognized for loss contingencies when a past event or exchange transaction makes a future outflow of resources probable and measurable.[4] It defines "probable" as that which can reasonably be expected or believed to be more likely than not on the basis of available evidence or logic but which is neither certain nor proven.[5]

5. SFFAS No. 5 uses the same general framework for evaluating loss contingencies as Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (SFAS No. 5). Contingencies can be "probable,"

[3]SFFAS No. 5, par. 35, and also in Appendix C.

[4]SFFAS No.5, par. 36.

[5]SFFAS No. 5, par. 33 and also see SFFAS No. 5's Glossary.

"reasonably possible," or "remote;" and, based on that, are recognized on the balance sheet, disclosed in footnotes, or not mentioned in the financial statements, respectively. However, SFAS No. 5 defines "probable" as "likely to occur" instead of "more likely than not."[6]

6. Some auditors have expressed reservations about their ability under Statement of Auditing Standards 12 (SAS 12) to express an unqualified opinion on the entity's financial statements without a legal representation letter that refers to the SFFAS No. 5 standard. Lawyers have expressed serious objection to the definition of probable ("more likely than not") contained in SFFAS No. 5. They state that a lawyer's prediction of failure under the SFFAS No. 5 definition of "probable" ("more likely than not"), and the recording of a liability to reflect that judgment, could be used as an admission against interest, thereby jeopardizing the government's ability to fairly defend the public interest. Similarly, they further state that a lawyer's response to an auditor's request for information on matters where an unfavorable outcome is more likely than not could result in the disclosure of information protected by the lawyer-client privilege, disadvantaging the government in any dispute, and violating the American Bar Association's Code of Professional Responsibility.

7. The Board believes that this amendment clarifies the standard for contingencies involving pending or threatened litigation and unasserted claims and will facilitate communication among auditors, lawyers, those who prepare financial statements, and those who use the financial statements.

Materiality

8. The provisions of this statement need not be applied to immaterial items.

Effective Date

9. This standard is effective for reports issued subsequent to the date of this statement for reporting periods beginning after September 30, 1997.

[6]SFFAS No. 5, par. 3.

Accounting Standard

10. Paragraph 33 of SFFAS No. 5 is amended by adding "with the exception of pending or threatened litigation and unasserted claims" at the end of the first sentence. Paragraph 33 is further amended by adding the following footnote to the first sentence:

    The concept of probability is imprecise and difficult to apply with respect to most legal matters. The "more likely than not" phrase suggests greater precision than is attainable when assessing the outcome of matters in litigation. Accordingly, in the context of assessing the outcome of matters of pending or threatened litigation and unasserted claims, and recognizing an associated liability, "probable" refers to that which is likely, not to that which is more likely than not. Note that the remaining two criteria for recognizing a liability--that is, a past event or exchange transaction has occurred and the future outflow or sacrifice of resources is measurable--also must be met before recognizing a contingent liability in matters involving litigation.

11. Other conforming changes to SFFAS No. 5 are:

    The first bullet of paragraph 36 is changed as follows: "Probable: The future confirming event or events are more likely than not to occur, with the exception of pending or threatened litigation and unasserted claims. For pending or threatened litigation and unasserted claims, the future confirming event or events are likely to occur."

    Paragraph 38 of SFFAS No. 5 is amended by replacing "more likely than not" in the second bullet with "likely."

Appendix A: Basis for Conclusions

12. In their capacity as legal counsel to federal agencies, lawyers should evaluate the outcome of matters of pending or threatened litigation and unasserted claims, and estimate any losses therefrom, in accordance with the American Bar Association's *Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information.* Attorneys note that neither the outcome of litigation nor any loss resulting therefrom can be assessed "in any way that is comparable to a statistically or empirically determined concept of probability" (see *Auditor's Letter Handbook*, American Bar Association, page 18). The "more likely than not" phrase suggests greater precision than is attainable when assessing the outcome of matters in litigation.

13. Accordingly, in the context of such cases the standard refers simply to that which is "likely." In this context, therefore, "likely to occur" is used in federal accounting standards in the same way that it is used in Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, published by the Financial Accounting Standards Board in 1975.

14. The Board believes that this amendment will serve the objectives of financial reporting because it will facilitate communications among auditors, lawyers, those who prepare financial statements, and those who use the statements.

15. The Board published an exposure draft of this standard on October 30, 1998, and received thirty responses, six of which had no comment. Of the 24 who commented, 22 concurred with the proposed standard. (Two responses were positive but could not be characterized as concurrence.) No respondent objected to the amendment. Five respondents suggested broadening the scope of the amendment to apply "likely to occur" to all contingent liabilities.

16. Although some respondents suggested broadening the application, the Board concluded that the amendment should be limited to contingent liabilities resulting from litigation. Most respondents concurred with this approach. The Board plans additional research on this subject in 1999.

17. The Board has made minor changes to the proposal published as an exposure draft. Several respondents suggested minor changes in

wording and/or notations in paragraphs 33 and 36 in addition to or instead of paragraph 38 to clarify the amendment. The Board has adopted most of these suggestions.

18. The Board makes this recommendation with a vote of nine members approving issuance and no members opposing issuance.

Appendix B: Selected Section from Statement of Financial Accounting Standards No. 5, Accounting for Contingencies.

1. For the purposes of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

* * *

3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

   a. *Probable*. The future event or events are likely to occur.

   b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.

   c. *Remote*. The chance of the future event or events occurring is slight.

   * * *

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if both of the following conditions are met:

   a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statement. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

   b. The amount of the loss can be reasonably estimated.

Appendix C: Selected Sections of Statement of Federal Financial Accounting Standards No. 5, Accounting for Liabilities of the Federal Government (footnotes omitted).

* * *

33. "Probable" refers to that which can reasonably be expected or is believed to be more likely than not on the basis of available evidence or logic. The probability of a future outflow or other sacrifice of resources is assessed on the basis of current facts and circumstances. These current facts and circumstances include the law that provides general authority for federal entity operations and specific budget authority to fund programs. If budget authority has not yet been provided, a future outflow or other sacrifice of resources might still meet the probability test if (1) it directly relates to ongoing entity operations and (2) it is the type for which budget authority is routinely provided. Therefore, the definition applies both to liabilities covered by budgetary resources and to liabilities not covered by budgetary resources.

* * *

Contingencies

35. A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm a gain (i.e., acquisition of an asset or reduction of a liability) or a loss (i.e., loss or impairment of an asset or the incurrence of a liability).

36. This Statement does not deal with gain contingencies or measurement of contingencies that involve impairment of nonfinancial assets. When a loss contingency (i.e., contingent liability) exists, the likelihood that the future event or events will confirm the loss or the incidence of a liability can range from probable to remote. The probability classifications are as follows:

    - Probable: The future confirming event or events are more likely than not to occur.
    - Reasonably possible: The chances of the future confirming event or events occurring is more than remote but less than probable.
    - Remote: The chance of the future event or events occurring is slight.

37. The following are some examples of loss contingencies:

- collectibility of receivables,
- pending or threatened litigation, and
- possible claims and assessments.

Criteria For Recognition Of A Contingent Liability

38. A contingent liability should be recognized when all of these three conditions are met:

- A past event or exchange transaction has occurred (e.g., a federal entity has breached a contract with a nonfederal entity).
- A future outflow or other sacrifice of resources is probable (e.g., the nonfederal entity has filed a legal claim against a federal entity for breach of contract and the federal entity's management believes the claim is more likely than not to be settled in favor of the claimant).
- The future outflow of resources is measurable (e.g., the federal entity's management determines an estimated settlement amount).

39. The estimated liability may be a specific amount or a range of amounts. If some amount within the range is a better estimate than any other amount within the range, that amount is recognized. If no amount within the range is a better estimate than any other amount, the minimum amount in the range is recognized and the range and a description of the nature of the contingency should be disclosed.

Criteria For Disclosure Of A Contingent Liability

40. A contingent liability should be disclosed if any of the conditions for liability recognition are not met and there is at least a reasonable possibility that a loss or an additional loss may have been incurred. "Disclosure" in this context refers to reporting information in notes regarded as an integral part of the basic financial information.

41. Disclosure should include the nature of the contingency and an estimate of the possible liability, an estimate of the range of the possible liability, or a statement that such an estimate cannot be made.

42. In some cases, contingencies may be identified but the degree of uncertainty is so great that no reporting (i.e., recognition or disclosure) is necessary in the general purpose federal financial reports. Specifically, contingencies classified as remote need not be reported in general purpose federal financial reports, though law may require such disclosures in special purpose reports. If information about remote contingencies or related to remote contingencies is included in general purpose federal financial reports (e.g., the total face amount of insurance and guarantees in force), it should be labeled in such a way to avoid the misleading inference that there is more than a remote chance of a loss of that amount.

Statement of Federal Financial Accounting Standards No. 13: Deferral of Paragraph 65.2—Material Revenue-Related Transactions Disclosures

Status

Issued	January 1999
Effective Date	This amendment is effective for fiscal periods beginning after September 30, 1998. Earlier implementation is encouraged.
Volume I References	SFFAS No. 7, *Accounting for Revenue and other Financing Sources,* paragraph 65.2
Volume II References	Revenue (R40)
Interpretations and Technical Releases	
Affects	SFFAS No. 7 by deferring the effective date of disclosure requirements in Paragraph 65.2.
Affected by	SFFAS No. 20 rescinded SFFAS No. 7, paragraph 65.2.

Summary

Paragraph 65.2 of SFFAS No. 7 is deferred three years; it will be effective for periods beginning after September 30, 2000.

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Background

1. Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources* including paragraphs 65.2 became effective for fiscal year 1998. It included detailed provisions that apply to entities collecting taxes on behalf of the Federal Government.

2. Paragraph 65.2 of SFFAS No. 7 states:

> Entities that collect taxes and duties should disclose:
> 65.2 **Material revenue related transactions**. Revenue-related transactions affecting the beginning and end-of-period balances of accounts receivable, accounts payable for refunds, and the allowance for uncollectible amounts should be disclosed. All material types of revenue transactions which relate to the custodial responsibilities of the collecting entities should be disclosed. The disclosure should be comprehensive enough to include as a minimum: self-assessments by the taxpayers (or importers); assessments by the entity; penalties; interest; cash collections applied to taxpayer accounts and unapplied collections; refunds, refund offsets, and drawbacks; abatements; accounts receivable written off during the reporting period as uncollectible; and provisions made to the allowance for uncollectible amounts.

3. Because of difficulties in preparing the information and questions as to its usefulness, the Board agreed to consider deletion of paragraph 65.2. Ultimately, the Board agreed that more study of the issues was needed. Accordingly, it agreed that the requirement should be deferred.

Statement of Standards

4. Paragraph 65.2 of SFFAS No. 7 is deferred three years; it will be effective for periods beginning after September 30, 2000.

Effective Date

5. This amendment is effective for fiscal periods beginning after September 30, 1998. Earlier implementation is encouraged.

Basis for Conclusions

6. Experience gained by IRS and GAO while attempting to implement the provisions of SFFAS No. 7 provided greater insight into the difficulties of preparing, analyzing, and communicating the information described in paragraph 65.2 than was available when SFFAS No. 7 was approved. Based on that additional experience and insight, the Board proposed that subparagraph 65.2 should be rescinded. An exposure draft to accomplish this was published in November 1998. The exposure draft included the alternative view of one Board member. He believed that subparagraph 65.2 should be retained, albeit possibly with some modification.

7. The responses received by the Board which expressed an opinion on the proposal were approximately evenly divided. Respondents supporting the deletion indicated that the requirements were calling for more detailed analysis than generally found in accounting standards, were not cost beneficial, and were potentially misleading because assessments and associated abatements are often substantially overstated. Respondents opposing the deletion indicated that the requirements were essential for proper management and oversight, necessary to overcome the limitations of the modified cash basis of accounting for tax revenues, and helpful in ensuring that systems support evaluations of activity during the year.

8. After reviewing the comment letters and redeliberating, the Board agreed that the primary question was the degree to which the information would be relevant. Some members believe the information would be relevant to users and that it, or similar information, is needed to address the objectives of federal financial reporting. Other members believe that the information presented by IRS and the GAO staff responsible for auditing the financial statements of IRS calls into question the Board's prior conclusion that the information is relevant. Responses to the exposure draft that proposed deletion of subparagraph 65.2 did not resolve this issue. Therefore, the Board agreed that it should conduct further study regarding the relevance of the items of information discussed in subparagraph 65.2.

9. The Board concluded that the effective date for subparagraph 65.2 should be deferred three years; from fiscal year 1998 to fiscal year 2001. The Board expects to complete the study before the new effective date.

Board Approval

10. The Board approves this recommendation by a vote of eight members approving its issuance and one member opposing its issuance.

Statement of Federal Financial Accounting Standards No. 14: Amendments to Deferred Maintenance Reporting Amending SFFAS No. 6, Accounting for Property, Plant and Equipment and SFFAS No. 8, Supplementary Stewardship Reporting

Status

Issued	April 1999
Effective Date	For fiscal years beginning after September 30, 1998 with earlier implementation encouraged.
Volume I References	SFFAS No. 6, *Accounting for Property, Plant, and Equipment.* SFFAS No. 8, *Supplementary Stewardship Reporting*
Volume II References	Deferred Maintenance (D20)
Interpretations and Technical Releases	
Affects	• SFFAS No. 14, paragraphs 5-9, affect SFFAS No. 6, paragraphs 79-80, and 83-84 by changing certain section headings and adding phrases to paragraphs 83-84. • SFFAS No. 14, paragraphs 10-11, replace phrases in SFFAS No. 8, paragraphs. 50, 68, and 81.
Affected by	No other statements.

Summary

Deferred maintenance reporting is a required disclosure per Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property*, *Plant*, *and Equipment* (SFFAS No. 6), and is referenced in SFFAS No. 8, *Supplementary Stewardship Reporting*. This amendment does not modify the information to be provided users of federal financial statements. It does, however, modify the status of that information and thus the level of its review by financial statement auditors.

When SFFAS No. 6 was issued, the Board indicated that deferred maintenance reporting would evolve as preparers gained experience. The Board provided maximum flexibility to preparers noting that management would determine "acceptable condition" against which deferred maintenance would be assessed. (see SFFAS No. 6, par. 78, footnote 58) In addition, the Board noted that acceptable condition might vary between entities **and** between sites within the same entity. To ensure that readers would understand the deferred maintenance disclosures, the Board required that management's method of measuring deferred maintenance and management's requirements for acceptable condition be disclosed with the estimated amounts.

After the statement became effective, questions arose about whether this flexibility was appropriate given the status of the information as basic information (i.e., an integral part of the financial statements). The Board agreed that a change in status was warranted.

This statement amends SFFAS No. 6 and SFFAS No. 8 to define deferred maintenance information as required supplemental information (RSI) rather than within the financial statements and the notes thereto.

As required supplementary information, the deferred maintenance information will be subject to the audit procedures prescribed in AU Section 558.07, *Codification of Statements on Auditing Standards.* These procedures include inquiries to management and comparisons of the information for consistency. In addition, the auditor should consider whether the RSI should be covered in management's representation letter. The auditor may need to apply additional procedures required by other guidance, and to make additional inquiries if necessary based on the outcome of the required procedures. Readers should refer to the most current auditing standards for relevant guidance.

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Introduction

Purpose

1. The purpose of this amendment is to change the status of deferred maintenance information required by Statement of Federal Financial Accounting Standard No. 6, *Accounting for Property, Plant, and Equipment*. Before amendment, this information would have been presented in association with the statement of net costs. As amended, the standards require that deferred maintenance information be included as required supplemental information (RSI). Thus, a line item for "deferred maintenance" would no longer be required on the statement of net costs with a reference to a note disclosure.

2. The Basis for Conclusions presents the reasons for these amendments.

Scope

3. The statement amends both SFFAS 6 and 8 with regard to information on deferred maintenance.

Effective Date

4. This amendment is effective for periods beginning after September 30, 1998 with earlier implementation encouraged.

Accounting Standards

Amendments to SFFAS No. 6

5. Paragraph 79 and the heading "RECOGNITION" that precedes it are deleted.

6. The section heading "DISCLOSURE REQUIREMENTS" which appears before paragraph 80 is deleted. Paragraph 80 is amended by replacing "disclosed" with "reported."

7. The section heading "Disclosures" before paragraph 83 is replaced with "Required Supplementary Information."

8. Paragraph 83 is amended by adding the phrase “as required supplementary information” between the phrases “shall be presented” and “for all PP&E.” The requirement to report a range estimate when using the condition assessment survey method is modified by inserting “or a point” after the words “and a range.”

9. The section heading “Optional Disclosures” before paragraph 84 is replaced with “Optional Information.” In the second sentence, the word “disclose” is replaced with “report” and the word “disclosure” is replaced with “information.”

Amendments To SFFAS No. 8

10. Bullet 4 of paragraphs 50, 68 and 81 are amended by replacing “a note to the financial statements in which case a reference to the note will suffice” with “with the deferred maintenance information included elsewhere in the report in which case a reference to the information will suffice.”

11. Bullet 5 of paragraphs 50, 68 and 81 are amended by replacing “a note to the financial statements” with “the information.” Footnote 15 is amended by adding “as amended by SFFAS No. 14" to the end of the footnote.

Appendix A: Basis for Conclusions

12. The Board believes that the experience gained in implementing SFFAS Nos. 6 and 8 provides greater insight into the required deferred maintenance disclosures. In recommending the deferred maintenance standards, the Board recognized that experimentation would be needed before high quality information on deferred maintenance was available throughout the federal government. However, the implementation experience brought to light concerns regarding the degree of flexibility afforded during the experimentation period and audit issues.

13. In December 1998, the Board issued an exposure draft proposing amendments intended to address the concerns being raised. The concerns included:

    a. the ability of preparers to disclose an extremely large range estimate; and

    b. users perceptions regarding the nature of the information[1] being presented.

14. The exposure draft proposed that deferred maintenance information be moved from being associated with the Statement of Net Cost to Required Supplementary Stewardship Information (RSSI). The Board believed that this was consistent with the importance of the information as well as the experimental nature of the information. The Board explained in the exposure draft that the information would be audited as if it were required supplemental information (RSI).

[1]While deferred maintenance information as required under the SFFAS 6 provisions is very relevant, implementation demonstrated that it may not be reliable or comparable. The Board is concerned that placement of this information in notes would be a disservice to users.

15. There were 20 respondents to the exposure draft. The respondents were from the following groups:

	Federal	Nonfederal	Total
Users and others		2	2
Preparers	9		9
Auditors	9		9
Total	**18**	**2**	**20**

16. One respondent opposed the proposal and stated a preference for a delayed effective date. Seventeen respondents supported the proposal and two did not directly indicate support or opposition.

17. Respondents noted the need for more detailed guidance on preparing estimates as well as specific issues such as overseas facilities which have differing facilities standards. One respondent suggested that guidance be developed for small agencies for which deferred maintenance reporting may be unnecessarily burdensome. Many respondents acknowledged the importance of the disclosures and the need to address auditing standards for deferred maintenance as well as accounting standards.

18. A number of respondents suggested that moving deferred maintenance disclosures to stewardship reports would be appropriate because doing so would:

    a. lower the profile of the information,

    b. prevent distortion of *financial* data,

    c. reduce the resources needed to prepare and audit the data, and

    d. resolve audit concerns.

19. The Board is concerned that stewardship reports—required for the first time for fiscal year 1998 reports—may be considered of lesser significance than “financial statements” and the associated notes. In fact, stewardship reports were intended to facilitate presentation of highly important financial and non-financial information about complex aspects of federal government operations and responsibilities. Thus the Board plans a review of the results of the

implementation of stewardship reporting requirements. That review is expected to take place during calendar year 1999.

20. The Board does not believe that adding deferred maintenance information to stewardship reports would be appropriate in light of the planned review. In addition, deferred maintenance information presents measurement issues not currently experienced in stewardship reports.

21. The Board believes that a period of experimentation is desirable for deferred maintenance information and that classifying it as RSI is appropriate during the experimentation period. The use of RSI for experimentation is consistent with the practices of other standard setting bodies. For example, the Financial Accounting Standards Board (FASB) conducted a five year experiment in reporting on changing prices through RSI. During the experimentation period, FASB permitted flexibility in measuring the effects of changing prices.

22. The Board believes that experimenting with deferred maintenance reporting is vitally important to improving its usefulness. The current standards for estimating deferred maintenance are intentionally flexible in the following ways:

    a. either life cycle costing or condition assessment may serve as the basis for the estimates;

    b. management determines the "acceptable condition" of PP&E and may vary the acceptable condition by site and type of property; and

    c. engineering and/or maintenance standards are not referenced.

23. The Board intends that the Accounting and Auditing Policy Committee (AAPC) work with government-wide groups such as the Chief Financial Officers Council and the Presidents Council on Integrity and Efficiency to review the first year reports and identify areas requiring further guidance. At a minimum, the Board expects to develop guidance on determining acceptable condition. The Board plans to revise the standards based on experience gained during the experimentation period.

Board Approval

24. This recommended statement was approved by the Board with a vote of seven members in favor of its issuance and one member opposing its issuance. (Only eight members voted on this recommendation due to a vacancy on the Board.)

Appendix B: Amended Standards

Amendments To SFFAS 6

Definition

77. "Deferred maintenance" is maintenance that was not performed when it should have been or was scheduled to be and which, therefore, is put off or delayed for a future period.

78. For purposes of this standard, maintenance is described as the act of keeping fixed assets in acceptable condition. It includes preventive maintenance, normal repairs, replacement of parts and structural components, and other activities needed to preserve the asset so that it continues to provide acceptable services and achieves its expected life.[58] Maintenance excludes activities aimed at expanding the capacity of an asset or otherwise upgrading it to serve needs different from, or significantly greater than, those originally intended.

79. .... [See SFFAS 14 for the explanation of deletions.][59, 60]

Measurement

80. Amounts ... [reported] for deferred maintenance may be measured using:

- condition assessment surveys,
- or life-cycle cost forecasts.[61]

[58][Acceptable services and condition may vary both between entities and among sites within the same entity. Management shall determine what level of service and condition is acceptable.]

[59][... See SFFAS 14]

[60][... See SFFAS 14]

[61][Other methods may be used which are similar or identical to condition assessment survey or life-cycle costing. These methods would also be acceptable sources of information on deferred maintenance.]

81. *Condition assessment surveys* are periodic inspections of PP&E to determine their current condition and estimated cost to correct any deficiencies. It is desirable that condition assessment surveys be based on generally accepted methods and standards consistently applied.[62]

82. *Life-cycle costing* is an acquisition or procurement technique which considers operating, maintenance, and other costs in addition to the acquisition cost of assets. Since it results in a forecast of maintenance expense, these forecasts may serve as a basis against which to compare actual maintenance expense and estimate deferred maintenance.

... [See SFFAS 14]

Required Supplementary Information

83. At a minimum, the following information shall be presented for all PP&E (each of the four categories established in the PP&E standard should be included).

- Identification of each major class[63] of asset for which maintenance has been deferred.'
- Method of measuring deferred maintenance for each major class of PP&E.
- If the condition assessment survey method of measuring deferred maintenance is used, the following should be presented for each major class of PP&E:
  - description of requirements or standards for acceptable operating condition,
  - any changes in the condition requirements or standards, and
  - asset condition[64] and a range estimate of the dollar amount of maintenance needed to return it to its acceptable operating condition.

[62][Management shall determine what methods and standards to apply. Once determined, it is desirable but not required that methods and standards be applied consistently from period to period.]

[63]["Major classes" of general PP&E shall be determined by the entity. Examples of major class include, among others, buildings and structures, furniture and fixtures, equipment, vehicles, and land.]

[64][Examples of condition information include, among others, (1) averages of standardized condition rating codes, (2) percentage of assets above, at or below acceptable condition, or (3) narrative information.]

- If the total life-cycle cost method is used the following should be presented for each major class of PP&E:
  - the original date of the maintenance forecast and an explanation for any changes to the forecast,
  - prior year balance of the cumulative deferred maintenance amount,
  - the dollar amount of maintenance that was defined by the professionals who designed, built or manage the PP&E as required maintenance for the reporting period,
  - the dollar amount of maintenance actually performed during the period,
  - the difference between the forecast and actual maintenance,
  - any adjustments to the scheduled amounts deemed necessary by the managers of the PP&E,[65] and
  - the ending cumulative balance for the reporting period for each major class of asset experiencing deferred maintenance.

Optional Information ... [See SFFAS 14]

84. Stratification between critical and noncritical amounts of maintenance needed to return each major class of asset to its acceptable operating condition. If management elects to ... [report] critical and noncritical amounts, the ... [information] shall include management's definition of these categories. [See SFFAS 14]

The provisions of this statement need not be applied to immaterial items.

Amendments To SFFAS 8

Paragraphs 50, 68 and 81 of SFFAS 8 as amended with respect to condition reporting are shown below:

[65][Adjustments may be necessary because the cost of maintenance foregone may not be cumulative. For example, if periodic painting is skipped twice it is not necessarily true that the cost would be double the scheduled amount.]

Heritage Assets

50. (fourth bullet) Condition of the assets[14] unless it is already reported in ... [deferred maintenance information included elsewhere in the report.... [See SFFAS 14]

(fifth bullet) A reference to ... [the information] if deferred maintenance is reported for the assets.[15]

National Defense PP&E

68. (fourth bullet) Condition of the assets[21] unless it is already reported ... [deferred maintenance information included elsewhere in the report] [See SFFAS XX]

(fifth bullet) A reference to ... [the information] if deferred maintenance is reported for the assets. [See SFFAS 14]

Stewardship Land

81. (fourth bullet) Condition[26] of the stewardship land, unless it is already reported in ... [deferred maintenance information included elsewhere in the report]

(fifth bullet) A reference to ... [the information] if deferred maintenance is reported for the assets.[27] [See SFFAS 14]

[14][Examples of condition information include, among others, (1) averages of standardized condition rating codes; (2) percentage of assets at, or below acceptable condition; or (3) narrative information.]

[15][For guidance relating to deferred maintenance reporting, see the Deferred Maintenance standard in Accounting for Property, Plant, and Equipment, SFFAS No. 6.]

[21][Examples of condition information include, among others, (1) averages of standardized condition rating codes; (2) percentage of assets at, or below acceptable condition; or (3) narrative information.]

[26][Examples of condition information include, among others, (1) averages of standardized condition rating codes; (2) percentage of assets at, or below acceptable condition; or (3) narrative information.]

[27][For guidance on deferred maintenance reporting, see the Deferred Maintenance standard Accounting for Property, Plant, and Equipment, SFFAS No. 6.]

Statement of Federal Financial Accounting Standards No. 15: Management's Discussions and Analysis

Status

Issued	April 1999
Effective Date	For fiscal periods beginning after September 30, 1999
Volume I References	SFFAC No. 3, *Management's Discussion and Analysis*
Volume II References	Management's Discussion and Analysis (M10)
Interpretations and Technical Releases	
Affects	No other statements.
Affected by	No other statements.

Summary

This document establishes standards for preparing Management's Discussion and Analysis (MD&A). MD&A is an important vehicle for (1) communicating managers' insights about the reporting entity, (2) increasing the understandability and usefulness of the general purpose federal financial report (GPFFR),[1] and (3) providing understandable and accessible information about the entity and its operations, service levels, successes, challenges, and future. Some federal agencies also refer to MD&A as the "overview."

The basic concept that underlies the standards for MD&A is:

Each general purpose federal financial report (GPFFR) should include a section devoted to management's discussion and analysis (MD&A). It should address the reporting entity's performance measures, financial statements, systems and controls, compliance with laws and regulations, and actions taken or planned to address problems. The discussion and analysis of these subjects may be based partly on information contained in reports other than the GPFFR. MD&A also should address significant events, conditions, trends and contingencies that may affect future operations.

A separate document titled *Concepts for Management's Discussion and Analysis* explains the conceptual basis for the role and importance of MD&A, the general content of the GPFFR, and the elements of MD&A. The concepts provide a foundation for the standards presented in this document. The concepts include suggestions about the contents of MD&A, but those suggestions are not accounting standards or principles for federal reporting entities. In particular, the concepts are not "prescribed guidelines" for required

[1]The term "general purpose federal financial report," abbreviated GPFFR, is used as a generic term to refer to the report that contains the entity's financial statements that are prepared and audited pursuant to the CFO Act of 1990, as amended. Entities may refer to these reports using different terms, such as "Annual Report," "Accountability Report," "Financial Management Report," etc. Paragraphs 54-112 and Appendix 1 of Statement of Federal Financial Accounting Concepts 2, Entity and Display, describe and illustrate the contents of the GPFFR.

supplementary information as discussed in section 558 of the *Codification of Statements on Auditing Standards* published by the American Institute of Certified Public Accountants (AICPA). The only standards and prescribed guidelines for MD&A are in paragraphs 1-8 of this document.

The standards require MD&A to be included in each GPFFR as required supplementary information (RSI). MD&A should address:

- the entity's mission and organizational structure;
- the entity's performance goals and results;
- the entity's financial statements;
- the entity's systems, controls, and legal compliance; and
- the future effects on the entity of existing, currently-known demands, risks, uncertainties, events, conditions and trends.

The discussion and analysis of these subjects may be based on information in other discrete sections of the GPFFR or it may be based on reports separate from the GPFFR. The standards are effective for reporting periods that begin after September 30, 1999.

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Management's Discussion And Analysis

Statement Of Standards

1. A report that presents a Federal reporting entity's financial statements in conformance with Federal accounting principles should include management's discussion and analysis (MD&A) of the financial statements and related information. MD&A should provide a clear and concise description of the reporting entity and its mission, activities, program and financial performance, systems, controls, legal compliance, financial position, and financial condition. MD&A should provide a balanced presentation that includes both positive and negative information about these topics. MD&A should be regarded as "required supplementary information" as that term is used in auditing standards.[2]

2. MD&A should contain sections that address the entity's:

   - mission and organizational structure;
   - performance goals, objectives, and results;
   - financial statements; and
   - systems, controls, and legal compliance.

3. MD&A should include forward-looking information regarding the possible future effects of the most important existing, currently-known demands, risks, uncertainties, events, conditions and trends. MD&A may also include forward-looking information about the

[2]See section 558, "Required Supplementary Information," in *Codification of Statements on Auditing Standards*, American Institute of Certified Public Accountants (AICPA)

possible effects of anticipated future demands, events, conditions, and trends.[3] Forward-looking information may comprise a separate section of MD&A or may be incorporated with the sections listed above.

4. MD&A should discuss important problems that need to be addressed, and actions that have been taken or planned. Actions needed, taken, and planned may be discussed within the sections listed above or in a separate section of MD&A.

5. Because MD&A must be concise if it is to be useful, management must select the most important matters to discuss. This means that some items that are material to the financial statements, notes, and other sections of the GPFFR may not be discussed in MD&A.

6. MD&A should deal with the "vital few" matters; i.e., the most important matters that will probably affect the judgments and decisions of people who rely on the GPFFR as a source of information. (The specific topics mentioned in *Concepts for Management's Discussion and Analysis* are examples of items that might be relevant for MD&A of a given entity.) Matters to be discussed and analyzed are those that management of the reporting entity believes it is reasonable to assume could:

   - lead to significant actions or proposals by top management of the reporting unit;
   - be significant to the managing, budgeting, and oversight functions of Congress and the Administration; or

[3]The word "anticipated" is used in a broad, generic sense in this document. In this context the term may encompass both "probable" losses arising from events that have occurred, which should be recognized on the face of the basic or "principal" financial statements, as well as "reasonably possible" losses arising from events that have occurred, which should be disclosed in notes to those statements. "Anticipated" may include the effects of future events that are deemed probable, for which a financial forecast would be appropriate. The term may also encompass hypothetical future trends or events that are not necessarily deemed probable, for which financial projections may be appropriate. Such information about the possible effects of anticipated future demands, events, conditions and trends, if presented, should include the term or label "projected" or "projection," and the key hypothetical underlying assumptions should be explained. As with other information presented in MD&A, no examination of this information by the auditor is now routinely included within the scope of an audit of a federal entity's financial statements; however, preparers and auditors may find useful background information in the AICPA's Statements on Standards for Attestation Engagements Nos. 1 and 4, codified as section 200, "Financial Forecasts and Projections," of the AICPA's *Codification of Statements on Standards for Attestation Engagements.*

- significantly affect the judgment of citizens about the efficiency and effectiveness of their Federal Government.

7. Management of the reporting unit is responsible for the content MD&A.

8. The standards are effective for reporting periods that begin after September 30, 1999.

This Statement of Recommended Standards was adopted unanimously by the eight members of the Federal Accounting Standards Advisory Board serving on the Board in April 1999.

Appendix A: Basis For Conclusions

Background, Rationale, and Project History

9. The Board identified MD&A as a topic for its agenda shortly after the Board's inception. The Board deferred work on this topic, however, until it completed recommendations for an initial set of basic accounting standards.

10. FASAB published an initial exposure draft on MD&A in January, 1997. It was presented as a statement of recommended concepts rather than standards. The Board proposed that it would deal with MD&A conceptually, with the understanding that OMB would provide authoritative guidance on MD&A to implement the concepts. This approach would have been similar to the one used to deal with the topics of entity and display. The Board dealt with those topics conceptually in SFFAC 2. OMB then provided authoritative guidance in its Bulletin on Form and Content.

11. The Board received comment letters on the initial exposure draft from the following sources:

	Federal (internal)	Nonfederal (external)	Total
Citizens, users, academics and others[4]		4	4
Auditors	7	3	10
Preparers and financial managers	16		16
Totals	23	7	30

Concepts and Standards

12. The first exposure draft asked respondents whether all or part of the exposure draft's provisions should be issued as recommended standards rather than recommended concepts. Responses were mixed; most of those who commented on this question favored concepts, but a significant number expressed the view that standards

[4]This category includes representational organizations, retired federal employees, federal employees responding as individuals, and federal contractors, as well as academics and other GPFFR users.

would be appropriate. The Board concluded that, given the importance of MD&A as an integral part of the GPFFR, it would be appropriate for federal accounting principles to include standards for MD&A.

13. At the same time, the Board concluded that MD&A should be treated as required supplementary information. The Board agreed that it would recommend no detailed requirements or guidelines for MD&A at this time, beyond those in paragraphs 1-8. In other words, a discussion and analysis by management that addresses the listed topics should be required, because it is an essential part of a complete GPFFR. At the same time, management should have great discretion regarding what to say about those topics, subject only to the criteria in paragraphs 1-8 and the pervasive requirement that MD&A not be misleading. The standard itself, therefore, is not extremely prescriptive.

14. Because of this change from what was originally exposed for comment, the Board decided to expose separately the proposed standards and concepts for further comment. The exposure drafts were issued in October, 1998; responses were requested by January 1999. The proposed standard, like the final recommended standard, would require the auditor to note the omission of MD&A or the failure to address the specified topics. At the same time, RSI status for MD&A—coupled with the lack of specific, detailed, prescriptive standards for the content of MD&A—would minimize the requirement for the auditor to scrutinize MD&A. This, the Board believed, would provide the flexibility appropriate for dealing with topics such as performance measurement at this point in the evolution of federal financial reporting.

Responses to Second Exposure Draft

15. The Board received comment letters on the second exposure draft from the following sources:

	Federal (internal)	Nonfederal (external)	Total
Citizens, users, academics and others		3	3
Auditors[5]	~~3~~	~~3~~	~~6~~
Preparers and financial managers	11		11
Totals	**14**	**6**	**20**

16. Most comments were generally favorable, but comments were mixed regarding some points. A few auditors and preparers expressed some concern about requiring forward-looking information as RSI. Others expressed support for doing so. After considering these responses, the Board agreed to defer the recommended implementation date of the standard by one year and to make minor editorial changes to the standards and concepts that were exposed for comment.

17. Although the resulting standard differs from private sector standards, the Board expects that, in practice, the effect on auditors will not be greatly different.[6] In the private sector, corporations frequently include with their annual financial report the MD&A that they are required to file with the SEC. Because it is required by the SEC rather than by accounting standards, the auditor engaged to audit the corporation's financial statements normally treats MD&A as "accompanying information" that is not audited in the context of the audit of the financial statements. The auditor also may review the submission to the SEC and may have certain responsibilities in that regard, but the auditor's usual role regarding MD&A is, nevertheless, fairly limited.

18. Because this standard defines MD&A for federal reporting entities as RSI, auditors will have certain responsibilities regarding it; however, both the accounting standards specified here and the auditing standards specified by the AICPA (and incorporated in Government

[5]Includes the AICPA's Federal Accounting and Auditing Subcommittee and the Comptroller General's Advisory Council on Government Audit Standards.

[6]The standard itself differs from the SEC's guidance for MD&A in ways that reflect the unique federal reporting environment. This will affect what financial statement preparers must do to comply with the standard. For example, reporting on performance of governmental programs requires measures in addition to net income or net cost.

Audit Standards) for RSI are rather general. Therefore, the Board does not expect that this standard will cause the auditor to be deeply involved in reviewing the contents of MD&A.

19. More specific requirements regarding the content of MD&A may be added later by OMB acting on its own authority or pursuant to future FASAB recommendations. For example, OMB might at some time in the future require preparers to address certain of the suggested items in Concepts for Management's Discussion and Analysis. OMB also may provide more specific guidance regarding the auditor's responsibility for MD&A. That guidance may call for more extensive review of all or parts of MD&A than the minimum contemplated by this accounting standard in the context of current auditing standards. For example, OMB might at some time in the future decide that the minimum scope of engagements to audit federal financial statements should be expanded to include a review or examination of all or parts of MD&A, consistent with attestation guidelines published by the AICPA.[7]

Accountability Reports

20. The Board notes that the concept and practice of the "Accountability Report" continue to evolve through the pilot project voluntarily undertaken by several agencies.[8] The Board supports this evolution and encourages agencies to participate in the pilot project. The concepts and standards FASAB recommends are intended to be applicable to the GPFFR of Federal entities, whether those reports are prepared pursuant to the Chief Financial Officers Act, the Government Management Reform Act, or some future law that might establish a

[7]See Statement on Standards for Attestation Engagements No. 8, *Management's Discussion and Analysis*, issued by the Auditing Standards Board of the AICPA, March 1998.

[8]Accountability reports are broader in scope than traditional general purpose financial reports. As explained by OMB: "Six pilot agencies volunteered to produce an 'Accountability Report' for FY 1995 to provide more useful information to decision makers by linking together information required by several management statutes... Accountability Reports integrate the following information: the FMFIA report, the CFOs Act Annual Report (including audited financial statements); management's Report on Final Action as required by the IG Act; Civil Monetary Penalty and Prompt Payment Act reports; and available information on agency performance compared with its stated goals and objectives, in preparation for implementation of GPRA." *Federal Financial Management Status Report and Five Year Plan*, June 1996, pp. 33-34. Twelve agencies produced accountability reports for FY 1997; eighteen plan to do so for FY 1998; the number will increase to 23 for FY 2000. (The requirement to include Civil Monetary Penalty and Prompt Payment Act reports has been deleted.)

statutory basis for Accountability Reports. In the event of such future legislation, OMB will need to resolve any questions about how to apply existing Federal accounting standards in the context of new legislative requirements.

Forward-looking Information

21. MD&A should include forward-looking information regarding the future effects of existing, currently-known demands, risks, uncertainties, events, conditions and trends. This kind of forward-looking information is required when management believes it would be important to people who read the financial report. Though not required, MD&A may also include forward-looking information about the possible effects of anticipated future demands, events, conditions, and trends. FASAB encourages management to include forward-looking information about the possible effects of anticipated future demands, events, conditions, and trends to the extent management believes such information would be useful and relevant. This information can be highly useful, but management should avoid turning this part of MD&A into mere "lobbying" for more budgetary authority.

Incorporation by Reference

22. Some respondents expressed concern that, if MD&A is to be regarded as RSI, audit problems might arise from "incorporation by reference" in MD&A of information drawn from other sources that might not have been subject to audit or review as basic or required supplementary information, and for which authoritative guidance had not been provided by a standard setter. The Board noted that most of those who commented, including most auditors, did not appear to be greatly concerned about this potential problem. The Board concluded, therefore, that any such problems were not likely to be insurmountable. The Board did, however, agree to defer by one year the implementation date of the standard to allow OMB and GAO time to resolve any audit issues that may arise.

Statement of Federal Financial Accounting Standards No. 16: Amendments to Accounting For Property, Plant, and Equipment—Measurement and Reporting for Multi-Use Heritage Assets - Amending SFFAS No. 6 and SFFAS No. 8 Accounting for Property, Plant, and Equipment and Supplementary Stewardship Reporting

Status

Issued	July 1999
Effective Date	For fiscal periods beginning after September 30, 1999
Volume I References	SFFAC No. 6, *Accounting for Property, Plant, and Equipment* SFFAS No. 8, *Supplementary Stewardship Reporting*
Volume II References	Federal Mission PP&E (F20), General PP&E (G20), Multi-use Heritage Assets (M40), National Defense PP&E (N20), Nonfederal Physical Property (N60), Property, Plant, and Equipment (P60), Required Supplementary Stewardship Reporting (R10)
Interpretations and Technical Releases	None.
Affects	• SFFAS No. 16, paragraphs 6 and 8-12 replace SFFAS No. 6, paragraphs 59 and 60-62, respectively. • SFFAS No. 16, paragraph 14, amends SFFAS No. 6, paragraph 63, by adding certain phrases to clarify the treatment of heritage assets and accumulated depreciation removed from the accounts. • SFFAS No. 16, paragraph 15, provides additional implementation guidance for general PP&E and multi-use heritage assets. • SFFAS No. 16, paragraph 17, rescinds SFFAS No. 8, paragraphs 48-49, and notes that SFFAS No. 16, paragraphs 6-15, provide guidance on multi-use heritage assets. • SFFAS No. 16, paragraph 18, adds a footnote requirement to SFFAS No. 8 to explain that financial information for multi-use heritage assets is presented in the principal statements.
Affected by	No other statements.

Summary

The purpose of this Statement is to amend certain standards for heritage assets in Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment*, (SFFAS No. 6), which was issued in November 1995; and, Statement of Federal Financial Accounting Standards No. 8, *Supplementary Stewardship Reporting*, (SFFAS No. 8), which was issued in June 1996. Specifically, the amendments affect accounting and reporting standards for heritage assets that serve a dual purpose; that is, heritage assets that 1) have a heritage characteristic, and 2) are used in general government operations.

In SFFAS No. 6 and SFFAS No. 8, these heritage assets were referred to as “multi-use heritage assets.” To clarify the meaning of the term “multi-use heritage assets,” the amendments define “multi-use heritage assets” as being heritage assets whose predominant use is general government operations. Heritage assets having incidental use in general government operations are not referred to as “multi-use heritage assets.” Rather, they are simply “heritage assets.”

In addition, the original standards required the cost of multi-use heritage assets that did not directly relate to operations be accounted for as an expense, while costs that directly support operations be accounted for as general property, plant, and equipment (PP&E). This treatment would have resulted in inconsistent cost measures between agencies using heritage office buildings and those using non-heritage office buildings.

To alleviate this inconsistency, the Board decided that all acquisition, reconstruction, and betterment costs of multi-use heritage assets (i.e., heritage assets whose predominant use is general government operations) be capitalized as general PP&E and depreciated over their service life. This amendment should result in consistent accounting for the cost of PP&E predominantly used in general government operations.

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Introduction

Purpose

1. The purpose of this Statement is to amend certain standards contained in Statement of Federal Financial Accounting Standards Number 6 (SFFAS No. 6), *Accounting for Property, Plant, and Equipment*, and Statement of Federal Financial Accounting Standards Number 8 (SFFAS No. 8), *Supplementary Stewardship Reporting*.

Scope

2. This Statement specifically affects the accounting standards for heritage assets in SFFAS No. 6, paragraphs 59 and 60 through 63, and SFFAS No. 8, paragraphs 48 through 50.

Effective date

3. The amending accounting standards in this statement are effective for periods beginning after September 30, 1999, with earlier implementation encouraged.

Amendments To SFFAS No. 6

Introduction

4. Accounting standards for multi-use heritage assets are presented in paragraphs 5 through 15 that follow. The standards presented in these paragraphs supersede designated paragraphs in SFFAS No. 6 as they relate to multi-use heritage assets. Other paragraphs in SFFAS No. 6, which are not amended by this document or by Statement 11, remain in effect.

Heritage Assets

5. Heritage assets are defined in paragraphs 57 and 58 in SFFAS No. 6. Those paragraphs are not changed. However, accounting for "multi-use heritage assets" is changed. The new provision is provided in paragraph 6 below, which replaces paragraph 59 of SFFAS No. 6.

6. Heritage assets may in some cases be used to serve two purposes—a heritage function and general government operations. In cases where a heritage asset serves two purposes, the heritage asset shall be considered a multi-use heritage asset if the predominant use of the asset is in general government operations (e.g., the main Treasury

building which is a heritage asset used as an office building). The cost of acquisition, betterment, or reconstruction of all multi-use heritage assets shall be capitalized as general PP&E and depreciated.

Recognition and Measurement

7. Paragraphs 8 through 12 below replace paragraphs 60 through 62 of SFFAS No. 6.

8. The cost of acquiring, improving, reconstructing, or renovating heritage assets, other than multi-use heritage assets, shall be recognized on the statement of net cost for the period in which the cost is incurred. The cost[1] shall include all costs incurred during the period to bring the item to its current condition at its initial location (See paragraph 26 of SFFAS No. 6 for examples of the costs to be considered).

9. The cost of acquisition, betterment, or reconstruction of multi-use heritage assets shall be capitalized as general PP&E and depreciated, with an appropriate footnote disclosure explaining that "physical quantity" information for the multi-use heritage assets is included in supplemental stewardship reporting for heritage assets. The multi-use heritage assets shall be depreciated over their useful life.

10. With the exception of multi-use heritage assets, as stated in paragraph 11 below, no amounts for heritage assets acquired through donation or devise[2] shall be recognized in the cost of heritage assets. The assets' fair value, if known and material, shall be disclosed in notes to the financial statements in the year received. If fair value is not known or reasonably estimable, information related to the type and quantity of heritage assets received shall be disclosed.

11. Multi-use heritage assets acquired through donation or devise shall be recognized as general PP&E at the assets' fair value, and the amount shall also be recognized as "nonexchange revenues" as defined in SFFAS No. 7, *Accounting for Revenue and Other Financing Sources*.

[1]For a full discussion of cost, including full cost, direct cost and indirect cost, see SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government* (June 1995). Also, see pars. 94-95, Statement of Federal Financial Accounting Concepts No. 2, *Entity and Display.*

[2]A will or clause of a will disposing of property.

12. Additional reporting requirements are provided in SFFAS No. 8, *Supplementary Stewardship Reporting*.

Implementation Guidance

13. Paragraph 14 below replaces paragraph 63 of SFFAS No. 6. Paragraph 15 provides additional guidance on multi-use heritage assets. (Paragraphs 64 and 65 of SFFAS No. 6 remain in effect.)

14. Heritage assets (excluding multi-use heritage assets) previously recognized as assets for balance sheet reporting and their related contra amounts (e.g. accumulated depreciation) shall be removed from the balance sheet and charged to the net position of the entity. The amount of the adjustment shall be reported as a "prior period adjustment" in the statement of changes in net position.

15. Implementation guidance for general PP&E, in paragraph 40 through 44, SFFAS No. 6, is applicable to multi-use heritage assets. Entities that implemented the multi-use heritage asset standard in SFFAS No. 8 in prior years for stewardship assets, will need to capitalize those amounts upon implementation of this amendment. That amount shall be added to the balance sheet and reported as a "prior period adjustment" in the statement of changes in net position.[3]

Amendments To SFFAS No. 8

Introduction

16. Accounting standards for multi-use heritage assets are presented in paragraphs 17 and 18 that follow. The standards presented in these paragraphs supersede designated paragraphs in SFFAS No. 8 as they relate to multi-use heritage assets. Other paragraphs in SFFAS No. 8, which are not amended by this document, remain in effect.

[3]SFFAS No. 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting, paragraph 76.

Heritage Assets

17. Paragraphs 48 and 49 in SFFAS No. 8 are rescinded. The reader should refer to paragraphs 6 through 15 in this document for guidance on multi-use heritage assets. Paragraph 18, which is presented below, is added as a reporting requirement in paragraph 50 of the Heritage Assets Minimum Reporting requirements in SFFAS No. 8. Other paragraphs on heritage assets in SFFAS No. 8 remain in effect.

18. A footnote shall explain that financial information for multi-use heritage assets is presented in the principal statements.

Appendix A: Basis For Conclusions

19. This appendix summarizes the Board's considerations in recommending modifications to amend SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, and SFFAS No. 8, *Supplementary Stewardship Reporting*, as they relate to heritage assets.

Multi-use Heritage Assets

Background

20. In the original PP&E Exposure Draft (February 1995), renovation, improvements, restoration or reconstruction costs for that portion of the heritage asset used in general government operations were to be capitalized and depreciated. Meanwhile, the costs that primarily related to the preservation of the asset for a heritage purpose (e.g., excess cost of maintaining original design and construction materials) rather than general government operations were to be excluded from general PP&E (i.e., expensed in the period incurred). The response to this proposal contained in the ED was that costs could not be divided between heritage and general PP&E in this manner.

21. In the existing standards (SFFAS No. 6 and No. 8), costs of renovation, improvement, restoration, or reconstruction that can be directly related to government operations (e.g., modification or improvement of office space, upgrading of electrical or communication equipment/wiring) are to be capitalized and depreciated. Meanwhile, the costs to renovate, restore, or reconstruct the heritage asset itself (the shell) were to be excluded from general PP&E (i.e., expensed in the period incurred). Again, comments the Board received pertaining to implementing this requirement were that the distinction for the costs cannot be made and that it produces inconsistent results.

Exposure Draft

22. In February 1998, the Board issued an exposure draft (ED), *Amendments to Accounting for Property, Plant, and Equipment*, proposing amendments to SFFAS No. 6 and No. 8. In the proposed amendments, the costs of acquisition, betterment, or reconstruction of multi-use heritage assets (i.e., heritage assets used in general government operations) were to be treated as general PP&E and depreciated. The Board believes that this treatment would be consistent with the full cost standards, eliminate the need to adjust cost amounts presented in the government-wide consolidated

financial statements, and be consistent with the predominant use notion.

23. The proposed modification for multi-use heritage assets is based on various entities' accounting for and reporting on multi-use heritage assets. The current accounting standards created inconsistent treatment of assets that were ultimately used in the same ways. For example, because the general PP&E category includes all PP&E used in a business-type activity, the General Services Administration (GSA) will capitalize the full cost of its buildings because they are used in business. Meanwhile, entities performing non-business-type entities (i.e., providing a service without receiving value in return) will not show the full costs of their building because of its multi-use heritage asset status. This is inconsistent accounting that is not justified by the uses of the assets.

24. The Board found that consolidation of entities accounting for similar assets differently also could add unnecessary complexity to the consolidation process. Since a monumental office building accounted for by GSA as general PP&E and entirely capitalized by GSA becomes a multi-use heritage asset at the government-wide level, the asset, cost of heritage assets, and depreciation expense amounts would have to be adjusted on consolidation (subject to materiality limitations). The Board believes that this change to the accounting for multi-use heritage assets will also correct this unnecessary complexity.

Responses to ED

25. Thirty written responses were received in regard to the ED. Of the thirty responses received, fifteen respondents commented on the proposed amendments for multi-use heritage assets. Thirteen of the respondents who commented on the proposed amendments for multi-use heritage assets agreed with the proposed amendments, while the other two respondents who commented on them disagreed.

Board Decisions

26. To allow for full costing on assets used in general government operations, the Board believes that the costs of acquisition, betterment, or reconstruction of multi-use heritage assets should be capitalized and depreciated to allow for full costing in accordance with SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government.* Thus, the Board decided to capitalize and depreciate multi-use heritage assets and allocate the depreciation based on function.

27. Some respondents to the ED asked if multi-use heritage assets reported as general PP&E on the balance sheet should also be reported in supplemental stewardship reporting, in order to recognize them as heritage assets. It was observed by the Board that it would be desirable to report all material heritage assets in stewardship reporting, including those multi-use heritage assets reported on the balance sheet, to show a complete picture for stewardship purposes of all material assets classified as heritage assets. This is consistent with the Board's decision in SFFAS No. 8 to specifically note that some land might be included in heritage assets and in stewardship land. Different information is captured under the reporting for each category.

28. This dual reporting of multi-use heritage assets is highlighted through note disclosures directing readers from the balance sheet to the stewardship reports and vice versa. The amended standards require balance sheets to have a note disclosure which explains that "physical quantity" information for the multi-use heritage assets is included in supplemental stewardship reporting for heritage assets. In addition, for multi-use heritage assets reported in stewardship reporting, an appropriate note disclosure is required to explain that financial information for multi-use heritage assets is presented in the principal statements.

29. The ED also added the predominant use notion for multi-use heritage assets, because the Board agreed that incidental office use should not determine the accounting treatment; that the predominant use should prevail. An example of incidental office use would be administrative offices or shop space in the Jefferson Memorial. In this case both uses are incidental, and the Jefferson Memorial should be treated as a heritage asset and not be capitalized and depreciated.

30. One respondent to the ED suggested that "predominant use" be defined in the standard. During its deliberations, however, the Board noted that the terminology "predominant use" is already used in SFFAS No. 8 without any questions or problems being raised about its definition. Therefore, the Board believed that if it did define the term, that action may create a problem where no problem exists.

Board Approval

31. The Board approved this recommendation by a vote of eight members approving its issuance and zero members opposing its issuance. Although the Board is comprised of nine members, only eight members cast a vote on SRAS 16. This is because the term of one Board member had expired and the appointment of a successor had not been finalized.

Appendix B: Cross References From Paragraphs In SFFAS No. 6 and No. 8 To Paragraphs In These Amendments

Table I: References Related to Standards in SFFAS No. 6

Paragraph Numbers In SFFAS No. 6	Status and Reference To Paragraphs In These Amendments
Multi-use heritage assets, par. 59	Par. 6
Heritage assets measurement and recognition, par. 60 through 62	Par. 8 through par. 12
Heritage assets implementation, par. 63	Par. 14

Table II: References Related to Standards in SFFAS No. 8

Paragraph Numbers In SFFAS No. 8	Status And Reference To Paragraphs In These Amendments
Multi-use heritage assets par. 48 and 49	Par. 6 through 15
Heritage Assets Minimum Reporting Requirements, par. 50	Add par. 18

Appendix C: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273.

Statement of Federal Financial Accounting Standards No. 17: Accounting for Social Insurance

Status

Issued	August 1999
Effective Date	For fiscal periods beginning after September 30, 1999
Volume I References	SFFAS No. 5, *Accounting for Liabilities of the Federal Government* SFFAS No. 6, *Accounting for Property, Plant, and Equipment*
Volume II References	Stewardship Reporting (S70), Social Insurance (S40)
Interpretations and Technical Releases	
Affects	No other statements.
Affected by	SFFAS No. 25, paragraph 6 affects SFFAS No. 17 in two ways (1) the information required para. 27(3) and 32(3) shall be presented as a basic financial statement rather than as RSSI, and (2) other information required by SFFAS No. 17 shall be presented as RSI, except to the extent that the preparer elects to include it in notes that and presented as an integral part of the basic financial statements. Effective for periods beginning after Sept. 30, 2004.

Summary

I. This statement presents accounting standards for federal social insurance programs. The standards cover the following programs: Social Security (Old-Age, Survivors, and Disability Insurance), Medicare (Hospital Insurance [Part A] and Supplementary Medical Insurance [Part B]), Railroad Retirement benefits, Black Lung benefits, and Unemployment Insurance. The standards do not cover any other programs at this time.

II. Social insurance programs have complex characteristics and thus require specialized accounting standards. These programs blend elements of exchange and nonexchange transactions and therefore do not completely fit traditional accounting notions of either annual governmental assistance programs (nonexchange transactions) or long-term pension programs (exchange transactions).

III. Because taxpayers rely on social insurance programs in their long-term planning, fundamental questions about social insurance programs include (1) whether they are sustainable as currently constructed and (2) what their effect on the government's financial condition will be. The requirements of this standard reflect the complexity of these programs. In its entirety, the information required will help users assess the government's financial condition and the sufficiency of future budgetary resources for these programs. No single element of the information required is sufficient to meet all the users' needs.

IV. The standards require that a liability be recognized when payments are due and payable to beneficiaries or service providers. Supplementary stewardship information is to be reported to facilitate assessing the program's long-term sustainability and the ability of the program and the nation to raise resources from future program participants to pay for benefits proposed to present participants.

V. The supplementary stewardship information is required in the financial reports of both the individual agency and the governmentwide entity. The information is tailored for specific programs but generally includes narrative and/or graphic presentation of the following:

(1) long-range cashflow projections in nominal dollars and as a percentage of (a) the payroll that is subject to the tax earmarked for the program and (b) the Gross Domestic Product;

(2) long-range projection of the ratio of contributors to beneficiaries (commonly called the "dependency ratio"); and

(3) a statement presenting the actuarial present values of (i) future benefits and (ii) contributions and tax income for social insurance programs.

VI. Although some RSSI is required for all programs, the differences in financing and benefits among programs require some tailoring of the RSSI. The standards also address the governmentwide entity where the RSSI necessarily must be presented at a more summarized level than at the agency level.

VII. The Board is issuing this statement after years of debate. Taken as a whole, the package of disclosures is a major step forward in meeting the objectives of federal financial reporting. Nonetheless, federal financial reporting is in a period of great change and the Board expects that further research regarding presentation of a federal balance sheet is needed. In Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, the Board acknowledged that an evolutionary approach would be taken:

> The FASAB recognizes that developing and implementing standards that will contribute to achieving certain objectives may take considerable time. Time will be needed to establish information-gathering systems and to gain experience by experimenting with alternative approaches. [par. 35]
>
> The FASAB expects that some of these objectives may best be accomplished through means of reporting outside general purpose financial reports. Indeed, the FASAB recognizes that information sources other than financial reporting, sources over which the FASAB may have little of no influence, also are important to achieving the goals implied by these objectives. [par. 36]

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Purpose

1. The purpose of this statement is to establish standards for reporting information on social insurance programs that will assist users in evaluating operations and aid in assessing the government's financial condition and the sufficiency of future budgetary resources to sustain program services and meet program obligations as they come due. Social insurance programs were studied and analyzed during the Board's work on Statements of Federal Financial Accounting Standards (SFFAS) No. 5, *Accounting for Liabilities of the Federal Government*, and No. 8, *Supplementary Stewardship Reporting*. However, the Board decided to address the subject in a separate project.

Scope

2. This statement establishes accounting standards to be used by component entities and by the governmentwide entity for the following federal programs: Old-Age, Survivors, and Disability Insurance (OASDI or "Social Security"), **Medicare**[1] Hospital Insurance (HI), Medicare Supplementary Medical Insurance (SMI), **Railroad Retirement** benefits, **Black Lung** benefits, and **Unemployment Insurance** (UI) for the general public. Accounting standards for UI for federal employees are provided in Statement of Federal Financial Accounting Standards No. 5 and are not within the scope of this statement. This statement should be applied only to programs listed in paragraph 14.

Background

3. As noted in FASAB's Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, *Objectives of Federal Financial Reporting* (*Objectives*), the Federal Government is unique when compared with any other entity in the country. It is the vehicle that citizens of the United States use to exercise their sovereign power. It has continuing responsibility for the general welfare. It also has unique access to financial resources in that it has the power to tax, to borrow, and to create money.

[1]See the [Consolidated] glossary (Appendix E) for definitions of terms used in the statement. Terms defined in the glossary are in **boldface** the first time they appear in the text.

4. As a result of these responsibilities, the Federal Government engages in many activities that have no counterpart or that are a relatively small part of the activities in the private sector. The government is concerned, for example, with macroeconomic policies to maintain incomes during recessions and therefore provides unemployment compensation and other benefits. It is concerned with the distribution of income and therefore (1) provides a wide variety of welfare payments in cash and in kind to low-income households and (2) makes taxes and many kinds of benefits "progressive." It is concerned about conditions and services in certain regions and communities, urban and rural, and therefore provides grants to state and local governments for various purposes. The fiscal year 2000 Budget of the United States reports that Social Security, Medicare, and other health and income security payments for individuals constituted more than 50 percent of the federal budget; grants to state and local governments comprised 15 percent.

5. In *Objectives*, the Board established four major reporting objectives around which accounting standards should be organized. Taken together, they provide a framework for assessing the existing accountability and financial reporting systems of the Federal Government and for considering how new accounting standards might enhance those systems.[2] The four objectives are

    1. Budgetary Integrity,
    2. Operating Performance,
    3. Stewardship, and
    4. Systems and Controls.

6. Although all the objectives are important, Nos. 2 and 3 directly impact the social insurance standards. Objective No. 2 provides,

    > Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities.[3]

[2]SFFAC No. 1, par. 109.

[3]SFFAC No. 1, par. 122.

As noted in *Objectives*, because government services are not usually provided in exchange for voluntary payments or fees, expenses cannot be matched against revenue to measure "net income." Moreover, directly measuring the value added to society's welfare by government actions is difficult. Nonetheless, expenses can be matched against the provision of services year by year. The resulting cost can then be analyzed in relation to a variety of measures of the achievement of results. Information about social insurance that is relevant to this objective includes the cost of the program as well as long-range estimates (and ranges of estimates) of future costs and other obligations. Estimates of future costs highlight the cost impact of changes in benefit levels as well as economic and demographic changes (e.g., in the cost of health care and in life expectancies).

7. Meeting Objective No. 3 is the other focus for this statement. It says,

> Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial condition has changed and may change in the future.[4]

This objective is based on the government's responsibility for the general welfare of the nation in perpetuity. It focuses not on the provision of specific services but on the requirement that the government report the broad outcomes of its actions. Thus, federal financial reporting should provide information that helps the reader to determine

- whether the government's financial position improved or deteriorated over the period,
- whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due, and
- whether government operations have contributed to the nation's current and future well-being.

8. In light of Objective Nos. 2 and 3, fundamental questions about social insurance programs that can be addressed by accounting standards include whether the programs are sustainable as currently

[4]SFFAC No. 1, par. 134.

constructed, whether the government's financial condition improved or deteriorated as a result of its efforts to provide these and other programs, and the likelihood that these programs will be able to provide benefits at current levels to those who are planning on receiving them. The information required by this standard, taken as a whole, will help users make this assessment while acknowledging the complexity of the programs and the uncertainty of long-term projections.

9. To meet the objectives of federal financial reporting, the standards require that:

   (1) a liability be **recognized**[5] when payments are due and payable to beneficiaries or service providers and

   (2) supplementary stewardship information be reported to facilitate the assessment of:

      (i) the long-term sustainability of the program from both an entity and a governmentwide perspective and

      (ii) the ability of the program and the nation to raise resources from future program participants to pay for benefits proposed to present participants.

10. The RSSI includes:

   - long-range cashflow projections,
   - long-range projections of the ratio between the number of those paying taxes earmarked for the program and the number of program beneficiaries, and

[5]The terms "recognition," "disclosure," and "required supplementary stewardship information" (RSSI) have specific, technical application in accounting. As explained further in the glossary to this statement, "recognition" (or "recognize") means formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, etc. "Disclosure" (or "disclose") means reporting information in notes or narrative regarded as an integral part of the basic financial statements. RSSI is information reported outside the principal financial statements that the Board considers essential to an entity's financial reporting and therefore recommends authoritative guidelines for its measurement and presentation.

- actuarial present values of (i) future benefits for and (ii) contributions and tax income from or on behalf of current and future program participants.

11. The specification of RSSI by the Board should not be construed as precluding management from voluntarily providing any additional information pertaining to the financial condition of its program that it believes useful and appropriate.

Materiality

12. The provisions of the accounting standards in this statement need not be applied to immaterial items.

Effective Date

13. The provisions of this statement would be effective for reporting periods that begin after September 30, 1999.

Accounting Standards For Social Insurance

14. The following programs are designated as social insurance and subject to these standards:

    - Old-Age, Survivors, and Disability Insurance (OASDI or "Social Security");
    - Hospital Insurance (HI) and Supplementary Medical Insurance (SMI), known collectively as "Medicare";
    - Railroad Retirement benefits;
    - Black Lung benefits; and
    - Unemployment Insurance (UI).

    No other programs are subject to these standards, and the characteristics presented below should not be used to include other programs.

Characteristics Of Social Insurance Programs

15. These programs were developed to carry out the responsibilities of the government and generally have characteristics that make them unique. Although they generally share certain characteristics, "social insurance" programs are too diverse to allow definitive criteria to be applied to include some and exclude others from the category. This statement identifies the following five characteristics common among social insurance programs:

(1) Financing from participants or their employers,
(2) Eligibility from taxes/fees paid and time worked in **covered employment**,
(3) Benefits not directly related to taxes/fees paid,
(4) Benefits prescribed in law, and
(5) Programs intended for the general public.

These characteristics are briefly described below.

Financing From Participants

16. Some of the resources needed to run these programs are raised through explicit taxes and fees collected from the program participant or from the participant's employer. Taxes paid are usually a fixed percentage of the participant's wage income.

17. Federal social insurance programs utilize "trust funds" to account for dedicated collections held for later use to accomplish the program's purpose. Federal **trust funds** are accounts designated by law as such for receipts earmarked for specific purposes and the associated expenditure of those receipts. Trust funds serve useful purposes in allocating federal spending authority and accounting for earmarked taxes.

Eligibility from Taxes/Fees Paid and Time Worked in Covered Employment

18. Eligibility for benefits under social insurance programs usually rests, in part, on current or previous taxes and/or fees paid by the individual, the individual's employer, or both, and the time worked in covered employment. Frequently an individual's taxes and/or fees paid and time worked in covered employment also make family members eligible.

Benefits Not Directly Related to Taxes/Fees Paid

19. Social insurance programs sometimes intentionally redistribute toward lower-wage workers. Lower-wage workers tend to receive proportionately more in benefits relative to taxes paid than the higher-wage workers, sometimes much more. Many social insurance plans also subsidize benefits for nonworking members of workers' families and others.

Benefits Prescribed in Law

20. Social insurance programs normally have uniform sets of entitling events; and schedules of benefits are developed, announced, and applied to all participants. Administrators of such programs have little discretion in determining who should get benefits or how much they should get.

Intended for the General Public

21. These programs are intended for the general public and not solely for present or former federal employees.

Component Entity Accounting & Reporting Standard

Expense & Liability Recognition

22. The expense recognized for the reporting period should be the benefits paid during the reporting period plus any increase (or less any decrease) in the liability from the end of the prior period to the end of the current period. The liability should be social insurance benefits due and payable to or on behalf of beneficiaries at the end of the reporting period, including claims incurred but not reported (IBNR).

23. For Unemployment Insurance (UI), the liability to be recognized includes (1) amounts due to states and territories for benefits they have paid to beneficiaries but for which they have not withdrawn funds from the federal unemployment trust fund (UTF) as of fiscal year end, and (2) estimated amounts to be withdrawn from UTF and benefits paid by states and territories after fiscal year end for compensable days occurring prior to fiscal year end.

Required Supplementary Stewardship Information

24. The entity responsible for the social insurance program should include in its financial report, as **required supplementary stewardship information** (RSSI), a clear and concise description of the program, how it is financed, how benefits are calculated, and its financial and actuarial status. The description should include a discussion of the long-term sustainability and financial condition of the program. A display should illustrate and the discussion should explain the trends

revealed in the data. The entity should consider both narrative and graphic presentations. Statutory or other material changes affecting the program after the current fiscal year, including those enacted between the fiscal year end and the date of the report, should be described, along with the implications thereof.

25. The projections and estimates used should be based on the entity's best estimates of demographic and economic **assumptions**, taking each factor individually and incorporating future changes mandated by current law. Significant assumptions should be disclosed.

26. All projections and estimates required in these standards should be made as of a date (the valuation date) as close to the end of the fiscal year being reported upon ("current year") as possible and no more than one year prior to the end of the current year. This valuation date should be consistently followed from year to year.

27. The information on financial and actuarial status should include the following measures and data:

    (1) *Cashflow Projections* - Projections of cashflow for those persons who are participating or eventually will participate in the program as contributors or beneficiaries during a projection period sufficient to illustrate long-term sustainability (e.g., traditionally the "Social Security," or OASDI, program has used a projection period of 10 years for relatively short-term and 75 years for long-term projections, and the UI program has used a projection period of 10 years for its projections). The projection should include current workers, retirees, survivors, disabled persons, and new participants entering the workforce or becoming beneficiaries, including those who will be born or immigrate to the United States during the projection period. The information should include the following:

        (a) Actuarial projections of the annual cashflow, in nominal dollars, with amounts reported for at least every fifth year in the projection period. The cashflow information should show

            (i) total cash inflow from:

                1) all sources and

2) excluding net interest on intragovernmental borrowing/lending,[6] and

(ii) total cash outflow.

The narrative accompanying the cashflow data should include identification of any year or years during the projection period when cash outflow exceeds inflow, both in total and excluding interest on intragovernmental borrowing/lending (the "cross-over points"), and an explanation of the significance of the "cross-over points.

(b) The actuarial estimate provided in 27(1)(a)(i)2) and 27(1)(a)(ii) immediately above as a percentage of

(i) **taxable payroll**[7] and

(ii) **Gross Domestic Product** (GDP).[8]

(2) *Ratio of Contributors to Beneficiaries* - With respect to the OASDI and HI programs, the ratio of the number of contributors to the number of beneficiaries (commonly called the "dependency ratio") during the same projection period as for cashflow projections (e.g., 75 years), using the program managers' best estimate.[9] At a minimum, the ratio should be reported for the beginning and end of the projection period.

[6]"Interest on intragovernmental borrowing" refers to interest earned by the social insurance program on obligations of the U.S. Government.

[7]Certain social insurance programs (i. e., SMI , Black Lung benefits, and UI) are either not financed by earmarked payroll taxes or are financed by state-determined payroll taxes on employers that can vary by state and by employer; therefore these programs are not required to provide this estimate.

[8]This requirement does not apply to the RRB, Black Lung, and UI programs.

[9]SMI, Black Lung benefits, and UI programs are financed by, respectively, premiums paid by covered participants and general fund contributions (SMI); direct payments from employers, excise taxes per ton of coal, and general fund contributions (Black Lung); and state/employer-specific payroll taxes (UI). Therefore, these programs are not required to provide the ratio of contributors to beneficiaries. The OASDI trustees refer to the ratio of beneficiaries to contributors as the "dependency ratio."

(3) *Actuarial Present Values* - For all programs except UI, a statement presenting the actuarial present value of each of the following:

All future expenditures during the projection period related to benefit payments:

(a) to or on behalf of current participants who have not yet attained retirement age (e.g., the Social Security Administration has assumed an age of 15 years for new participants and an age of 62 years for retirement),

(b) to or on behalf of current participants who have attained retirement age,

(c) to or on behalf of those who are expected to become plan participants (i.e., new entrants) during a projection period encompassing substantially all the present value attributed to (a) and (b) immediately above;[10]

All future contributions and tax income (from taxation of benefits) during the projection period:

(d) from or on behalf of current participants who have not yet attained retirement age (same group as in (a) above),

(e) from or on behalf of current participants who have attained retirement age (same group as in (b) above),

(f) from or on behalf of those who are expected to become plan participants (same group as in (c) above) during a projection period encompassing substantially all the present value attributed to (d) and (e) immediately above.

[10]A projection period for ***future*** participants would cover their working and retirement years. The entity would make an assumption about the length of this period. For example, the OASDI program uses a projection period of 75 years. A projection period for ***current*** participants (that is, for the people actually participating in the program) would theoretically cover all of their working and retirement years, a projection period that could be greater than 75 years a in few instances. As a practical matter the present values of future payments and contributions for/from current participants beyond 75 years usually would not be material, and a 75 year projection period would include virtually all the future contributions, tax income, and benefit payments for current as well as future participants.

Net present value of cashflow during the projection period:

(g) the actuarial present value of future contributions and tax income during the projection period [(d)+(e)+(f)] should be subtracted from the actuarial present value of future expenditures for the projection period related to benefit payments [(a)+(b)+(c)] to derive a total excess of future benefit payments over future contributions and tax income (or contributions and tax income over benefits).

Notes to the statement should present:

(h) the accumulated excess of all past cash receipts, including interest on investments, over all past cash disbursements within the social insurance program represented by the fund balance at the valuation date, and

(i) a statement that the actuarial net present value of the excess of future expenditures related to benefit payments to or on behalf of current participants, that is, of the "closed group" of participants (see (a) and (b) above), over future contributions and tax income from them or paid on their behalf (see (d) and (e) above) is calculated by subtracting the actuarial present value of future contributions and tax income paid by and for current participants [(d)+(e)] from the actuarial present value of the future benefit payments to them or on their behalf [(a)+(b)].

(j) information required in subparagraphs 27(3)(a)-(h) for the current year and separate estimates for each of the four preceding years.

(4) *Sensitivity Analysis* -

(a) For all programs except UI illustrate the sensitivity of the projections and present values required by paragraphs 27 (1) and 27(3) to changes in the most significant individual assumptions. For example, using the entity's "best estimate" cost assumptions as a baseline, show the effect of varying several significant assumptions one at a time to show the effect on the projection. At a minimum the OASDI and Medicare programs should analyze assumptions regarding

the birth and death rates, net immigration, the real wage differential, and the real interest rate. The real-wage differential is the difference between the annual percentage increase in wages in covered employment and the inflation rate, as measured by the CPI. The Medicare program should also analyze the health care cost factors and their trend.

(b) For UI illustrate the sensitivity of the projections required by paragraph 27(1) to changes in the unemployment rate assumption. The illustrations should reflect the effect of increasing the unemployment rate (1) by approximately one percentage point and (2) to a level sufficient to put stress on the system (e.g., to simulate the largest recession occurring within the last 25 years).

(5) *State-by-State Analysis* - For the UI program provide a state-by-state analysis illustrating the relative solvency of individual state programs. The analysis should provide the ratio of each state's current accumulated fund balance to a year's projected benefit payments based on the highest level of annual benefit payments experienced by that state over the last 20 years.

Transition

28. In instances where data are not available to calculate the actuarial estimates for one or more prior years, as required in paragraph 27(3)(j) the entity may apply the standard prospectively.

Consolidated Governmentwide Entity Accounting & Reporting Standard

29. The standard for consolidated governmentwide accounting and reporting for social insurance programs is the same as that for component entities except as provided below. Thus, except for the specific modifications listed below, the governmentwide entity should refer to the relevant paragraphs of the standard for component entities in the preceding section for a description of the information to be provided.

Expense & Liability Recognition

30. Expense and liability recognition for the consolidated governmentwide entity are the same as for the component entities (see pars. 22-23).

Required Supplementary Stewardship Information

31. The consolidated governmentwide financial report should include, as required supplementary stewardship information (RSSI), a summary of the entities' descriptions of their social insurance programs (see paragraph 24). The description should include a discussion of the long-term sustainability and financial conditions of the programs, illustrate and explain the trends revealed in the data, and explain the relationship of the social insurance program(s) to governmentwide financing, especially regarding the intra-governmental nature of trust fund assets and government debt.

32. The information on financial and actuarial status should include the following measures and data:

(1) *Cashflow Projections* -

(a) Cashflow projections should be made for all social insurance programs as described under the component entity standard (see par. 27), except that only cash inflow from the public (that is, excluding interest on intragovernmental borrowing/lending) and total cash outflow are required. At a minimum the OASDI, HI, and SMI programs should be separately identified. The projection period of the display should be based on those used by the component entities, which may require summarization or presentation techniques such as using more than one graph (e.g., a 10-year graph and a 30-year graph). The presentation should include an explanation of material crossover points, if any, where cash outflow exceeds cash inflow and the possible reasons therefore.

(b) For the programs indicated immediately below, estimated future cash inflow (excluding net interest on intergovernmental borrowing/lending) and outflow for the projection period described in paragraph 27 as a percent of

(i) taxable payroll for OASDI and HI, presenting each program separately, and

(ii) GDP for OASDI, HI, and SMI, presenting each program separately.

(2) *Ratio of Contributors to Beneficiaries* - For OASDI and HI, the ratio of the number of contributors to the number of beneficiaries (commonly called the "dependency ratio") during the projection period as described under the standard for component entities (see par. 27(2)).

(3) *Actuarial Present Values* - For all programs except UI provide a statement combining the entity statements required in paragraph 27(3)(a)-(i). The presentation should include data for the current year and separate estimates for each of the four preceding years. At a minimum OASDI, HI, and SMI should be separately identified.

(4) *Sensitivity Analysis* - For all social insurance programs provide a summary of the sensitivity analyses required under the standard for component entities (see par. 27(4)). At a minimum the summary should present the OASDI, HI, SMI, and UI separately.

(5) *State-by-State Analysis* - Provide a summary of the state-by-state analysis required for the UI program (see par. 27(5)).

Transition

33. In instances where data are not available to calculate the actuarial estimates for one or more prior years, as required in paragraph 27(3)(j) the entity may apply the standard prospectively.

Appendix A—Basis For Conclusions

Section 1 — Response To Comments Received

34. This appendix does not constitute authoritative guidance for those who prepare and audit general purpose federal financial reports. It summarizes important matters that the FASAB members considered as they deliberated on this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

35. FASAB published the exposure draft *Accounting for Social Insurance* in February 1998. The exposure draft included five questions and invited comments on the usefulness of the proposal for accounting and reporting for social insurance. Twenty-nine letters were received from the following sources:

	Federal (internal)	Nonfederal (external)	Total
General Public	2 [retired employees]	8	**10**
Auditors	3	4	**7**
Preparers and Financial Managers	12	0	**12**
Total	**17**	**12**	**29**

36. FASAB also held a public hearing on the exposure draft on October 5-6, 1998. Testimony was received from representatives of accounting, auditing, and actuarial organizations; from a public service organization; and from the Social Security and Medicare programs. Appendix C, Historical Background, provides a history of past accounting for these programs.

37. Section 1 of this basis for conclusions addresses certain responses to the exposure draft and the comments received at the public hearing.

38. The responses to the exposure draft illustrate what was described in the basis for conclusions for the exposure draft as two polarized views regarding recognizing or even disclosing a liability measure beyond the due and payable amount called for in this standard. Some respondents restated their views on the propriety of the accounting

proposed in the ED, and/or they said they favored one or the other of the two opposing views described in the basis for conclusions. Some respondents argued once again that social insurance programs are pay-as-you-go, income transfer programs for which an estimate of accrued and future benefits and contributions and tax income is inappropriate. Other respondents reiterated the contrary argument. They said that such programs are commitments for which a long-range accrual is not only appropriate but also essential for the balance sheet, if the information presented therein is not to be misleading.

39. The Board continues to believe that the original basis for conclusions in the exposure draft describes and explains the Board's conclusions adequately. Therefore, except for those issues specifically discussed immediately below, the Board is presenting the original basis for conclusions from the exposure draft in Section 2. Changes were made where necessary to reflect the requirement for a statement of social insurance in the final standard.

Expanded Presentation and Visibility of Actuarial Present Values

40. In response to comments received on the exposure draft and subsequent public hearing, the Board is adding a requirement for a statement presenting the actuarial present values (APV) of future benefits for and future contributions and tax income from or on behalf of all current and future participants during the projection period normally used by the programs. For example, the OASDI program uses a 75-year projection period. The net total of the statement will present the total excess of benefits over contributions and tax income.

41. The Board believes that this information will be useful in analyzing the sustainability and financial position of SI programs. The added detail on individual components of the actuarial net present value will provide analysts interested in different facts with useful detail. In addition, the statement presentation will increase the prominence of important data otherwise obscured in a long narrative.

42. The Board has considered whether the changes made regarding the presentation of actuarial present values requires re-exposure. The original exposure draft focused on one net actuarial present value, for the "closed group," while the final standard presents the components of that value as well as data on future participants. Also, the exposure draft proposed subtracting the fund balance at the valuation date from the actuarial present value of the net cash outflow over the projection

period, while the standard now calls for fund balance information to be presented in a note to the statement.

43. The Board decided that the new presentation and data did not require re-exposure. The information added to the standard results from adding more detail and modifying the display to increase visibility. These modifications are responsive to the views expressed by many during the comment period. The Board believes that the difference in the presentation does not warrant delaying the issuance of the standard.

Specific Identification of Social Insurance Programs

44. A few of the respondents disagreed with the approach in the exposure draft whereby programs are specifically identified. One respondent reasoned that an accounting standard would be more useful if it established definitive criteria for current and future programs to meet rather than designating only specific programs. Conversely, another respondent said the standard should be even more specific and deal with the individual programs separately because some have characteristics of defined benefit plans while others are similar to welfare programs.

45. After weighing these arguments carefully, the Board continues to believe that definitive criteria would be unworkable. Although these programs do generally share certain characteristics, they are complex. Each program has unique benefits, different eligibility requirements, and different financing arrangements. Because definitive criteria would be subject to interpretation, questions would arise about individuals programs that would require a response from the Board. The Board has decided to identify social insurance programs that now exist and consider the classification of other programs as they may arise in the future.

Consistency of Assumptions

46. Several respondents to the exposure draft expressed concern that projections of cashflow and GDP would not be consistent between entities and within an entity due to the use of different assumptions by separate programs. One respondent believed that cashflow estimates as a percentage of GDP would not be meaningful without a tremendous amount of effort and cost expended in coordinating assumptions and methodologies to achieve consistency.

47. The Board considered these arguments and decided not to require uniform assumptions. The assumptions used by Social Security and

Medicare, the two predominant programs, will be consistent. These programs use the same principal assumptions and have the same **trustees**. On the other hand, the Board concluded that the GDP projection should not be required of smaller programs and therefore explicitly exempts them from that requirement.

Sensitivity Analysis

48. Some respondents disagreed with the approach in the exposure draft regarding sensitivity analysis, which calls for showing the effect of changing one major assumption at a time. One respondent favored a general requirement that entities provide sensitivity analysis rather than telling them how to do it. This respondent favored the high-, low-, and intermediate sets of cost assumptions that are featured in the trustees' annual reports for Social Security and Medicare. Another respondent suggested that the standard not require sensitivity analysis because most users would not understand it and the potential for misuse would be great. Another respondent said that the requirement in the standard was useful because it gives an idea about the uncertainty associated with the estimate. However, this respondent said sensitivity analysis was inadequate without a further discussion of the nature of uncertainty itself and recommended mandating such a discussion.

49. The Board continues to believe that the analysis required by the standard is a clear, easily understood illustration of the sensitivity of projections to changes in assumptions. The Board recognizes the difficulty in illustrating the uncertainty inherent in all projections, especially very long-range projections. However, the requirement in the standard would not preclude the entity from presenting additional discussions of uncertainty and the Board expects that agencies would do so voluntarily.

State and Local Government Pension Accounting

50. Some respondents urged the Board to consider whether the approach used by state and local governments to account for employee pensions would be suitable, at least for some social insurance programs that are most analogous to pensions, such as the retirement benefit portion of Social Security. Those respondents focus on similarities, such as defined benefit formulas tied to earnings.

51. The Board concluded that there are important differences in the programs and environments involved. For example, state and local pension plans typically do not have extensive income transfer features. They are much like federal employee pension programs,

which are not considered to be social insurance. On balance the Board concluded that such an approach would be inappropriate.

Vote of Approval

52. This recommended statement was approved by the Board with a vote of 6 members in favor of its issuance and 3 member(s) opposing its issuance. Two members submitted written dissents, which are available for public inspection at the FASAB's offices.

Section 2 — Basis For Conclusions From The Exposure Draft

[Note: The Board's recommendation differs from the proposal made in the exposure draft. Certain sections from the basis for conclusion in the exposure draft were deleted since they are no longer relevant to the final recommendation. Paragraphs 40-51 explain the differences and reasons therefore.]

53. The following paragraphs address the basis for the Board's proposals on

- defining social insurance,
- recognition of liabilities and expense for social insurance, and
- required supplementary stewardship information (RSSI).

Characteristics of Social Insurance Programs

54. As stated in the introductory sections, the Board has analyzed certain programs that are generally considered social insurance. These programs have certain characteristics that set them apart from general assistance programs on the one hand and insurance programs on the other hand. Accounting standards for liabilities associated with general assistance and insurance programs are provided in SFFAS No. 5, *Accounting for Liabilities of the Federal Government*.

55. After analyzing specific programs, the Board determined that, although these programs generally shared certain characteristics, their operational features were too diverse for establishing definitive criteria that would include all the subject programs and exclude all other federal programs for which accounting standards have already been provided. Thus, the Board has outlined the general characteristics that social insurance programs usually—but not always—possess and has listed the specific programs to which the standards apply. This does not preclude the Board from considering an additional program(s) in the future and, given the individual circumstances pertaining to that program, including it within this

statement. However, no entity on its own volition should apply this statement to any program not listed in this statement.

56. Accounting for UI for federal employees is provided in SFFAS No. 5 and is not within the scope of this standard. SFFAS No. 5 provides that the unemployment program for federal employees should be accounted for like other postemployment benefits (e.g., severance benefits and workers' compensation) because the nature of the liability is similar. Federal employer entities must reimburse the Labor Department for the full cost of unemployment benefits received by former federal employees rather than paying a payroll tax each period.

Nature of Social Insurance

57. In determining how social insurance program transactions should be recognized in the financial statements and the supplementary information that should be provided about them, the Board considered the nature of the Federal Government, the nature of those programs, and the needs of users of federal financial reports. Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, *Objectives of Federal Financial Reporting*, notes the Federal Government's unique responsibilities for the common defense and general welfare and its unique access to financial resources and financing, including the power to tax and create money. The government undertakes many programs despite potentially unfavorable effects on its financial condition, and transactions between citizens and the government generally are not individual exchanges between willing buyers and sellers.[11]

58. Consideration of guidance for the recognition, measurement, and display of obligations for social insurance programs has continued to present the Board with significant, vexing theoretical and practical problems. The programs are complex, reach a unique order of magnitude, and involve projections that are extremely sensitive to assumptions whose range of possibilities is large.

Expense & Liability Recognition

59. The Board believes that the annual expenses of such programs should be the benefits paid during the accounting period plus any increase (or less any decrease) in the liability from the end of the prior period to the end of the current period, including claims incurred but not

[11]SFFAC No. 1, *Objectives of Federal Financial Reporting*, pars. 52, 53, 55, and 60.

reported. The liability should be social insurance benefits due and payable to or on behalf of beneficiaries at the end of the reporting period, and supplementary stewardship information should be provided as described in the standards.

Exchange and Nonexchange Transactions

60. During its consideration of social insurance and, before that, of liability accounting, the Board considered whether social insurance programs result in **exchange** or **non-exchange transactions** or whether they contained features of both. As described in Statement of Federal Financial Accounting Standards (SFFAS) No. 5, *Accounting for Liabilities of the Federal Government*, nonexchange transactions give rise to a different kind of obligation than exchange transactions under federal accounting principles.

61. The distinction between exchange and nonexchange transactions is important in determining the point of liability recognition in federal accounting. In an exchange transaction, a liability is recognized when one party receives goods or services in return for a promise to provide money or other resources in the future. However, for a nonexchange transaction, a liability is recognized for any unpaid amounts due and payable as of the reporting date, including estimates of claims incurred but not yet reported.

62. As defined in SFFAS No. 5, obligations become liabilities against the Federal Government in different ways and at different points within transaction cycles that relate to various programs. An important factor in distinguishing the liability recognition point among various federal programs is whether a nonexchange transaction is involved. Although a high probability may exist that a grant, a subsidy, or an income transfer will be made or will continue to be made in future years, the recipients do not have as high an equitable claim to receive grants, subsidies, or transfers in the future as do those who exchange service for promises of future payments. The latter have a greater probability of being paid than the former. At the same time, many people feel that some social insurance benefits, Social Security in particular, also have similar “exchange” or “equitable” claims. They also believe that social insurance benefits have as great a probability of being paid as any other payments.

63. Whether on the balance sheet or elsewhere in the financial report, estimates of the future amounts required to continue present policies regarding such programs are relevant to certain decisions and should

be disclosed or otherwise reported. In the context of the Board's definition, however, estimates of future nonexchange payments should not be recognized as a current period liability. On the other hand, any payments due as a result of past events but unpaid at the end of the period constitute a liability.[12]

Polarization

64. With regard to social insurance, the Board notes the strength of feelings on this issue. The Board has been faced with two polarized views. On the one hand there are those who believe a liability should be recognized for the net benefits expected to be paid in future periods to current participants. On the other hand, there are those who believe that the long-term obligation (i.e., beyond amounts due and payable at the end of an accounting period) associated with these programs is not a liability and should not be recognized as such. Some people also believe such amounts should not be reported as RSSI.

Arguments against Recognition, Disclosure, or Supplementary Reporting

65. The latter group would argue that social insurance programs do not result in exchange transactions, that social insurance programs are income transfers financed primarily by compulsory earmarked taxes and also, in certain cases, general revenues of the government. For them, the political nature of the commitment is critical, for its terms can be and are changed by the Congress to maintain **actuarial balance**. In this regard, they point to *Flemming*, *Secretary of HEW v. Nestor*, *Part I* (363 U.S. 608-611) wherein Mr. Justice Harlan, delivering the opinion of the Court, said,

> [T]he entire [Social Security System] rests on the legislative judgment that those who in their productive years were functioning members of the economy may justly call upon that economy, in their later years, for protection from the 'rigors of the poor house'...

He continued,

> It is apparent that the noncontractual interest of an employee covered by the Act cannot be soundly analogized to that of the holder of an annuity, whose right to benefits are bottomed on his contractual premium payments.... *To engraft upon the Social*

[12]SFFAS No. 5, pars. 129-131.

Security System a concept of 'accrued property rights' would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands. (Emphasis added.)

66. Those who believe that only the due and payable amount should be recognized as the liability would argue that, under social insurance, the government uses its sovereign power to require payment of taxes that it dedicates to finance benefits. The individual beneficiaries of these programs are receiving payments that may be indirect and disproportionate to the taxes paid by them or on their behalf. In the case of Social Security, the oldest social insurance program, those who retired in the first years after enactment in 1935 received benefits that were many times their taxes. This was possible because the system transfers resources across generations. The system transfers resources within a generation as well, from those working and paying taxes to the disabled, the surviving spouse, and dependent children.

67. They would argue that benefits have also been very different by family type, wage level, and sex. One-earner couples receive benefits that are far larger than taxes paid, followed by two-earner couples. Single females have still lower benefit/tax ratios, followed by single males. Low-wage earners have a higher benefit ratio than those with average or high wages. For each type of recipient, benefit/tax ratios have been trending down. High- and average-earning single males retiring now cannot expect to get their money back, with interest; and this will soon also be true for high-earning single females.[13]

Uncertainty

68. Some of those who do not believe that social insurance obligations constitute a liability argue that the level of future benefit payments is too uncertain for accrual as a liability. They point out that not only did Congress expressly include (and retain) the right to alter, amend, or repeal any provision in the **Social Security Act** itself, it has made such changes frequently. In the early years, the changes generally expanded benefits—for example, to dependents, the disabled, and early retirees; to a broader coverage of workers; to protect retirees against inflation—and increased tax rates. But as the system has matured, the changes have increased the tax rate further, taxed an increasing proportion of benefits, reduced cost of living adjustments

[13]See Steuele, C. Eugene, and Jon M. Bakija, *Retooling Social Security for the 21st Century: Right and Wrong Approaches to Reform*, (The Urban Institute Press, Washington, DC).

and various benefit provisions, and prospectively raised the retirement age.

69. They argue further that the benefit payments that might be made in the future are dependent on economic and demographic variables including the growth of real wages, interest rates, births, immigration, and labor force participation. The aggregate benefits under the **high cost Social Security assumptions** in 2070 are estimated by the Social Security Trustees to be 2.5 times those under the **low cost assumptions**. And the estimates change over time. The legislative changes in 1983 were expected to maintain a positive fund balance until 2063; however, by current **intermediate cost assumptions** the fund will run out three decades sooner.

Period Costs

70. Some argue that the critical issue is the period to which a particular cost or expense relates. They emphasize that a significant determination in accounting is to decide in which period a transaction should be recognized as an expense. They believe that social insurance benefits, like other non-exchange transactions, should be recognized as expenses in the time period when they are paid or are due and payable and not earlier when a participant has covered wages. Future social insurance benefits constitute program costs of future periods, notwithstanding that they may be for the purpose of carrying out responsibilities that the government has already assumed.

71. They would argue further that, given the nature of the Federal Government and of social insurance, liability-type measures of the social insurance obligation (e.g., the closed group measure...) are meaningless or even potentially misleading. In particular, they argue that this information would not be useful to assess sustainability. It ignores the pay-as-you-go financing, excludes future earmarked taxes from future participants, and results in such an enormous **actuarial present value** that it may needlessly scare those unfamiliar with the debate. Such measures do not reflect the way the program is financed under current law and could, if taken out of context, imply that the current participants have a right to benefits superior to future participants.

72. They argue that other supplementary information would provide useful sustainability information. For example, the Social Security Trustees' annual report provides "open group" projections of cashflow—in dollars, as a percentage of the tax base earmarked for

the program, of the GDP, etc.—and the "dependency ratio." The open group measure reflects the way the program is financed; and the dependency ratio—the ratio of contributors to beneficiaries—indicates whether the program could potentially encounter stress in the future. Both of these were proposed in the exposure draft on social insurance as part of the supplementary information. They argue that these and other measures provide meaningful sustainability information.

Arguments for Recognition, Disclosure, or Supplementary Reporting

73. Those who hold a contrary view believe either that the distinction between exchange and non-exchange transactions is not relevant to the liability recognition or supplementary reporting issue or that the programs possess characteristics that make the transactions predominantly exchanges. They argue that social insurance programs possess certain characteristics that, taken together, cause the criteria for recognizing a liability to be met long before payments are due and payable. Those characteristics are

    1. the contributory nature of the program (i.e., benefits are predicated to some extent on prior payments),
    2. time in covered employment,
    3. government sponsorship,
    4. benefits prescribed in law, and
    5. specific accounting entity (e.g., the trust fund) and long-range financing.

74. These characteristics, in conjunction with the historical experience and political climate affecting the programs, create obligations and societal expectations that make the outflow of resources highly probable — far more than 50 percent. Therefore, an accounting liability should be recognized at an earlier point than when payments are due and payable; and the liability should be based on long-term or actuarial estimates of future payments.

75. Supporters of this view note that social insurance programs, as distinguished from general assistance programs, require the payment of taxes in order to establish an "insured status" before an individual is eligible for benefits. This is often referred to as an "earned right to benefits." In addition, most such programs have an element of individual equity in their benefit formulas whereby greater levels of taxes result in greater levels of benefits — although Medicare HI is a notable exception. Moreover, both the participant and the employer

sacrifice value in anticipation of future benefit. Not only do the participants anticipate retirement benefits as a result of these sacrifices, many employers, including the Federal Government, build in the value of Social Security benefits when designing retirement plans. Those holding this view would argue that these factors make social insurance programs predominantly exchanges.

76. Some of those arguing for recognition or **disclosure** believe that social insurance programs are constructive liabilities and that users of financial statements are accustomed to seeing commitments as firm as these quantified in financial statements or in notes to the statements. Some say that there is little conceptual difference between the liability that is recognized for federal pensions and the closed group obligation for social insurance. They would say that the failure at least to disclose a liability-type measure of the obligation therefore would potentially be misleading to those who relied on the financial statements and would raise questions about the credibility of the statements.

77. In addition, they believe that the closed group number is a measure of the intergenerational transfer implicit in the program under its current terms and that this number should be reported. They would argue that the failure to disclose this number makes these programs look healthier than they are and thus may lead to poor decisions about consumption and saving by Congress and by citizens. Those who hold this view would argue that a closed group measure that treats social insurance benefits as earned annually would help users to understand the extent to which social insurance programs have committed future-year taxpayers to finance amounts earned by participants as of a given point in time.

78. Some of those who argue that a liability should be recognized on the balance sheet maintain that most of the financial reporting community in the United States have adopted a different standard than exchange or nonexchange. The Financial Accounting Standards Board (FASB) concept statements adopt an “asset/liability” perspective in which what matters is whether a promise has been made, not whether something has been received for it or how it will be funded—in other words, what matters is whether a future sacrifice of resources is probable, regardless of whether it arises from an exchange of consideration. From this perspective, the only reason for not recognizing a liability for the amount promised by the social insurance program would be the assumption that it may not be paid.

79. Because most users are familiar with FASB's definition, or at least are accustomed to seeing financial reports based on it, those who favor recognition or disclosure of a liability-type measure argue it is inherently misleading to fail to quantify the size of the promise that is continually being made and on which people are told they can rely. While many who support liability-type disclosure agree the open group data are desirable to aid in assessing the sustainability of social insurance programs, they also believe that an assessment of the financial condition of the program — and more importantly, of the Federal Government — is not possible absent liability or closed group data. If a reader seeks to answer the question — Have we burdened future generations of citizens with the cost of the current and past years? and, if so, to what extent? — the very large obligations for social insurance must be considered.

The Board's Conclusion Regarding Recognition, Disclosure, or Supplementary Reporting

80. The Board acknowledges that it is faced with two polarized views without much hope of one side convincing the other side of the correctness of its position. On the one side are those who believe that social insurance programs — especially Social Security and Medicare — constitute a liability of the Federal Government that should be recognized on the consolidated balance sheet and that the closed group is the best measure of it. They agree that other measures such as a long-range projection of a program's cash inflow from all sources and outflow for all purposes are also useful, and note that all measures of sustainability and financial condition must be taken in context to be meaningful. At the opposite pole are those who firmly believe that the closed group measure is meaningless or even potentially misleading and should not be disclosed at all in the financial report.

81. The Board recognizes that both approaches have limitations and that the data are best understood when used together. An "earned right" measure, for example, produces a relatively large dollar amount that could confuse the reader who is unaware of the way in which the program was intended to be funded. Although both sides make strong arguments, no empirical evidence has been offered that would prove one side right and the other wrong. The Board believes the best approach to resolve this issue is for the closed group data to be reported off the balance sheet as part of a balanced RSSI package of disclosures about the Social Security and other social insurance programs. *[The Board subsequently affirmed that the data necessary to calculate the closed group measure should be reported. See*

paragraphs 40-43 for a discussion of the Board's final recommendation.]

82. The Board believes such disclosure will provide useful information and also serve the interests of users who are concerned primarily with federal accounting in its entirety. The Board has heard much from the two opposing sides, within the Federal Government, with the keenest interest in this issue. It does not forget, however, a larger third group of constituents, both within and outside the Federal Government, who are concerned with federal accounting in its entirety.

83. The Board believes that these users would consider social insurance accounting in general and Social Security accounting in particular to be important but only as one element of the complex of problems in federal accounting that led to the establishment of the FASAB. A closed group measure of some type undoubtedly will be provided to this group of users from some source if it is not provided based on government standards. These users will be better served if the Federal Government defines a credible measure, calculating it by using assumptions consistent with other Social Security and other social insurance program estimates, and disclosing it with explanatory materials and in a governmentwide and national context.

Measurement of Social Insurance Obligations

84. Considering the polarity of these positions, the Board is persuaded that the requirements incorporated in this statement best serve the users of federal financial information. The Board continues to believe that, given the strength of these differing views concerning the nature of social insurance transactions, an overriding concern exists that no single measurement on the balance sheet or elsewhere could adequately convey the financial sustainability of social insurance programs or the impact on the financial condition of the administrative entities or the government as a whole. Using Social Security as an example, one could approach measurement from the perspective of an obligation to participants based on earned rights to future benefits; or one could approach measurement from a pay-as-you-go funding perspective, giving consideration to both future inflows and outflows. Projections based on a pay-as-you-go approach would acknowledge the way in which Social Security is funded and provide data on long-range sustainability based on the current benefit structure. An "earned rights" approach would acknowledge that, at any given point in time, Social Security has $X of accumulated

obligation to current participants that would need to be provided by future generations under current law.

85. The Board believes that a more complete picture of the financial condition of the government can be provided by a forward-looking assessment of whether it can "sustain public services and meet obligations as they come due." The users of federal financial information need to know a great deal about the future of social insurance programs, a large and growing proportion of federal spending with financing that is under demographic and other strains. Understanding the financial condition of these programs is important to understanding the condition of the Federal Government as a whole. In addition, many citizens depend on these programs for their own financial security. The Board therefore believes that useful information about the future prospects of these programs should be fully and impartially presented in the financial reports of entities operating these programs and in the consolidated financial report of the United States government. The social insurance standards set forth the minimum information that the Board believes necessary for that purpose.

Required Supplementary Stewardship Information

86. The Board believes that the required information is relevant for assessing the sustainability of social insurance programs and also bears on the government's financial condition. The following paragraphs discuss each of the RSSI elements.

Cashflow

87. An estimate based on the amount and timing of future cash inflows and outflows will help users understand the long-range sustainability of the social insurance programs based on current revenue and benefit structure. The Board believes that the yearly inflows and outflows under the open group method should be disclosed over a sufficient number of years (e.g., 10 years, 75 years) to display "crossover" points where outflows begin exceeding inflows. Crossover points provide an early warning as to the need to adjust either the revenue stream or the expenditure stream to ensure that the program is sustainable under current law.

88. The Board considered specifying the length of the projection (e.g., 10-20 years). However, it decided that allowing the entity to use its traditional timeframe was preferable, if the period presented is long

enough to reveal anticipated critical points as mentioned in the preceding paragraph.

Percentage of Taxable Payroll & GDP

89. Cashflow should also be put in relation to the taxable payroll or other tax base earmarked for the program, the GDP, or other benchmark that would be meaningful to users. The sustainability of a social insurance program cannot be determined solely on the basis of the financial position of the Federal Government. Rather, the size of the total fiscal burden shifted by government to future taxpayers—in relation to their ability to bear it—is critical to that determination. Thus, sustainability from the governmentwide perspective is better measured in terms of a healthy relationship between social insurance programs—and, indeed, the entire budget—and the national economy, as measured by the GDP or taxable wages.

Dependency Ratio

90. The ratio of contributors to beneficiaries, also commonly called the "dependency ratio" shows the estimated number of contributors (e.g., **covered workers**) per program beneficiary. The Board believes that a projection of the trend in the relationship between contributors and beneficiaries should be displayed. This ratio helps readers assess whether the program is under potential stress and whether it is sustainable as currently constructed. A deteriorating dependency ratio would illustrate the effect of demographic trends on relationships between contributors and beneficiaries that may affect the sustainability of the program as currently constructed.

The "Closed Group" Measure

[The social insurance exposure draft proposed that the net APV for the closed group of participants be reported as RSSI. As explained in paragraphs 40-43, the final standard requires information about the closed group APV, within the structure of the new statement of actuarial values, and an explanation of how to calculate it. See note No. 3 of the illustrated statement of social insurance, page 46. The closed group measure proposed in the exposure draft represented the actuarial net present value of (a) the future benefit payments to current participants, (b) future contributions to be made be them and their employers, and (c) the accumulated excess of cash receipts

over cash disbursements within the social insurance program represented by fund balance at the valuation date. The Board continues to believe that the closed group measure is useful, and that the following paragraphs from the exposure draft retain their cogency.]

91. The closed group measure is sometimes referred to as an actuarial liability[14] for certain social insurance programs relating to the closed group of current participants. Some believe it is analogous to the liability that would be recognized on the face of the balance sheet if social insurance programs were accounted for like federal pension and retiree health care benefits. Others dispute this, pointing to different financing arrangements, legal status, and the nature of social insurance and pensions.

92. Until 1985, the "prototype" *Consolidated Financial Statements of the United States* recognized a liability for Social Security, using a calculation similar to that called for by Opinion No. 8 of the Accounting Principles Board, *Accounting for the Cost of Pension Plans*, (APB 8). This liability was calculated by amortizing the "closed group" obligation and recognizing as a liability the unfunded portion that was amortized each year. APB 8 defined a variety of acceptable methods for measuring pension expense and required that any unfunded pension expense be recognized as a liability. APB 8 was superseded by Statement 87 of the Financial Accounting Standards Board (FASB), published in December 1985. FASB published Statement 87 to make accounting for pensions more independent of the financing arrangements, to provide more standardization in measurement of the pension expense and liability, and to require that at least a "minimum liability" be recognized in employers' Statements of Financial Position (balance sheets). From 1985 through 1994, the closed group amount was disclosed in a footnote in the *CFS*.

93. Some people believe that the closed group measure is analogous to the measure of "risk assumed" that would be reported as supplementary stewardship information if social insurance programs were accounted for like other federal insurance programs. SFFAS No. 5, *Accounting*

[14][A variety of actuarial methods exist which can be used to calculate an actuarial liability. The "closed group" measure is not identical to the methods that would be used in pension accounting. See paragraph 97]

for Liabilities of the Federal Government, defines "risk assumed" as the present value of unpaid expected losses net of associated premiums, based on the risk inherent in the insurance or guarantee coverage in force (i.e., the expected loss on the "current book of business"). In the context of social insurance, one would use the term "closed group" instead of "current book of business."

94. SFFAS No. 5 requires insurance programs, other than social insurance programs, to report the risk assumed amount if it differs from the amount recognized as a liability. (SFFAS No. 5 exempts federal life insurance and loan guarantee programs from this disclosure requirement because the relevant accounting standards already incorporate a similar concept in determining the amount to be recognized in the financial statements.) Some people believe that it is useful to report this information, for the same reason that it is useful to report it for other kinds of government programs. This reason was summarized in a report on budgeting for federal insurance programs other than social insurance. Although FASAB is concerned with financial reporting, not budgeting, the underlying rationale is similar:

> As a general principle, decision-making is best informed if the government recognizes the costs of its commitments at the time it makes them. For most programs, cash-based budgeting accomplishes this. However, for insurance programs, accrual-based budgeting, which would recognize the expected long-term cost of the insurance commitment at the time the insurance is extended, offers the potential to overcome a number of the deficiencies of cash-based budgeting by improving cost recognition. In concept, recognition in the budget of the risk assumed by the government would permit policymakers to consider these costs in relation to other funding demands and would improve the measurement of a program's impact on private economic behavior. In most cases, the risk-assumed approach to accrual would be analogous to a premium rate-setting process in that it looks at the long-term expected cost of an insurance commitment at the time the insurance commitment is extended. The risk assumed by the government is essentially

that portion of a full risk-based premium not charged to the insured.[15]

95. Other people believe that, because there has been no intent for individuals or cohorts of individuals (generations) to make contributions commensurate with the benefits they receive (as would be the case in other kinds of insurance programs), it would be misleading to report the amount of this intergenerational transfer implicit in social insurance.

96. The Board believes that ... the closed group measure represents a reasonably good estimate of the net responsibility of future participants, under current laws, to pay benefits to current participants. Although this amount is subject to change due to changing long-range demographics, it is not as volatile as the computation under the "open group" method that includes all current and future participants over the next 75 years since it relates only to individuals who already are participating in the program.

Transition Costs

97. Some people note that the closed group measure, in addition to being an important factor in assessing the financial position and condition of the program and of the government, also represents a rough estimate of the maximum "transition cost" of the program if it were to move from the present pay-as-you-go system to one that, like most pension plans, sets aside resources during workers' careers to finance the benefits they will receive after they retire.[16] The primary reason for reporting the size of this implicit liability in general purpose federal financial reports is to ensure that the financial report fairly presents the financial position, condition, and results of operations of the

[15]Budget issues: Budgeting for Federal Insurance Programs, General Accounting Office, GAO/AIMD-97-16, Sept. 30, 1997, p. 5.

[16]Several ways exist for measuring transition costs depending on, among other things, whether one assumes the current program will continue for current participants alongside a new program for new participants (similar to federal employees continuing with the Civil Service Retirement System after the creation of the Federal Employee Retirement System in 1983). In such a transition, the older program would be closed to new entrants. Another type of transition would be where the current participants will move on to the new system, with the transition cost being the amount owed them under the former program. The discussion of different methodologies for calculating transition cost is beyond the scope of this accounting standard; but see the Stephen Goss, "Measuring Solvency in the Social Security System," *Prospects for Social Security Reform*, ed. Olivia S. Mitchell, Robert J. Myers, and Howard Young (Philadelphia: University of Pennsylvania Press, 1999), 16-36.

reporting entities involved. It is also true, however, that this number is one way of quantifying the financing challenges relating to changing social insurance programs and is relevant to the concerns of users who are assessing options for dealing with those challenges. The number not only draws attention to the challenge but also quantifies it in a way that can support further analysis and decision-making. Federal accounting and financial reporting attempt to address the needs of users and to inform them for their decisions, including decisions on these highly important and topical issues.

98. For example, the 1994-96 Advisory Council on Social Security expressed interest in three different approaches to restoring financial solvency and improving the rate of return on individual's contributions to the Social Security System. The three plans were entitled "Maintenance of Benefits," "Individual Accounts," and "Personal Security Accounts (PSA)." The PSA plan involved transition costs that the plan's advocates explained as follows:

> Transition costs arise because, under the present system, there are large unfunded accrued obligations—that is, benefits scheduled to be paid to current retirees and to workers who have already paid taxes in excess of assets on hand. Under the plan, these obligations would be met as they mature. At the same time, the new fully-funded component of the system would be implemented. During the phase-in of the new system, the cost of meeting obligations under the existing system is sometimes referred to as the "transition cost."
>
> Transition costs would be met with a combination of added taxes and added Federal borrowing. The SSA [Social Security Administration] actuaries project that a 1.52 percent supplement to the payroll tax would cover average long-range transition costs over the next 72 years.[17] However, because the unfunded accrued obligations under the existing system are highest in the next couple of decades and taper off in later decades, there is a shortfall of revenues between about 2000 and 2034 and an excess of revenues thereafter. It is assumed that the shortfall would be met by issuing bonds to the public for the next 40 years (totaling an estimated $1.9 trillion in 2034, in 1995 dollars), and that these bonds would be fully repaid by the excess of tax revenues in the later period. [vol. 1, p. 32]

99. Similarly, Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, has discussed the challenge confronting the Social Security system and the relevance of the transition amount:

[17]Note that this rate differs from the 2.17 percent increase in the payroll tax that has been estimated to be necessary to maintain benefits under current law; see p. 25 of the 1994-96 Advisory Council report, vol. 1.

... It has become conventional wisdom that the social security system, as currently constructed, will not be fully viable after the baby boom generation starts to retire.... This imbalance in social security stems primarily from the fact that, until very recently, payments into the social security trust accounts by the average employee, plus employer contributions and interest earned, were inadequate to fund the total of retirement benefits. This has started to change. Under the most recent revisions to the law and presumably conservative economic and demographic assumptions, today's younger workers will pay social security taxes over their working years that appear sufficient, on average, to fund their benefits during retirement. However, the huge liability for current retirees, as well as for much of the work force closer to retirement, leaves the system as a whole badly underfunded.[18]

100. In the course of discussing a variety of economic issues and policy options (including "privatization") that transcend accounting, Mr. Greenspan continues:

Any move toward privatization will confront the problem of how to finance previously promised benefits. That would presumably involve making the implicit accrued unfunded liability of the current social security system to beneficiaries explicit.... If markets perceive that this liability has the same status as explicit federal debt, then one must presume that interest rates have already fully adjusted to the implicit contingent liability. However, if markets have not fully accounted for this implicit liability, then making it explicit could lead to higher interest rates for U.S. government debt.... There is reason to suspect, however, that if such a liability is made explicit in a manner similar to the transition procedure in Chile, each dollar of new liability will weigh far less on financial markets than a dollar of current public debt.[19]

101. Mr. Greenspan mentioned some reasons why the capital market's reaction—though possibly substantial—might be muted if the government made this implicit liability more explicit. The Federal Reserve has estimated that, using a 2 percent real rate of discount and other assumptions, the value of all currently accrued legislated future Social Security retirement benefits would be roughly $9.5 trillion.

102. The assumptions, benefits, population, and actuarial approach covered by this estimate differ somewhat from those used by the Social Security Trustees in the past to produce the closed group estimate comparable to the one called for by this statement. The calculation used for Mr. Greenspan's testimony is an estimate of the

[18]Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Task Force on Social Security, Committee on the Budget, United States Senate, Nov. 20, 1997, p. 1.

[19]Greenspan, p. 4-5.

actuarial present value of future benefits arising from individuals' covered employment to the date of calculation, without considering their expected future employment until they retire. The estimate for the closed group in this standard considers both benefits to be earned and contributions to be made for current participants, in addition to benefits already earned or credited. Also, Mr. Greenspan's estimate is for Old-Age and Survivors Insurance only while this standard proposes that the closed group estimate for Social Security also include Disability Insurance. However, the numbers are roughly comparable.

103. The Chairman concluded by saying

> We owe it to those who will retire after the turn of the century to be given sufficient advance notice to make what alterations in retirement planning may be required. If we procrastinate too long, the adjustments could be truly wrenching. Our senior citizens, both current and future, deserve better.[20]

. . .

Money's Worth

104. The Board considered requiring a "money's worth" measure. Such a measure would show all contributions paid and benefits received by different age groups (e.g., those born in 1920 compared with 1940). The 1994-96 Advisory Council on Social Security recommended that Social Security meet a test of providing a reasonable money's worth return on the contributions of younger workers and future generations, while taking into account the redistributive nature of the system. The Council said that, although money's worth return was only one measure among many, it was important to the long-range sustainability of the program for younger generations to believe that they were getting a reasonable return on their taxes. The Council said,

> **Social Security should provide benefits to each generation of workers that bear a reasonable relationship to total taxes paid, plus interest.**
>
> Many important values served by a Social Security system are not fully captured by looking solely at money's worth or rates of return. Nevertheless, the Council believes that it is important that young workers perceive that the system is fair. This perception suggests that the younger generation should be well treated in terms of the issue of money's worth, taking into account the fact that within each generation there will be a redistribution toward the lower paid. [vol. 1, p. 17]

[20]Greenspan, p. 9.

105. Some argue that the money's worth measure may be viewed as a good measure of potential future stress caused by the disparity between taxes and anticipated benefits. However, others argue that this measure is of questionable relevance given the basic design and breadth of the benefits available under some social insurance programs. For example, the Social Security benefit formula is designed to provide relatively higher benefits for workers with lower earnings. This feature of the program is inconsistent with a pure focus on money's worth. Finally, as commonly reported, this measure does not reflect some social insurance programs and program features such as benefits to the disabled or dependents in the event of the participant's death.

106. The Board considered the money's worth measure and believes that it presents a useful perspective. However, the Board decided not to require it because it fails to capture the complexity of social insurance programs and could be calculated from too many perspectives. The Board recognizes the usefulness of the measure for policy analysis (and management may wish to report it voluntarily) but it goes beyond what the Board regards as essential to present fairly the financial position, condition, and results of operations of the reporting entities involved (including the governmentwide entity). Accordingly, the Board decided not to require RSSI about money's worth.

Trust Fund Ratio

107. The Board also considered the "trust fund ratio" which is defined as the fund balance at the beginning of the year expressed as a percentage of the outgo during the year; or, in other words, the proportion of a year's outgo that could be paid with the funds available at the beginning of the year.[21] The trust fund ratio is one of several measures the Social Security trustees use to evaluate the short-term financial status of the trust funds. Also, the 1994-96 Social Security Advisory Council advocated using the trust fund ratio as a gauge of long-term sustainability. The Council recommended that, in addition to the actuarial balance over 75 years, the program should have a stable trust fund ratio over the final years of the 75-year forecast horizon.[22] The Council believed that the trend of trust fund ratio would indicate

[21]The 1997 Annual Report of The Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, p. 221.

[22]See *Findings and Recommendations*, vol. 1, p. 17 (Jan. 1997).

whether there would be cause for concern about the years beyond the 75-year horizon. The Council was concerned that all factors known at the time of the 75-year projection be considered and reported, including whether there were problems beyond the 75-year projection period. For example, even as the trustees are reporting that the system is in actuarial balance over 75 years, demographic trends could make the next 10 years beyond the 75-year horizon more expensive.

108. The Board decided not to recommend the trust fund ratio as RSSI for a number of reasons. In particular, to be useful, the ratio would have to be used in conjunction with a projection that was in actuarial balance or nearly so. Under the current "best estimate" projection, where fund balance is expected to be exhausted well before 75 years, the trust fund ratio would not be usable. Although the Board acknowledges that the ratio may be useful as an indicator of short-term financial condition, it believes the projections and estimates in this standard will be more informative for accounting purposes.

. . .

Component & Governmentwide Perspectives

109. In developing these standards, the Board attempted to address the component entity as well as governmentwide reporting. From the perspective of the component federal entity, the accounting and reporting includes assets in the form of Treasury securities as well as interest thereon. These are not claims on third parties. The assets of the funds are offset by an identical liability of the U.S. Treasury. Like other intragovernmental assets and liabilities, they do not represent assets (or liabilities) of the Federal Government as a whole and are eliminated for governmentwide reporting. The nonmarketable Treasury debt securities are evidence of the accumulation of excess cash receipts over cash disbursements within the social insurance program.

Appendix B - Sample Reporting For Illustration Only

NOTE

The sample report sections in Appendix B provide nonauthoritative illustrations of possible RSSI that would comply with this standard. The narrative, charts, tables, and other information shown there are intended to be one approach among others to provide a full description of the programs and to supply the required information. The standard does not require any particular format or graph. Most, but not all, of the data presented in Appendix B would be required by pars. 27 and 32 of the standard (e.g., the year the fund balance is exhausted [see par. 117] and the open group actuarial deficit as a percentage of taxable payroll [see par. 120] would not be required). This is done to illustrate that management may provide more supplementary information than is required by the standard.

Most data are taken from various reports for FY 1996 and are "actual data." Certain data are hypothetical. Although the data are realistic, readers should not rely on the validity of the data in the sample reports.

OMB provides specific form and content guidance on financial reports.

Social Security - Required Supplementary Stewardship Information

Statement of Social Insurance - Old-Age, Survivors and Disability Insurance - 75-Year Projection[a] as of September 30, 1996 [HYPOTHETICAL DATA]

Dollars in Trillions

		Prior Years			
	1996	**1995**	**1994**	**1993**	**1992**
Actuarial present value of future benefit payments[b] during the 75-year period to or on behalf of:					
Current participants not yet having attained retirement age[c]	$ X	$ X	$ X	$ X	$ X
Current participants who have attained retirement age[c]	X	X	X	X	X
Those expected to become participants (i.e., new entrants)	X	X	X	X	X
Subtotal—benefit payments for the 75-year period	**19**	**X**	**X**	**X**	**X**
Less the actuarial present value of future contributions and tax income during the 75-year period from and on behalf of:					
Current participants not yet having attained retirement age	Y	Y	Y	Y	Y
Current participants who have attained retirement age[c]	Y	Y	Y	Y	Y
Those expected to become participants (i.e., new entrants)	Y	Y	Y	Y	Y
Subtotal—contributions and tax income for the 75-year period	16	Y	Y	Y	Y
Excess of actuarial present values of future benefit payments over future contributions and tax income for the 75-year period [d]	**$ 3**	**$ X**	**$ X**	**$ X**	**$ Y**

Notes to the Statement:

[a]The projection period for new entrants covers the next 75 years. The projection period for current participants (or "closed group") would theoretically cover all of their working and retirement years, a period that could be greater than 75 years a in few instances. As a practical matter the present values of future payments and contributions for/from current participants beyond 75 years are not material.

[b]"Benefit payments" include administrative expenses.

[c]To calculate the actuarial net present value of the excess of future benefit payments to current participants (that is, to the "closed group" of participants) over future contributions and tax income from them or on their behalf, subtract the actuarial present value of future contributions and tax income by and on behalf of current participants from the actuarial present value of the future benefit payments to them or on their behalf.

[d]The calculation of the "close actuarial balance" used for analysis by the Social Security trustees differs from the calculation of the amount presented on this line. The trustees' close actuarial balance calculation includes the fund balance at the beginning of the period as an item of cash inflow and the cost of about one year's expenditure, as a target fund balance at the end of the period, as a cash outflow. The fund balance—which represents the accumulated excess of all past cash inflow, including interest on intragovernmental securities, over cash outflow within the social insurance program—for 1996 for the OASDI program is $ .6 trillion (OASI, $ .5 trillion, and DI $ .1 trillion). The fund balances for 1995-2, in trillions, were $.6, .5, .5, .4, respectively. The fund balance consists of a small amount of cash for current operations with the balance invested in Treasury securities. When presented for redemption, these securities will represent a first claim on the resources of the government.

Program Description

110. The Old-Age, Survivors, and Disability Insurance (OASDI) program, collectively referred to as "Social Security" or OASDI, provides cash benefits for eligible U.S. citizens and residents. During calendar year 1996, OASDI provided benefits to approximately 44 million beneficiaries. Eligibility and benefit amounts are determined under the laws applicable for the period. Current law provides that the amount of the monthly benefit payments for individuals, or dependent spouses and children, is based on the individuals' taxable earnings up to the date when payments commence.

111. The amount of the effective monthly OASDI benefits may be altered by changes in laws governing the program. In 1983 for example, up to one-half of OASDI benefits became taxable; cost-of-living-adjustments (COLAs) were permanently delayed six months; and the age for full retirement benefits was gradually increased from 65 to 67 over a 24-year period.

112. OASDI has been described as an income transfer program—that is, a program designed to reduce economic disparity by redistributing income between households. OASDI transfers income in at least two ways. First, its benefit structure is progressive in the sense that benefits during retirement for lower-income workers replace a larger proportion of income earned during their working years than is the case for higher-income workers. This results in an income transfer among workers of the same age group but in different income groups. Second, OASDI is financed largely on a pay-as-you-go basis. The payroll taxes paid to OASDI each year by current workers are primarily used to pay the benefits provided during that year to current beneficiaries. This results in income transfers between current workers and current beneficiaries and therefore between younger workers and older retirees, the disabled, and surviving family members.

Program Finances and Sustainability

113. As discussed in Note X to the consolidated financial statements, a liability of $34 billion is included in "Other Liabilities" on the balance sheet for unpaid amounts of OASDI benefits due to recipients for periods ended on or before September 30, 1996 ($33 billion in FY 1995). Virtually all of this amount was paid in October 1996. Also, an asset is recognized for the "investments in Treasury securities" as of September 30, 1996, of $550 billion ($483 billion in FY 1995). This investment represents trust fund assets accumulated from the excess of payroll taxes over benefits in prior periods. This fund balance is

available for OASDI's use in future periods when a deficit occurs in the program. These investments are referred to as "trust fund assets" throughout the remainder of this disclosure.

114. No liability has been recognized on the balance sheet for future payments to be made to present and future program participants, beyond the unpaid amounts as of September 30, 1996. This is because the OASDI is accounted for as a social insurance program rather than a pension program. Accounting for a social insurance program recognizes the expense of benefits when they are actually paid or are due to be paid because benefit payments are primarily nonexchange transactions and are not considered deferred compensation as would employer-sponsored, employee's pension benefits. Accrual accounting for a pension program, by contrast, would recognize the retirement benefit expenses as they are earned during a worker's career so that the full actuarial present value of the expected retirement benefits has been recognized by the time the worker retires.

115. ***Supplementary Stewardship Information*** - While no liability has been recognized on the balance sheet for future payments beyond those due at period end, actuarial estimates of future program activities are made annually to assess the financial condition and prospects for OASDI and are presented here as supplementary stewardship information. The statement presented above and the displays below represent the best estimate of future cash inflow and outflow based on the assumptions shown at the end of this section and considering future changes previously mandated by law. However, estimates extending so far into the future are inherently uncertain, and the uncertainty is greater for the later years in the period. This stewardship information includes:

(1) actuarial present values of future benefits for and contributions and tax income from or on behalf of current and future program participants;

(2) cashflow in **nominal dollars** and as percentages of taxable payroll and the GDP;

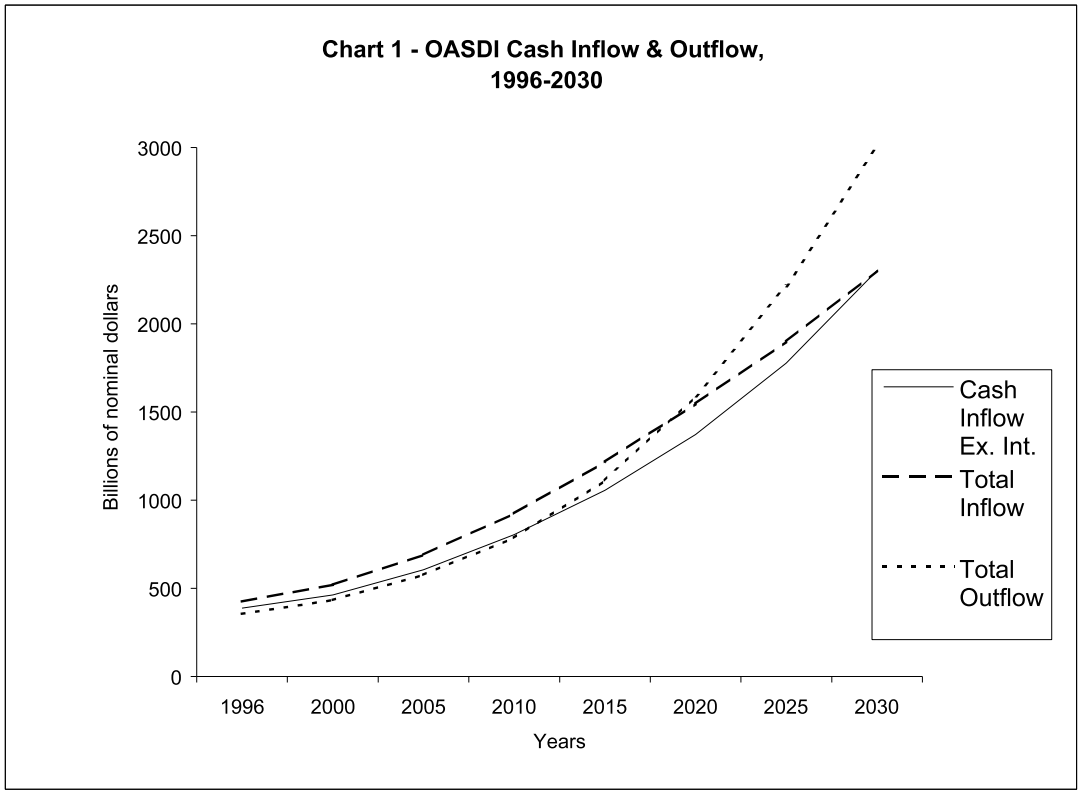
(3) the ratio of contributors to beneficiaries or "dependency ratio" showing the long-range relationship between the program's beneficiaries and contributors; and

(4) an analysis of the sensitivity of the projections to changes in assumptions.

116. *Cashflow Projections* - Chart 1 below shows the actuarial estimate of OASDI cash inflow and outflow for each of the next 35 years, in nominal dollars, using data from the OASDI Trustees' annual report. The estimate is based on what the Trustees refer to as the **open group population** (i.e., all persons who will participate in the program as contributors or beneficiaries or both over the next 35 years). Thus, it includes payments from, and on behalf of, employees who will enter the workforce during the next 35 years as well as those now in the workforce.

117. As chart 1 shows, present estimates indicate that, in nominal dollars, cash outflow would start to exceed total inflow (including interest on intragovernmental borrowing/lending) in about 2019. This deficiency would continue at an increasing rate thereafter, require the redemption of investments in Treasury securities held as assets by the trust fund, and result in the exhaustion of accumulated asset balances in 2029.[23] Even before 2019, outflow would exceed cash inflow from the public (i.e., excluding interest paid by Treasury). Estimates indicate this will happen in about 2012, as shown in chart 1. From about 2012 forward, OASDI would pay more to the public than it would receive in taxes. This would increase the government's financing needs. Compared to a situation in which OASDI taxes equaled outgo, the government would have to finance this difference by increased borrowing from the public, spending cuts, tax increases, or some combination of these measures.

[23][Please note: the standard does not require information on the year when the assets would be exhausted as the program is currently structured (see par. 117). This information illustrates that management can provide data in addition to that required by the standard where it feels doing so would be useful to readers of the report.]



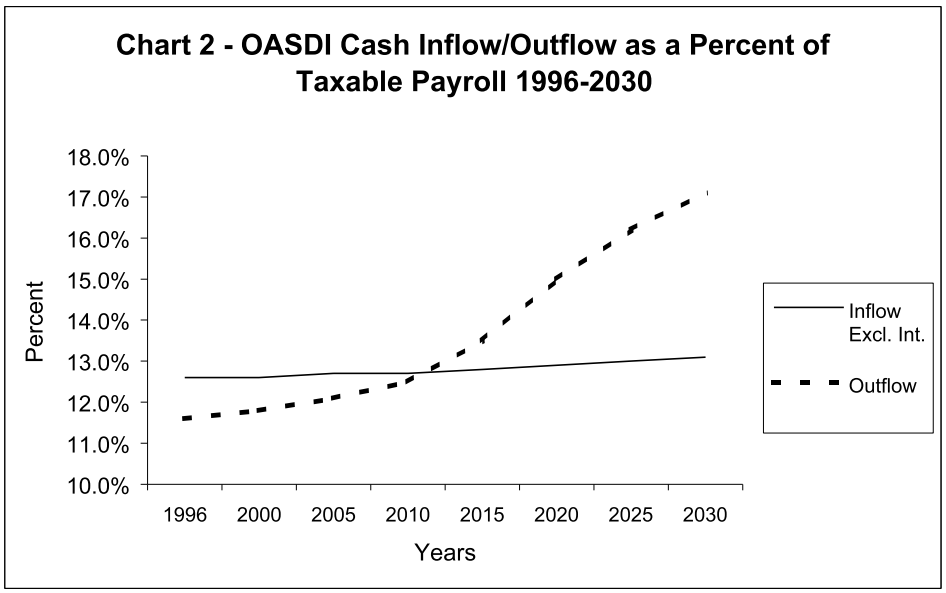
Source: Data from Tables III B1, B3, & C1, 1996 OASDI Trustee's Report.

Terms Used In Chart 1

The following terms are used in chart 1:

- **total inflow** includes payroll taxes, income tax on certain OASDI benefits, interest income, and miscellaneous reimbursement from the general fund;
- **cash inflow excluding interest** is income exclusive of interest on trust fund assets;
- **total outflow** includes benefit payments, administrative expenses, net transfers to the Railroad Retirement program, and vocational rehabilitation expenses for disabled beneficiaries.

118. *Percentage of Taxable Payroll* - The excess of cash outflow over inflow is due to a variety of factors including the retirement of the "baby boom" generation and the relatively small number of people born during the subsequent period of low birth rate. As presently constructed, the program receives most of its cash inflow from the 6.2 percent payroll tax that employees and employers each pay, for a total of 12.4 percent of taxable payroll. Chart 2 below illustrates the rising annual cost of the program relative to its annual income as a percentage of taxable payroll.



Source: Data from Tables III A2, 1996 OASDI Trustee's Report.

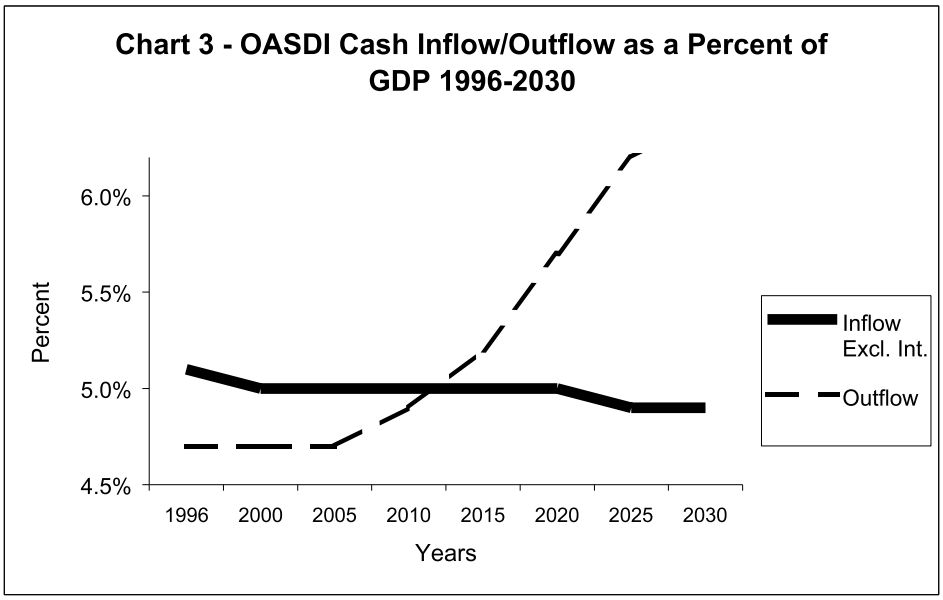
119. The total excess of cash outflow over inflow for OASDI over the next 75 years is estimated to be 2.17 percent of taxable payroll; in other words, a tax increase today of about 1.09 percent of taxable payroll each on employees and employers, over the 6.2 percent they each now pay, would produce enough inflow over 75 years to pay all benefits due under current law.[24] There would be trust fund surpluses in the early

[24][Please note: the standard does not require information on the total excess of cash outflow over inflow as a percentage of taxable payroll. It requires a cashflow projection as a percentage of taxable payroll as in Chart 2.]

years of the projection from which the Trustees would acquire Treasury securities to be used to pay benefits later.

120. Stated in terms of actuarial present value, the 2.17 percent deficit equates to an excess of expenditures over contributions of about $3 trillion over the next 75 years from September 30, 1996. The accumulation and subsequent redemption of substantial trust fund assets have economic and public policy implications that go beyond the operation of the OASDI program itself. Discussion of these broader issues is not within the scope of this report.

121. *Percentage of GDP* - In addition to analyzing OASDI operations as a percentage of taxable payroll, viewing them as a percentage of the Gross Domestic Product (GDP) provides an additional perspective on these funds in relation to the capacity of the national economy to sustain them. The GDP represents the total value of goods and services produced in the United States. Chart 3 below shows OASDI's cost as a percentage of GDP.



Source: Data from Tables III C1, 1996 OASDI Trustee's Report.

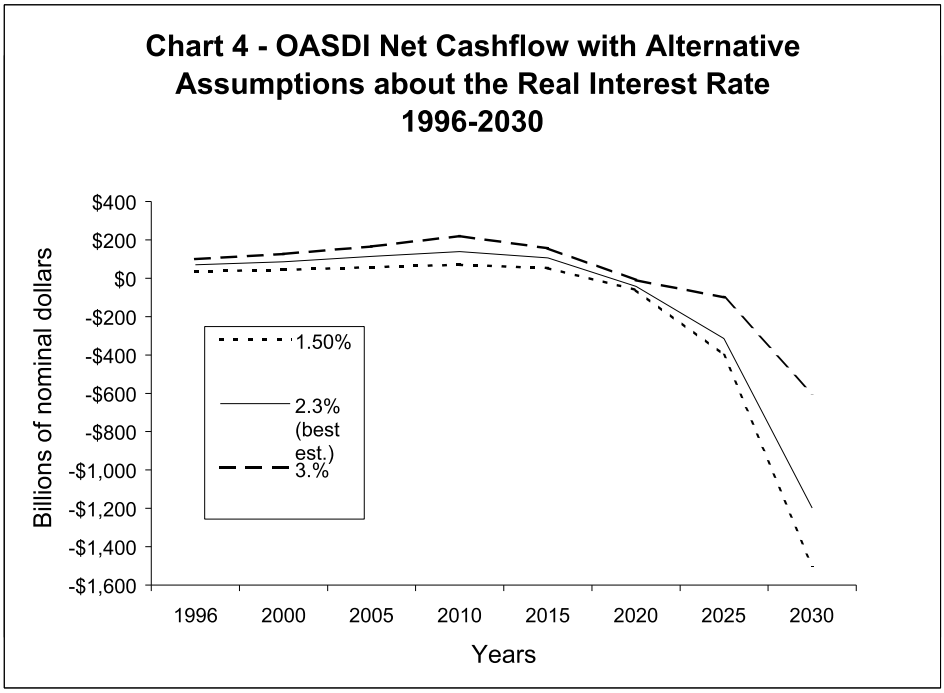
122. In 1996, federal spending for OASDI exceeded $350 billion, which was about 4.7 percent of GDP. By 2030, when most baby boomers will have retired, the program (based on current law) will consume nearly

50 percent more of GDP than it does today—6.4 percent. Nearly all of the increase between now and 2030 will occur between 2010 and 2030, as retired baby boomers become eligible for those programs.

123. ***Sensitivity Analysis*** - As indicated by the assumptions shown at the end of this section, the future cashflow of the OASDI program depends on many economic and demographic assumptions, including GDP, labor factors, unemployment, average wages and self-employment earnings, interest rates on Treasury securities, productivity, inflation, fertility, mortality, net immigration, marriage, divorce, retirement patterns, and disability incidence and termination. The cash inflow will depend on how these factors affect the size and composition of the working population and the level and distribution of wages and earnings. Similarly, the outgo will depend on how these factors affect the size and composition of the beneficiary population and the general level of benefits. Precise long-range projections of these factors is impossible.

124. This section illustrates the sensitivity of the long-range projections to changes in assumptions by analyzing five key individual assumptions: the real interest rate, the death and birth rates, net immigration, and the real wage differential. For this analysis the "best estimate" cost assumptions are used as the reference point, and each assumption is varied within it individually.

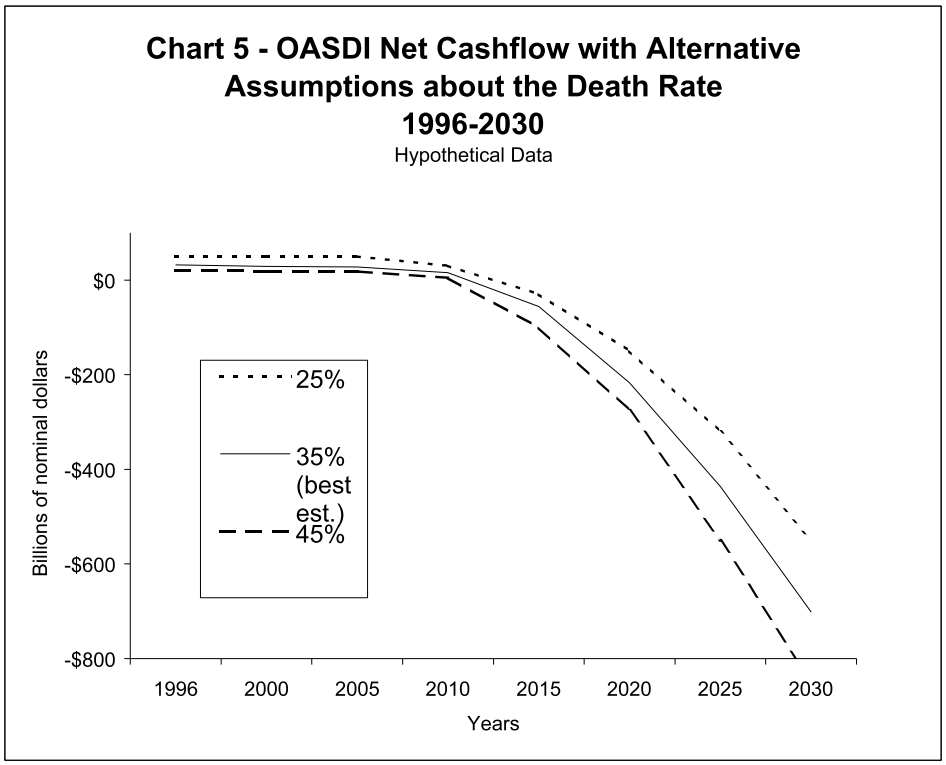
125. *Real Interest Rate* - The "best estimate" long-range cashflow projections presented in Chart 1 above assume a 4 percent increase in Consumer Price Index (CPI) per year after the year 2000 as the inflation rate and a 2.3 percent real interest rate. The "real interest rate" is the difference between the interest on the Treasury securities held by the trust fund and the inflation rate, as measured by the CPI. Chart 4 below compares the estimated OASDI net cash outflow using the best estimate cost assumptions, including the 2.3 percent real interest rate, with the net cashflow that would result from decreasing the real interest rate to 1.5 percent and increasing it to 3 percent.



Source: Data regarding "best estimate" is from Tables III B1, B3, & C1, 1996 OASDI Trustee's Report

As stated above, the estimated total excess of OASDI cash outflow over cash inflow over the next 75 years is $3 trillion. If the annual real interest rate—that is, the difference between the interest on the Treasury securities held by the trust fund and the inflation rate, as measured by the Consumer Price Index (CPI)—is changed from the 2.3 percent used for the best estimate projection to 1.5 percent, the total excess of cash outflow would increase to $3.8 trillion; if the rate were changed to 3 percent, the total excess would decrease to $2.5 trillion.

126. Death Rate - Chart 5 below shows the estimated OASDI cash inflow and outflow using a death rate above and below the rate used for the projection in Chart 1 above. This analysis was developed by varying the percentage decrease in the death rate assumed to occur during 1996-2030. The rate used for Chart 1 above assumes a 35 percent decrease. Chart 5 assumes 25 percent and 45 percent decreases.

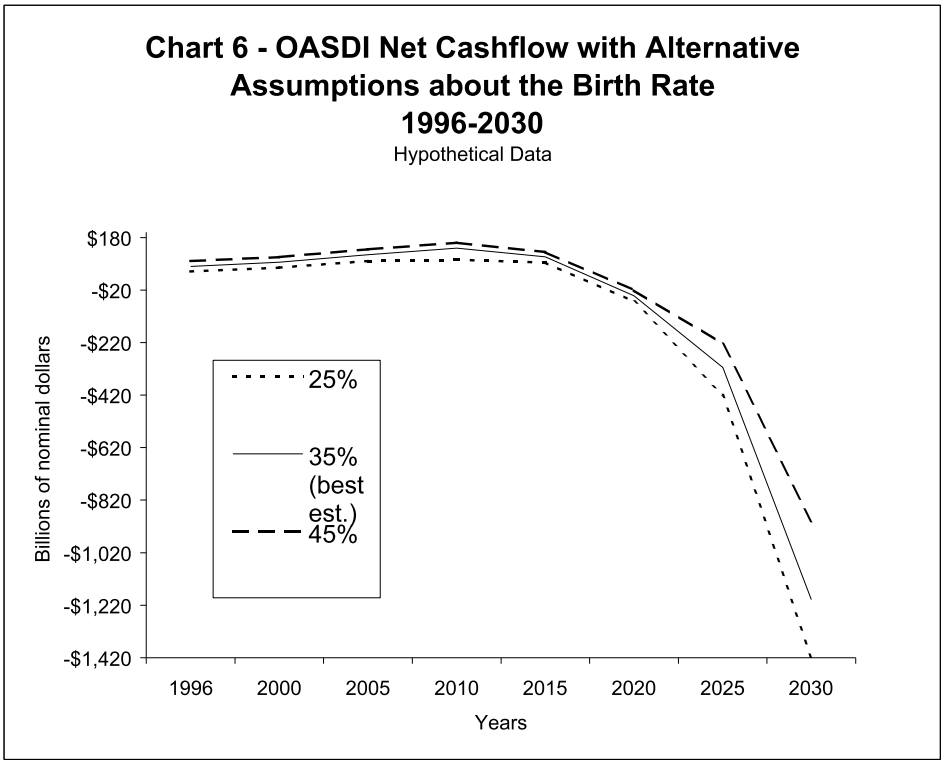


Source: Data regarding "best estimate" is from Tables III B1, B3, & C1, 1996 OASDI Trustee's Report.

Regarding actuarial present values for a 75-year projection period, if the decrease in the death rate is changed from the 35 percent used for the best estimate projection to 15 percent, meaning that more people are dying, the total excess of cash outflow for the period would decrease to $2.1 trillion, from $3.0 trillion; if the rate were changed to 55 percent, the total excess cash outflow would increase to $4.2 trillion.

127. *Birth Rate* - Table 1 below shows the estimated total excess OASDI cash outflow over inflow over a 75 year projection period using a birth rate above and below the rate used for the best estimate projection. This analysis was developed by varying the percentage increase in the birth rate assumed to occur during 1996-2070. The rate used for the best estimate projection assumes a ultimate birth rate in 2070 of 1.9 children per woman. Chart 6 below shows the estimated OASDI cash inflow and outflow using a birth rate above and below the rate

used for the projection in Chart 1 above. Chart 6 below compares the estimated OASDI net cash outflow using the best estimate cost assumptions, including the 1.9 birth rate, with the net cash outflow that would result from decreasing the rate to 1.6 percent and increasing it to 2.2 percent.



Source: Data regarding "best estimate" is from Tables III B1, B3, & C1, 1996 OASDI Trustee's Report.

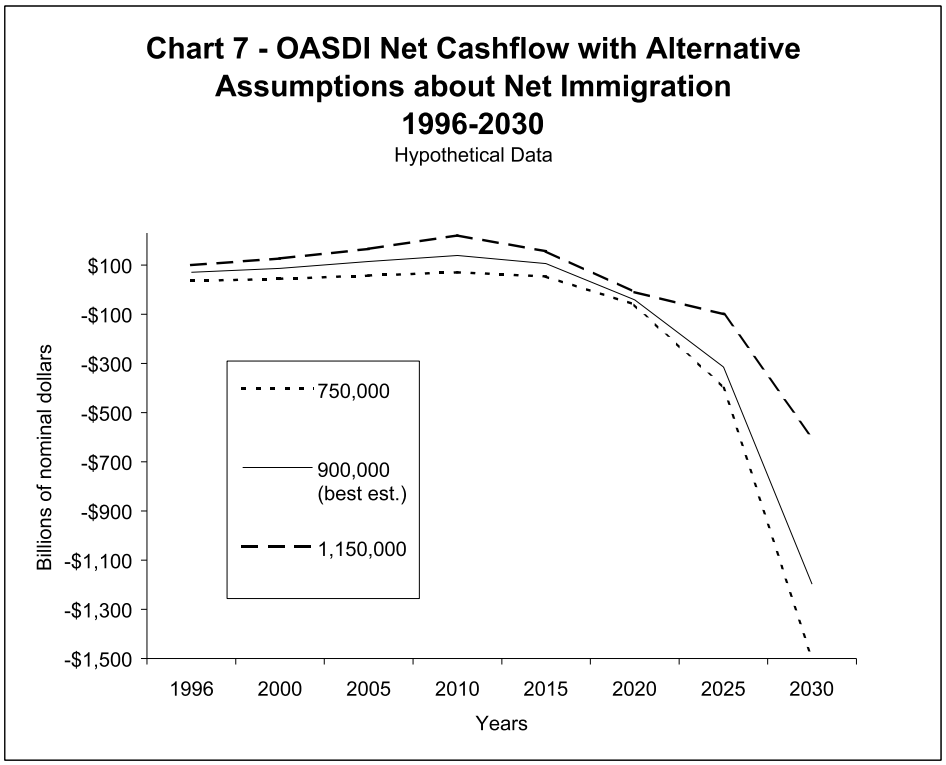
Table 1 presents the affect of using rates of 1.6 and 2.2 on the excess of cash outflow over inflow during the projection period. The rate is assumed to increase gradually from its current level to reach the ultimate values in 2070.

Table 1: Estimated Total Excess OASDI Cash Outflow over Inflow with Various Birth Rate Assumptions - Valuation Period: 1996-2070

Dollars in trillions

	Ultimate Birth Rate Per Woman		
Valuation Period: 1996-2070	1.6 births	1.9 births (from best estimate cost assumptions)	2.2 births
Excess of cash outflow over cash inflow	$3.7	$3.0	$2.5

128. *Net Immigration*—Chart 7 below compares the estimated OASDI net cash outflow using the best estimate cost assumptions, including the 900,000 per year net immigration rate, with the net cashflow that would result from decreasing the rate to 750,000 and increasing it to 1,150,000.



Source: Data regarding "best estimate" from Tables III B1, B3, & C1, 1996 OASDI Trustee's Report.

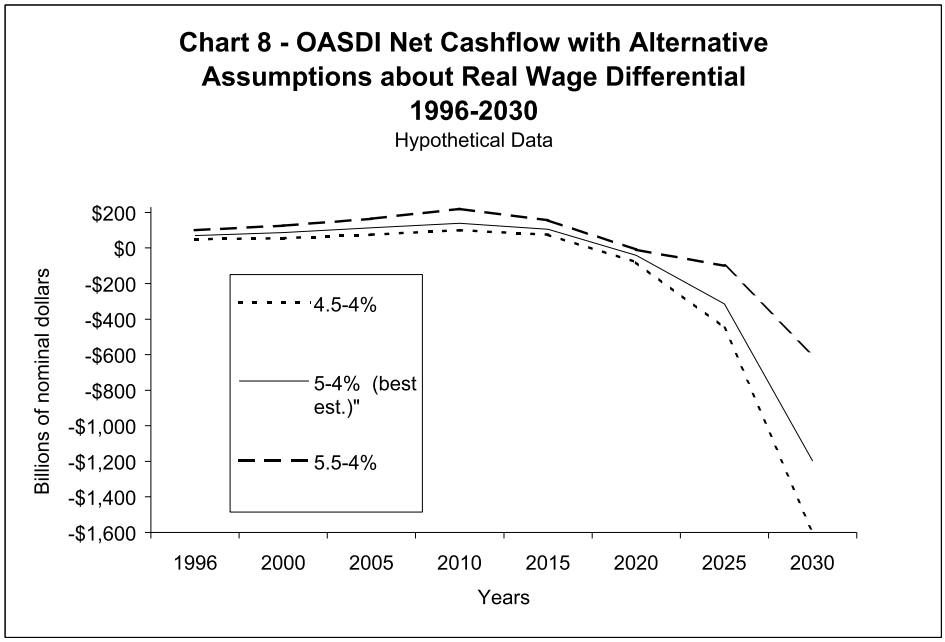
Regarding actuarial present values over 75 years, table 2 below shows the estimated total excess of OASDI cash outflow over inflow with assumptions that differ from those used for the "best estimate" projection.

Table 2: Estimated Total Excess OASDI Cash Outflow over Inflow with Various Net Immigration Assumptions - Valuation Period: 1996-2070

Dollars in trillions

	Net immigration per year		
Valuation Period: 1996-2070	750,000	900,000 (from best estimate cost assumptions)	1,150,000
Excess of cash outflow over cash inflow	$3.2	$3.0	$2.9

129. *Real-Wage Differential* - Chart 8 below compares the estimated OASDI net cash outflow using the best estimate cost assumptions, including the 1 percent real wage differential, with the net cashflow that would result from decreasing the rate to .5 percent and increasing it to
1.5 percent. The real-wage differential is the difference between the annual percentage increase in wages in covered employment and the inflation rate, as measured by the CPI.



Source: Data regarding "best estimate" is from Tables III B1, B3, & C1, 1996 OASDI Trustee's Report.

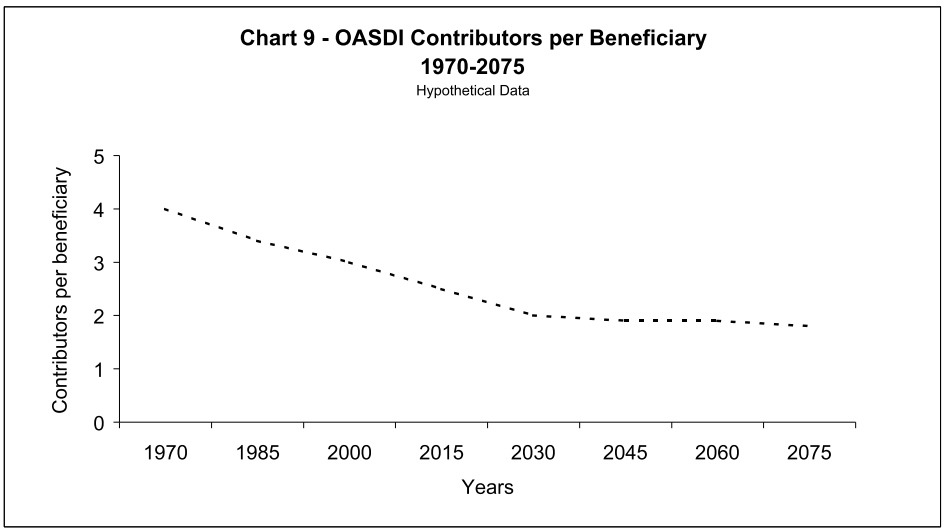
Regarding actuarial present values over 75 years, table 3 below shows the estimated total excess of OASDI cash outflow over inflow with various assumptions about the real-wage differential.

Table 3- Estimated Total Excess OASDI Cash Outflow over Inflow with Various Real-Wage Assumptions - Valuation Period: 1996-2070

Dollars in trillions

	Ultimate percentage in wages-CPI *The first value in each of the pairs below is the assumed ultimate annual percentage increase in average wages in covered employment. The second value is the assumed ultimate annual percentage increase in the CPI. The difference between the two values is the real-wage differential.]*		
Wages-CPI	4.5-4.0	5.0-4.0 (from best estimate cost assumptions)	5.5-4.0
Excess cash outflow over inflow	$3.9	$3.0	$2.3

130. ***Dependency Ratio*** - Chart 9 below shows the estimated number of covered workers per OASDI beneficiary using the Trustees' best estimate. As defined by the Trustees, covered workers are persons having earnings creditable for OASDI purposes on the basis of services for wages in covered employment and/or on the basis of receipts from covered self-employment. As Chart 6 shows, the number of workers to beneficiaries will decline from 3.3 per beneficiary in 1995 to 2 per beneficiary in 2030 and 1.8 in 2075.



Social Security Assumptions-

Assumptions Used

The estimates used in this presentation are based on the assumption that the programs will continue as presently constructed. They give effect to certain additional economic and demographic assumptions, including those in the following table:

	Average Annual Percent Change			Ave. Annl. Interest Rate on Treasury Secur. (%)	Ave. Annl. Unempl. Rate	Ave. no. of children per woman	Death rate per 100,000	Life expectancy	
	GDP	Wages	CPI					Men	Women
1996	2.0	4.0	2.0	6.0	5.0	2.0	757	72	79
2000	2.0	4.3	3.5	6.5	6.0	2.0	731	73	79
2005	2.0	5.1	4.0	6.4	6.0	2.0	700	73	80
2010	1.8	5.0	4.0	6.3	6.0	2.0	677	74	80
2020	1.3	5.1	4.0	6.3	6.0	1.9	638	75	81
2030	1.4	5.0	4.0	6.3	6.0	1.9	603	76	81

These assumptions and the other values on which these displays are based represent the latest and most likely — or "best" — estimates of these values by the Trustees. Estimates made in certain prior years have changed substantially because of revisions to the assumptions due to changed conditions or experience, and to changes in actuarial methodology. It is reasonable to expect more changes for similar reasons in the future.

Unemployment Insurance Programs

131. The U. S. Department of Labor operates two programs classified under federal accounting standards as social insurance, the Unemployment Insurance Program and the Black Lung Disability Benefits Program. Presented below is the required supplementary stewardship information for the Unemployment Insurance Program.

Program Description

132. The Unemployment Insurance (UI) program was created in 1935 to provide income assistance to unemployed workers who have lost their jobs through no fault of their own. The program protects workers during temporary periods of unemployment, through the provision of unemployment compensation benefits. These benefits replace part of the unemployed worker's lost wages and, in so doing, stabilize the economy during recessionals periods by increasing the unemployed worker's lost wages and purchasing power. The UI program operates counter cyclically, paying benefits during recessionary periods and collecting UI tax revenue during periods of recovery.

133. ***Program Administration and Funding*** - The UI program is administered through a unique system of federal-state partnerships,

established in federal law but executed through conforming state laws by state officials. The Federal Government provides broad policy guidance and program direction through the oversight of the U.S. Department of Labor, while program details are established through individual state UI statutes, administered through state UI agencies.

134. ***Federal and State Unemployment Taxes*** - The UI program is financed through the collection of federal and state unemployment taxes levied on subject employers and deposited in the unemployment trust fund (UTF). Federal unemployment taxes are used to pay for the administrative costs of the UI program, including grants to each state to cover the costs of state UI operations, as well as the federal share of extended UI benefits. Federal unemployment taxes are also used to maintain a loan account within the UTF, from which insolvent state accounts may borrow funds to pay UI benefits. State UI taxes are used exclusively for the payment of regular UI benefits, and the state's share of extended benefits. These taxes and the UTF established to account for their receipt, investment, and disbursement are discussed below.

135. *Federal Unemployment Taxes* - Under the provisions of the Federal Unemployment Tax Act (FUTA), a federal tax is levied on covered employers, at a current rate of 6.2 percent of the first $7,000 in annual wages paid to each employee. This federal tax is reduced by a credit of up to 5.4 percent granted to employers paying state UI taxes under conforming state UI statutes. Accordingly, in conforming states, employers pay an effective federal tax of .8 percent. Federal unemployment taxes are collected by the Internal Revenue Service.

136. *State Unemployment Taxes* - In addition to the federal tax, individual states finance their UI programs through state tax contributions from subject employers on the wages of covered employees. (Three states also collect contributions from employees.) Within Federal confines, state tax rates are assigned in accordance with an employer's experience with unemployment. Actual tax rates vary greatly among the states and among individual employers within the state. At a minimum, these rates must be applied to the federal tax base of $7,000; however, states may adopt a higher wage base than the minimum established by FUTA. State UI agencies are responsible for the collection of state unemployment taxes.

137. ***Unemployment Trust Fund*** - Federal and state UI taxes are deposited into designated accounts within the UTF. The UTF was established under the authority of Title IX, section 904 of the Social Security Act of 1935, as amended, to receive, hold, invest, loan, and disburse federal and state UI taxes. The U.S. Department of the Treasury invests amounts in excess of disbursing requirements in Treasury securities. The UTF is comprised of the following accounts:

138. *Federal Accounts* - The Employment Security Administration Account (ESAA) was established pursuant to section 901 of the Social Security Act. All tax receipts collected under the FUTA are appropriated to the ESAA and used to pay the costs of federal and state administration of the UI program and veterans employment services, as well as 97 percent of the costs of the state employment services. Excess balances in ESAA, as defined under the act, are transferred to other federal accounts within the fund, as described below.

139. The Federal Unemployment Account (FUA) was established pursuant to section 904 of the Social Security Act. FUA is funded by any excesses from the ESAA as determined in accordance with section 902 of the act. Title XII, section 1201 of the act authorizes the FUA to loan federal monies to state accounts that are unable to make benefit payments because the state UI account balance has been exhausted. Title XII loans must be paid with interest. The FUA may borrow from the ESAA or the Extended Unemployment Compensation Account (EUCA), without interest, or may also receive repayable advances, with interest, from the general fund of the U.S. Treasury when the FUA has a balance insufficient to make advances to the states.

140. The Extended Unemployment Compensation Account (EUCA) was established pursuant to section 905 of the Social Security Act. EUCA provides for the payment of extended unemployment benefits authorized under the federal/state Extended Unemployment Compensation Act of 1970, as amended. Under the extended benefits program, extended unemployment benefits are paid to individuals who have exhausted their regular unemployment benefits. These extended benefits are financed one-half by state unemployment taxes and one-half by FUTA taxes obtained from the EUCA. The EUCA is funded by a percentage of the FUTA tax transferred from the ESAA in accordance with section 905(b)(1) and (2) of the Social Security Act. The EUCA may borrow from the ESAA or the FUA, without interest, or may also receive repayable advances from the general fund of the

Treasury when the EUCA has a balance insufficient to pay the federal share of extended benefits. During periods of sustained high unemployment, the EUCA may also receive payments and non repayable advances from the general fund of the Treasury to finance emergency unemployment compensation benefits. Emergency unemployment benefits require congressional authorization.

141. The Federal Employees Compensation Account (FECA) was established pursuant to section 909 of the Social Security Act. FECA provides funds to states for unemployment compensation benefits paid to eligible former federal civilian personnel and ex-service members. Generally, benefits paid are reimbursed to the FECA by the various federal agencies. Any additional resources necessary to ensure that the account can make the required payments to states, due to the timing of the benefit payments and subsequent reimbursements, will be provided by non repayable advances from the general fund of the Treasury.

142. *State Accounts* - Separate state accounts were established for each state and territory depositing monies into the UTF, in accordance with section 904 of the Social Security Act. State unemployment taxes are deposited into these individual accounts and may be used only to pay state unemployment benefits. States may receive repayable advances from the FUA when their balances in the UTF are insufficient to pay benefits.

143. *Railroad Retirement Accounts* - The Railroad UI Account and Railroad UI Administrative Account were established under section 904 of the Social Security Act to provide for a separate unemployment insurance program for railroad employees. This separate unemployment insurance program is administered by the Railroad Retirement Board, an agency independent of the Department of Labor (DOL). DOL is not responsible for the administrative oversight or solvency of the railroad unemployment insurance system. Receipts from taxes on railroad payrolls are deposited in the Railroad UI Account and the Railroad UI Administrative Account to meet benefit payment and related administrative expenses.

144. ***UI Program Benefits*** - The UI program provides regular and extended benefit payments to eligible unemployed workers. Regular UI program benefits are established under state law, payable for a period not to exceed a maximum duration. In 1970, federal law began

to require states to extend this maximum period of benefit duration by 50 percent, during periods of high unemployment. These extended benefit payments are paid equally from federal and state accounts.

145. *Regular UI Benefits* - There are no federal standards regarding eligibility, amount, or duration of regular UI benefits. Eligibility requirements, benefit amounts, and benefit duration are determined under state law. Under state laws, worker eligibility for benefits depends on experience in covered employment during a past base period, which attempts to measure the workers' recent attachment to the labor force. Three factors are common to state eligibility requirements: (1) a minimum duration of recent employment and earnings during a base period to unemployment, (2) unemployment not the fault of the unemployed, and (3) availability of the unemployed for work.

146. Benefit payment amounts under all state laws vary with the worker's base period wage history. Generally, states compute the amount of weekly UI benefits as a percent of an individual's average weekly base period earnings, within certain minimum and maximum limits. Most states set the duration of UI benefits by the amount of earnings an individual has received during the base period. Currently, all but two states have established the maximum duration for regular UI benefits at 26 weeks (Massachusetts and Washington state provide 30 weeks). Regular UI benefits are paid by the state UI agencies from monies drawn down from the state's account within the UTF.

147. *Extended UI Benefits* - The Federal/State Extended Unemployment Compensation Act of 1970 provides for the extension of the duration of UI benefits during periods of high unemployment. When the insured unemployment level within a state, or in some cases total unemployment, reaches certain specified levels, the state must extend benefit duration by 50 percent, up to a combined maximum of 39 weeks. Fifty percent of the cost of extended unemployment benefits is paid from the EUCA within the UTF, and 50 percent by the state, from the State's UTF account.

148. *Emergency UI Benefits* - During prolonged periods of high unemployment, Congress may authorize the payment of emergency unemployment benefits to supplement extended UI benefit payments. Emergency benefits were last authorized in 1991 under the EUCA. Emergency benefit payments in excess of $28 billion were paid over

the three year period ending in 1994. Emergency benefits were paid from the surplus of federal unemployment taxes in EUCA and, once EUCA balances were exhausted, from general revenues of the U.S. Treasury.

149. *Federal UI Benefits* - Unemployment benefits to unemployed federal workers are paid from the FECA within UTF and then reimbursed by the responsible federal agency. They are not considered to be social insurance benefits. Federal unemployment compensation benefits are not included in this discussion of social insurance programs.

Program Finances and Sustainability

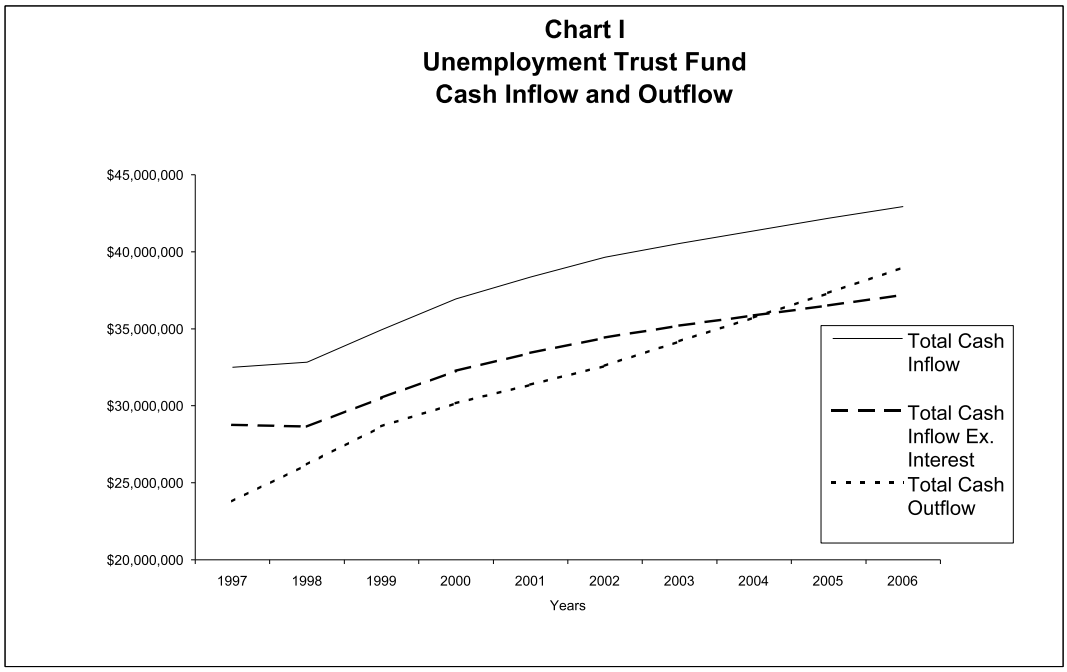
150. At September 30, 1996, total assets within the UTF exceeded liabilities by $54.0 billion.[25] This fund balance approximates the accumulated surplus of tax revenues and earnings on these revenues over benefit payment expenses and is available to finance benefit payments in future periods when tax revenues may be insufficient. Treasury invests this accumulated surplus in federal securities. The net value of these securities at September 30, 1996, was $53.9 billion. These investments accrue interest, which is distributed to eligible state and federal accounts within the UTF. Interest income from these investments during FY 1996 was $3.4 billion. As discussed in Note 1.B.3 to the consolidated financial statements, DOL recognized a liability for regular and extended unemployment benefits to the extent of unpaid benefits applicable to the current period. Accrued unemployment benefits payable at September 30, 1996, were $506.4 million.

151. ***Effect of Projected Cash Inflows and Outflows on the Accumulated Net Assets of the UTF*** - The ability of the UI programs to meet a participant's future benefit payment needs depends on the availability of accumulated taxes and earnings within the UTF. The DOL measures the effect of projected benefit payments on the accumulated net assets of the UTF, under an open group scenario, which includes current and future participants in the UI

[25][Please note: the standard does not require information on the total amount of securities held at the balance sheet date. This information illustrates that management can provide data in addition to that required by the standard when it feels doing so would be useful to readers of the report.]

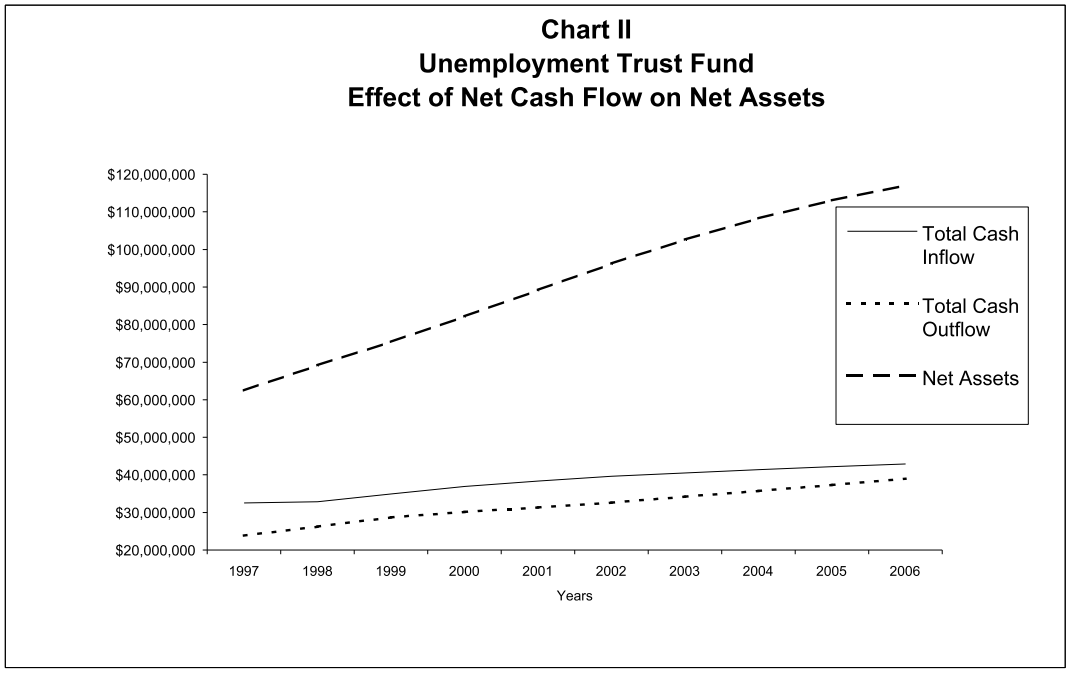
program. Future estimated cash inflows and outflows of the UTF are tracked by DOL for budgetary purposes. These projections allow the DOL to monitor the sensitivity of the UI program to differing economic conditions, and to predict the program's sustainability under varying economic assumptions. Charts I through IV graphically depict the effect of varying economic conditions on the UTF over the next 10 years.

152. *Projected Cash Inflows and Outflows Under Expected Economic Conditions* - Chart I depicts projected cash inflow and outflow of the UTF over the next 10 years, under expected economic conditions. Total cash inflow as well as cash inflow excluding interest earnings is displayed. DOL's current estimates were based on an expected unemployment rate of 5.1 percent during FY 1997, increasing to 5.5 percent in FY 2001 and thereafter. These projections indicate net cash inflow through FY 2004, with a crossover to net outflow in FY 2005. Cash inflows combined with interest earnings exceed cash outflows for each of the 10 years presented, although this net excess decreases from $8.7 billion at the end of FY 1997 to $3.9 billion at the end of FY 2006.

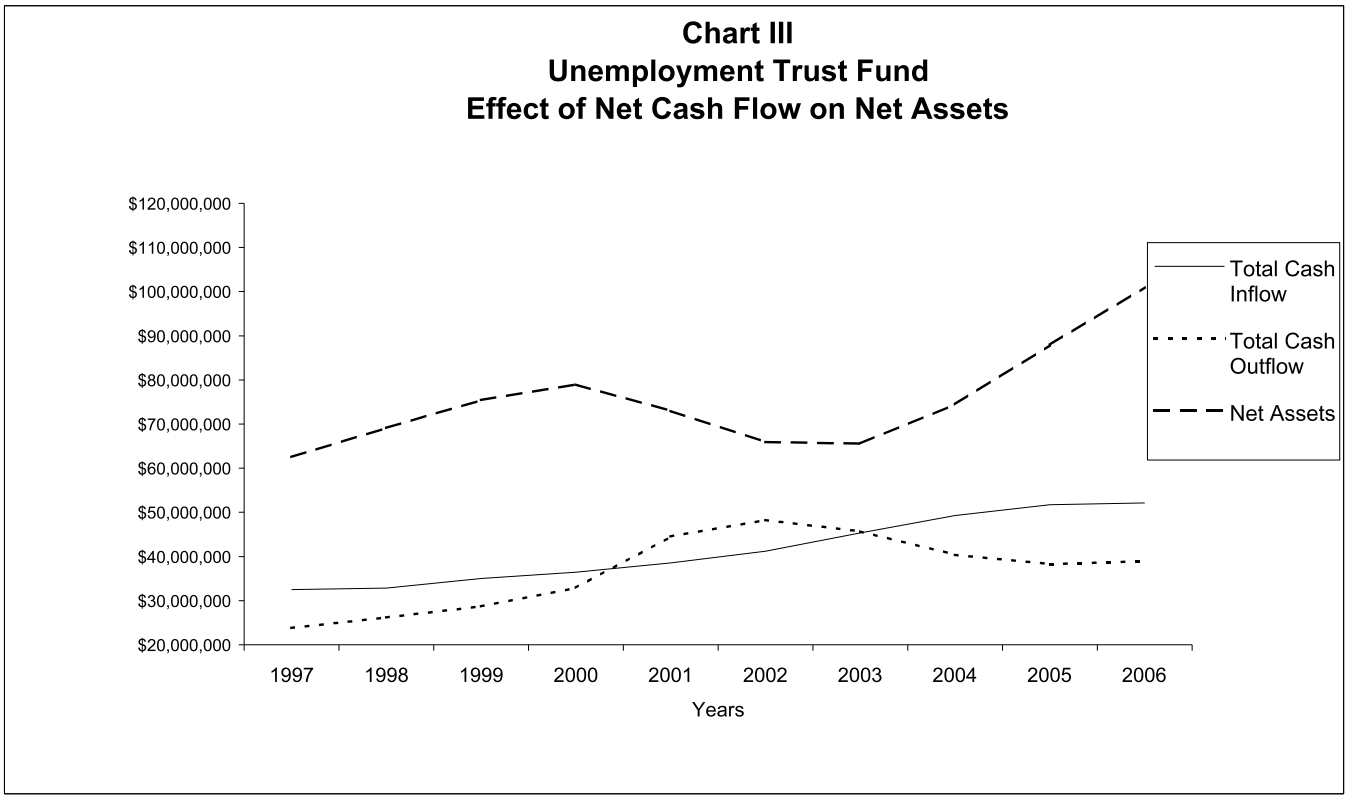


153. *Effect of Expected Cashflows on UTF Assets* - Chart II demonstrates the effect of the expected cash inflow and outflow on the net assets of the UTF over the 10-year period ending September 30, 2006. Yearly projected total cash inflows, including interest earnings, and cash outflows are depicted, as well as the net effect of this cashflow on UTF assets.

Under this scenario, total cash inflow exceeds cash outflow in each of the 10 years projected, although the margin of excess decreases by 55 percent from FY 1997 to FY 2006. Net UTF assets increase by 87 percent over the 10-year period, from $62.5 billion in FY 1997 to $117.0 billion in FY 2006.



154. ***Recession Scenarios***—Charts III and IV demonstrate the effect on accumulated UTF assets of projected total cash inflow and cash outflow of the UTF over the 10-year period ending September 30, 2006, under moderate and severe recession scenarios. Each scenario uses an open group, which includes current and future participants in the UI program. Charts III and IV assume increased rates of unemployment during mild and deep periods of recession.

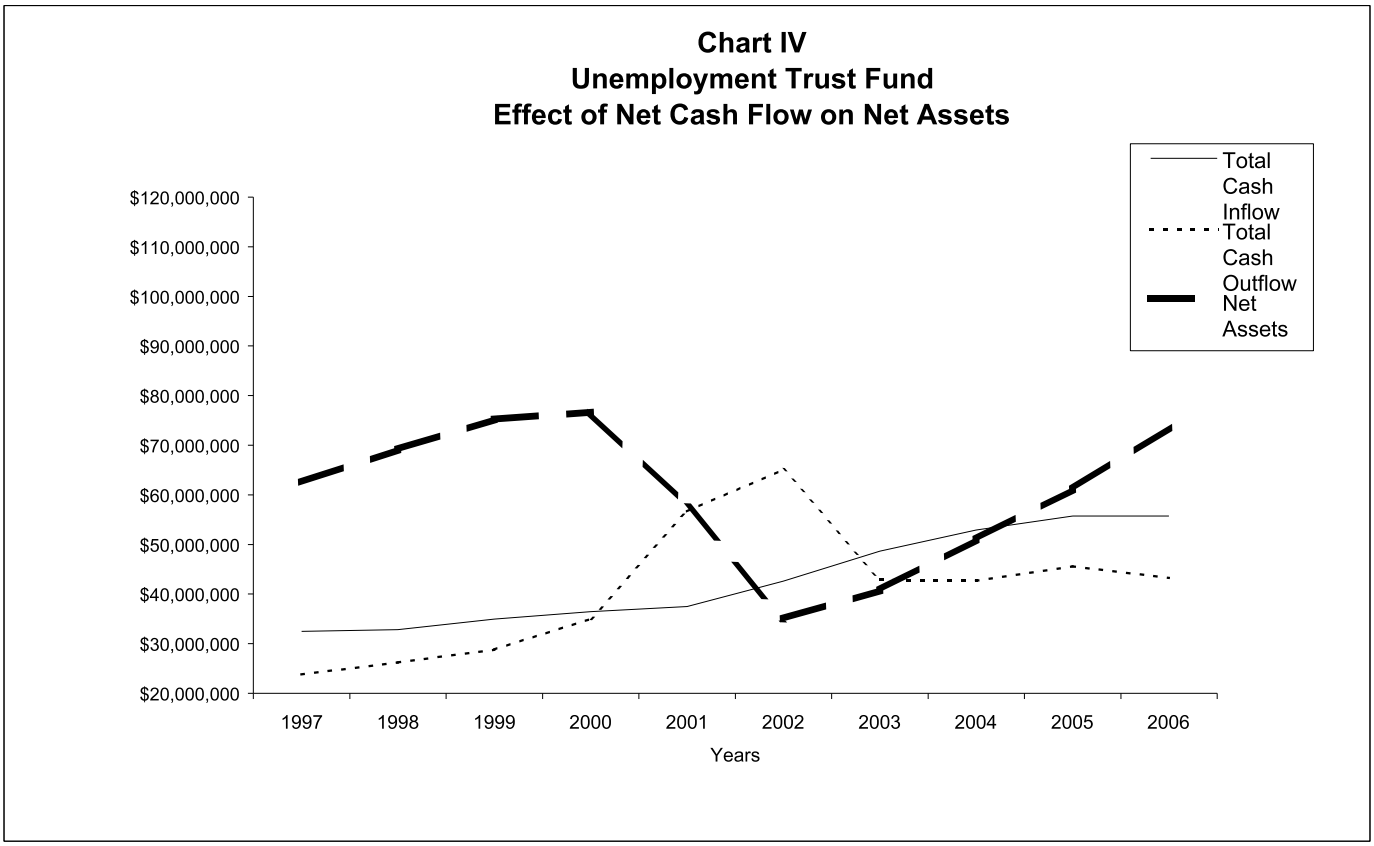


155. *Effect on UTF Assets of Mild Recession* - Chart III shows the projected effects of moderate recession on the cash inflow and outflow of the UTF. Under this scenario, which utilizes a rising unemployment rate peaking at 7.4 percent in FY 2002, net cash outflows are projected to begin in FY 2001, increasing to a maximum of $7.0 billion in FY 2002. Net cash inflow is reestablished in FY 2004 with a drop in the unemployment rate to 6.4 percent.

156. *Effect on UTF Assets of Deep Recession* - Chart IV shows the effect of severe recession on the cash inflow and outflow of the UTF. This scenario assumes a rising unemployment rate peaking at 10.2 percent in FY 2002. Under this scenario, net cash outflows are projected to begin early in FY 2000, increasing to $22.5 billion in FY 2002. During this two-year period, the net assets of the UTF decrease from $76.7 billion to $35.0 billion, a decline of $41.7 billion (54 percent). While aggregate UTF balances remain positive, state accounts without

sufficient reserve balances to absorb negative cashflows would be forced to borrows funds from the FUA to meet benefit payment requirements. State borrowing demands could also deplete the FUA, which borrows from the ESAA and the EUCA until they were depleted. The FUA would then require advances from the general fund of the U.S. Treasury to provide for state borrowing. (See discussion of state solvency measures *infra*.)

157. Net cash inflows are reestablished early in FY 2003, with a drop in the unemployment rate to 7.82 percent. By the end of FY 2006, this positive cashflow has replenished UTF account balances to $73.6 billion, or to within $3.0 billion of their FY 2000 peak. This example demonstrates the counter-cyclical nature of the UI program, which experiences net cash outflows during periods of recession, to be replenished through net cash inflows during periods of recovery.



158. Tables containing the yearly cash inflow, interest earnings, and cash outflow for each scenario are presented in the following pages.

U.S. Department of Labor - Required Supplemental Stewardship Information - Cash Inflow and Outflow of the Unemployment Trust Fund excluding the Federal Employees Compensation Account For the Ten Year Period Ended September 30, 1996

(1) Expected Unemployment Rate

(Dollars in thousands)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Balance, start of year	$ 53,800,832	$ 62,495,644	$ 69,134,779	$ 75,410,218	$ 82,183,369	$ 89,188,172	$ 96,242,575	$ 102,591,615	$ 108,232,958	$ 113,075,913
Cash inflow										
State unemployment taxes	22,681,000	22,442,000	24,195,000	25,837,000	27,011,000	27,927,000	28,666,000	29,217,000	29,792,000	30,439,000
Federal unemployment taxes	6,046,000	6,141,000	6,201,000	6,300,000	6,332,000	6,428,000	6,474,000	6,545,000	6,616,000	6,690,000
Deposits by the RRB	27,600	67,800	127,600	136,600	101,000	70,000	75,100	102,400	109,800	91,400
Total cash inflow ex. interest	28,754,600	28,650,800	30,523,600	32,273,600	33,444,000	34,425,000	35,215,100	35,864,400	36,517,800	37,220,400
Interest on Federal securities	3,744,328	4,179,810	4,413,592	4,670,414	4,924,397	5,227,889	5,326,384	5,503,356	5,656,406	5,711,029
Total cash inflow	32,498,928	32,830,610	34,937,192	36,944,014	38,368,397	39,652,889	40,541,484	41,367,756	42,174,206	42,931,429
Cash outflow										
State unemployment benefits	20,179,000	22,357,000	24,875,000	26,443,000	27,619,400	28,831,233	30,329,870	31,765,260	33,267,761	34,821,713
State administrative costs	3,357,406	3,561,582	3,513,672	3,456,087	3,474,974	3,498,455	3,591,026	3,687,876	3,787,445	3,889,713
Federal administrative costs	165,641	169,182	170,441	171,565	172,610	172,612	174,589	176,885	179,237	181,644
Interest on tax refunds	3,248	3,299	3,165	3,136	3,035	3,011	2,984	3,017	3,033	3,016
RRB withdrawals	98,821	100,412	99,475	97,075	93,575	93,175	93,975	93,375	93,775	93,575
Total cash outflow	23,804,116	26,191,475	28,661,753	30,170,863	31,363,594	32,598,486	34,192,444	35,726,413	37,331,251	38,989,661
Excess of total cash inflow ex. int. over total cash outflow	4,950,484	2,459,325	1,861,847	2,102,737	2,080,406	1,826,514	1,022,656	137,987	(813,451)	(1,769,261)
Excess of total cash nflow over total cash outflow	8,694,812	6,639,135	6,275,439	6,773,151	7,004,803	7,054,403	6,349,040	5,641,343	4,842,955	3,941,768
Balance, end of the year	$ 62,495,644	$ 69,134,779	$ 75,410,218	$ 82,183,369	$ 89,188,172	$ 96,242,575	$ 102,591,615	$ 108,232,958	$ 113,075,913	$ 117,017,681
Total unemployment rate	5.09%	5.12%	5.38%	5.47%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%

U.S. Department of Labor - Required Supplemental Stewardship Information - Cash Inflow and Outflow of the Unemployment Trust Fund excluding the Federal Employees Compensation Account For the Ten Year Period Ended September 30, 1996

(2) Mild Recessionary Unemployment Rate

(Dollars in thousands)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Balance, start of year	$ 53,800,832	$ 62,495,644	$ 69,134,779	$ 75,427,203	$ 78,997,497	$ 72,977,460	$ 65,947,568	$ 65,595,389	$ 74,470,094	$ 87,923,108
Cash inflow										
State unemployment taxes	22,681,000	22,442,000	24,195,000	25,837,000	27,889,000	31,018,000	35,304,000	39,150,000	41,096,000	40,839,000
Federal unemployment taxes	6,046,000	6,141,000	6,201,000	6,169,000	6,139,000	6,177,000	6,224,000	6,335,000	6,462,000	6,549,000
Deposits by the RRB	27,600	67,800	127,600	136,600	101,000	70,000	75,100	102,400	109,800	91,400
Total cash inflow ex. interest	28,754,600	28,650,800	30,523,600	32,142,600	34,129,000	37,265,000	41,603,100	45,587,400	47,667,800	47,479,400
Interest on Federal securities	3,744,328	4,179,810	4,485,592	4,324,625	4,389,403	3,957,469	3,737,486	3,670,448	4,053,078	4,639,297
Total cash inflow	32,498,928	32,830,610	35,009,192	36,467,225	38,518,403	41,222,469	45,340,586	49,257,848	51,720,878	52,118,697
Cash outflow										
State unemployment benefits	20,179,000	22,357,000	24,930,015	29,083,333	40,393,938	44,027,625	41,544,306	36,305,687	34,175,845	34,832,298
State administrative costs	3,357,406	3,561,582	3,513,672	3,541,887	3,875,374	3,956,055	3,877,026	3,804,276	3,816,045	3,861,112
Federal administrative costs	165,641	169,182	170,441	171,565	172,610	172,612	174,589	176,885	179,237	181,644
Interest on tax refunds	3,248	3,299	3,165	3,071	2,943	2,894	2,869	2,920	2,962	2,953
RRB withdrawals	98,821	100,412	99,475	97,075	93,575	93,175	93,975	93,375	93,775	93,575
Total cash outflow	23,804,116	26,191,475	28,716,768	32,896,931	44,538,440	48,252,361	45,692,765	40,383,143	38,267,864	38,971,582
Excess of total cash inflow ex. interest over total cash outflow	4,950,484	2,459,325	1,806,832	(754,331)	(10,409,440)	(10,987,361)	(4,089,665)	5,204,257	9,399,936	8,507,818
Excess of total cash nflow over total cash outflow	8,694,812	6,639,135	6,292,424	3,570,294	(6,020,037)	(7,029,892)	(352,179)	8,874,705	13,453,014	13,147,115
Balance, end of the year	$ 62,495,644	$ 69,134,779	$ 75,427,203	$ 78,997,497	$ 72,977,460	$ 65,947,568	$ 65,595,389	$ 74,470,094	$ 87,923,108	$ 101,070,223
Total unemployment rate	5.09%	5.12%	5.38%	5.60%	6.57%	7.43%	7.07%	6.42%	5.62%	5.50%

U.S. Department of Labor - Required Supplemental Stewardship Information - Cash Inflow and Outflow of the Unemployment Trust Fund excluding the Federal Employees Compensation Account For the Ten Year Period Ended September 30, 1996

(3) Deep Recessionary Unemployment Rate

(Dollars in thousands)	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Balance, start of year	$ 53,800,832	$ 62,495,644	$ 69,134,779	$ 75,247,218	$ 76,661,227	$ 57,496,183	$ 34,990,203	$ 40,790,676	$ 51,029,964	$ 61,156,933
Cash inflow										
State unemployment taxes	22,681,000	22,442,000	24,195,000	25,837,000	27,001,000	33,246,000	40,275,000	44,151,000	46,310,000	45,904,000
Federal unemployment taxes	6,046,000	6,141,000	6,201,000	6,169,000	6,139,000	6,177,000	6,224,000	6,335,000	6,462,000	6,549,000
Deposits by the RRB	27,600	67,800	127,600	136,600	101,000	70,000	75,100	102,400	109,800	91,400
Total cash inflow ex. interest	28,754,600	28,650,800	30,523,600	32,142,600	33,241,000	39,493,000	46,574,100	50,588,400	52,881,800	52,544,400
Interest on Federal securities	3,744,328	4,179,810	4,413,592	4,313,207	4,254,058	3,108,756	2,055,502	2,331,404	2,840,149	3,202,881
Total cash inflow	32,498,928	32,830,610	34,937,192	36,455,807	37,495,058	42,601,756	48,629,602	52,919,804	55,721,949	55,747,281
Cash outflow										
State unemployment benefits	20,179,000	22,357,000	25,038,000	31,171,000	52,201,000	60,454,000	38,737,870	38,517,260	41,302,761	38,980,713
State administrative costs	3,357,406	3,561,582	3,513,672	3,599,087	4,189,974	4,385,055	3,819,826	3,890,076	4,016,245	4,004,112
Federal administrative costs	165,641	169,182	170,441	171,565	172,610	172,612	174,589	176,885	179,237	181,644
Interest on tax refunds	3,248	3,299	3,165	3,071	2,943	2,894	2,869	2,920	2,962	2,953
RRB withdrawals	98,821	100,412	99,475	97,075	93,575	93,175	93,975	93,375	93,775	93,575
Total cash outflow	23,804,116	26,191,475	28,824,753	35,041,798	56,660,102	65,107,736	42,829,129	42,680,516	45,594,980	43,262,997
Excess of total cash inflow ex. interest over total cash outflow	4,950,484	2,459,325	1,698,847	(2,899,198)	(23,419,102)	(25,614,736)	3,744,971	7,907,884	7,286,820	9,281,403
Excess of total cash nflow over total cash outflow	8,694,812	6,639,135	6,112,439	1,414,009	(19,165,044)	(22,505,980)	5,800,473	10,239,288	10,126,969	12,484,284
Balance, end of the year	$ 62,495,644	$ 69,134,779	$ 75,247,218	$ 76,661,227	$ 57,496,183	$ 34,990,203	$ 40,790,676	$ 51,029,964	$ 61,156,933	$ 73,641,217
Total unemployment rate	5.09%	5.12%	5.38%	6.65%	9.07%	10.15%	7.82%	7.28%	7.05%	6.43%

159. ***States Minimally Solvent*** - Another measure of the sufficiency of accumulated UTF assets to meet future benefit payment requirements analyzes the adequacy of each state's accumulated net assets or reserve balance to provide a defined level of benefits over a defined period of time. To be considered minimally solvent, a state's reserve balance should provide for one year's projected benefit payment needs based on the highest levels of benefit payments experienced by the state over the last 20 years. A ratio of 1.0 or greater indicates a state is minimally solvent. States below this level are the most vulnerable to exhausting their funding in a recession. States exhausting their reserve balance must borrow funds from the FUA to make benefit payments. During periods of high sustained unemployment, balances in the FUA may be depleted. In these circumstances, FUA is authorized to borrow from the Treasury general fund.

160. Chart V presents the state-by-state results of this analysis at September 30, 1996, in descending order, by ratio. As the table illustrates, 23 states failed to meet the minimum solvency test of 1.0 at September 30, 1996.

Chart V

Minimally Solvent		Not Minimally Solvent	
State	**Ratio**	**State**	**Ratio**
Virgin Islands	2.89	Maryland	0.99
New Mexico	2.43	Alaska	0.94
New Hampshire	2.18	Nevada	0.94
Vermont	2.17	Alabama	0.90
Georgia	1.96	Kentucky	0.71
Mississippi	1.93	Arkansas	0.64
Oklahoma	1.86	Ohio	0.63
Utah	1.84	Pennsylvania	0.62
Delaware	1.74	Massachusetts	0.58
Wyoming	1.65	Michigan	0.57
Kansas	1.63	Minnesota	0.56
Puerto Rico	1.6	Maine	0.54
Virginia	1.58	North Dakota	0.54
Indiana	1.57	California	0.53
Florida	1.55	Illinois	0.50

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Minimally Solvent		Not Minimally Solvent	
State	**Ratio**	**State**	**Ratio**
Iowa	1.39	Rhode Island	0.47
Nebraska	1.37	Missouri	0.45
North Carolina	1.32	Dist. of Col.	0.45
Arizona	1.28	West Virginia	0.42
Idaho	1.26	Texas	0.33
South Carolina	1.24	Connecticut	0.31
Louisiana	1.23	New York	0.13
Oregon	1.2		
Wisconsin	1.18		
Montana	1.13		
Colorado	1.08		
Tennessee	1.08		
Washington	1.07		
Hawaii	1.06		
South Dakota	1.06		

Governmentwide Entity Perspective

(Note: This pro forma illustration is a partial display featuring Social Security and Medicare and is not intended to be the full consolidated presentation wherein all social insurance programs would be summarized and consolidated in accordance with par. 32.)

Stewardship Information: Consolidated Statement of Social Insurance - 75-Year Projection[a] as of September 30, 1996 [HYPOTHETICAL DATA]

Dollars in Trillions

		Prior Years			
	1996	**1995**	**1994**	**1993**	**1992**
Actuarial present value of future benefit payments[b] during the 75-year period to or on behalf of:					
Current participants not yet having attained retirement age[c]	$ X	$ X	$ X	$ X	$ X
OASDI	[X]	[X]	[X]	[X]	[X]
HI	[X]	[X]	[X]	[X]	[X]
SMI	[X]	[X]	[X]	[X]	[X]
Other	[X]	[X]	[X]	[X]	[X]
Current participants who have attained retirement age[c]	X	X	X	X	X
OASDI	[X]	[X]	[X]	[X]	[X]
HI	[X]	[X]	[X]	[X]	[X]
SMI	[X]	[X]	[X]	[X]	[X]
Other	[X]	[X]	[X]	[X]	[X]
Those expected to become participants (i.e., new entrants)	X	X	X	X	X
OASDI	[X]	[X]	[X]	[X]	[X]
HI	[X]	[X]	[X]	[X]	[X]
SMI	[X]	[X]	[X]	[X]	[X]
Other	[X]	[X]	[X]	[X]	[X]
Subtotal—benefit payments for the 75-year period	X	X	X	X	X
Less the actuarial present value of future contributions and tax income during the 75-year period from and on behalf of:					
Current participants who have not yet attained retirement age[c]	Y	Y	Y	Y	Y
OASDI	[Y]	[Y]	[Y]	[Y]	[Y]
HI	[Y]	[Y]	[Y]	[Y]	[Y]
SMI	[Y]	[Y]	[Y]	[Y]	[Y]
Other	[Y]	[Y]	[Y]	[Y]	[Y]

(Continued From Previous Page)

Dollars in Trillions

		Prior Years			
	1996	**1995**	**1994**	**1993**	**1992**
Current participants who have attained retirement age[c]	Y	Y	Y	Y	Y
OASDI	[Y]	[Y]	[Y]	[Y]	[Y]
HI	[Y]	[Y]	[Y]	[Y]	[Y]
SMI	[Y]	[Y]	[Y]	[Y]	[Y]
Other	[Y]	[Y]	[Y]	[Y]	[Y]
Those expected to become participants (i.e., new entrants)	Y	Y	Y	Y	Y
OASDI	[Y]	[Y]	[Y]	[Y]	[Y]
HI	[Y]	[Y]	[Y]	[Y]	[Y]
SMI	[Y]	[Y]	[Y]	[Y]	[Y]
Other	[Y]	[Y]	[Y]	[Y]	[Y]
Subtotal—benefit payments for the 75-year period	Y	Y	Y	Y	Y
Excess of actuarial present values of future benefit payments over future contributions and tax income for the 75-year period [d]	**$ X**	**$ X**	**$ X**	**$ X**	**$ X**

Notes to the Statement:

[a]The projection period for new entrants covers the next 75 years. The projection period for current participants (or 'closed group") would theoretically cover all of their working and retirement years, a period that could be greater than 75 years a in few instances. As a practical matter the present values of future payments and contributions for/from current participants beyond 75 years are not material.

[b] "Benefit payments" include administrative expenses.

[c] The actuarial net present value of the excess of future benefit payments to current participants (that is, to the "closed group" of participants) over future contributions and tax income from them or paid on their behalf is calculated by subtracting the actuarial present value of future contributions and tax income by and on behalf of current participants from the actuarial present value of the future benefit payments to them or on their behalf.

[d]The fund balance—which represents the accumulated excess of all past cash inflow, including interest on intragovernmental securities, over all past cash outflow within the program—for fiscal year 1996 is $ X_1 trillion. The fund balances for 1995-2, in trillions, were $$X_2$, X_3, X_4, X_5, respectively. The accumulated excess of cash inflow over outflow at the valuation date consists of a small amount of cash for current operations with the balance invested in Treasury securities. When presented for redemption, these securities will represent a first claim on the resources of the government.

Program Description

161. As discussed in Note X to the *CFS*, a liability of $75 billion is included in "Other Liabilities" on the balance sheet for unpaid amounts of Old-Age, Survivors, Disability Insurance (OASDI), Medicare (HI and SMI), and other social insurance benefits due to recipients or service providers for periods ended on or before September 30, 1996. Most of this amount was paid in October 1996.

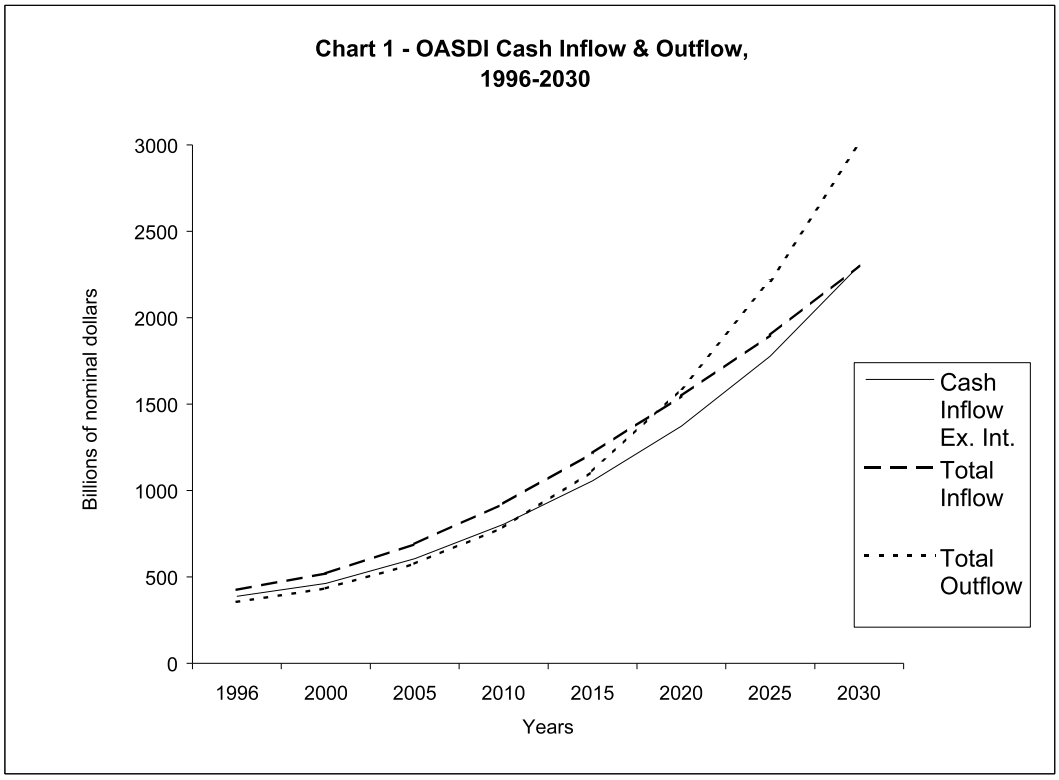
162. While no liability has been recognized on the balance sheet for future payments beyond the amount due as of September 30, actuarial estimates of future program activities have been prepared for the social insurance programs. Long-term actuarial views are a critical

element in assessing the financial condition of social insurance programs. In addition, social insurance programs must be assessed as a large and growing part of the governmentwide financial entity where they impact the balance between future government obligations and resources.

163. By projecting receipts from all sources and outlays for all federal programs for all purposes—as is the goal when analyzing trends in the federal budget, and as shown for the short-term in the Current Services Estimate, which shows the current and six future years (see page XX of this report)—it is possible to examine whether there will be sufficient resources to support all the government's ongoing responsibilities. It is also possible to see the interrelationship among the various types of government receipts (e.g., income taxes, payroll taxes, exchange revenue) and outlays (e.g., social insurance, national defense), where increases/decreases in one area of the budget can be offset by decreases/increases in other areas. Another perspective for assessing the financial condition of the government is its relationship to the national economy as measured by the GDP.

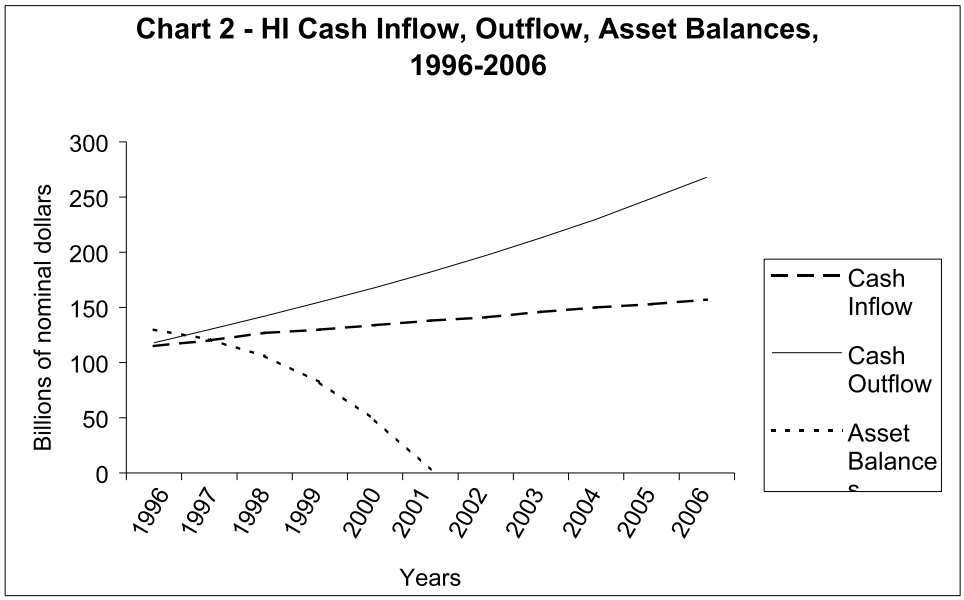
164. The actuarial present values and projections presented here for Social Security and Medicare, which are by far the largest social insurance programs, use the best estimate of the programs' actuaries of future costs over periods ranging up to 75 years. Estimates extending so far into the future, however, are inherently uncertain; and the uncertainty is greater for the later years in the period.

165. As shown in Chart 1, under current policies Social Security cash outflow will exceed inflow from the public in about 2012.



Source: Data from Tables III B1, B3, C1, 1996 OASDI Trustee's Report.

166. The Medicare Hospital Insurance (HI) program cash outflow exceeded annual cash inflow in FY 1996. using the actuaries' best estimate, the HI program will be insolvent in 2001, as shown in Chart 2 below. Projected HI payroll tax will meet a declining share of cash outflow under present law. Tax receipts are expected to equal 84 percent of cash outflow in 1997 and 74 percent in 2001 and would cover less than one-third of costs 75 years from now.

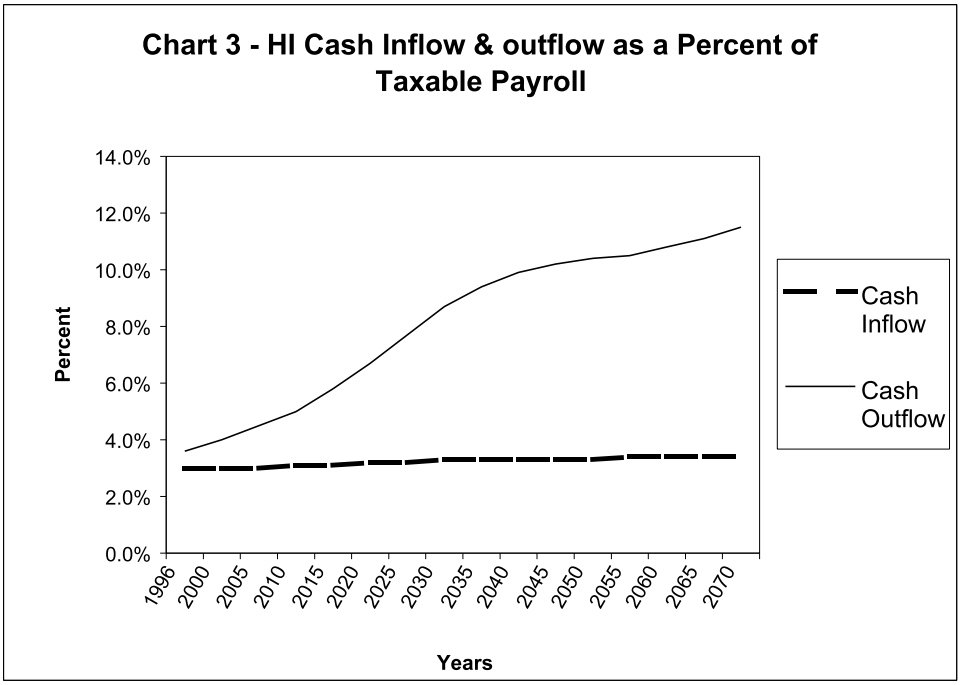


Source: Data from Table II D3, 1997 HI Trustee's Report.

167. The Medicare Supplementary Medical Insurance (SMI) is funded by premiums paid by participants and annual general fund appropriations. Current law provides for annual calculations of expected cost. Premiums, which currently cover approximately 25 percent of the program's cost, are expected to pay 16 percent by 2006 and decline further thereafter.

168. SMI benefits have been growing rapidly. Expenditures have increased 45 percent over the past five years. During this period the program grew about 14 percent faster than the economy as a whole, despite efforts to control costs.

169. As presently constructed, the HI program receives most of its income from the 1.45 percent payroll tax that employees and employers each pay, for a total of 2.9 percent of taxable payroll. Chart 3 below illustrates the cost rate of this program relative to its income rate as a percentage of taxable payroll.



Source: Data from Table II A.2, 1997 OASDI Trustee's Report.

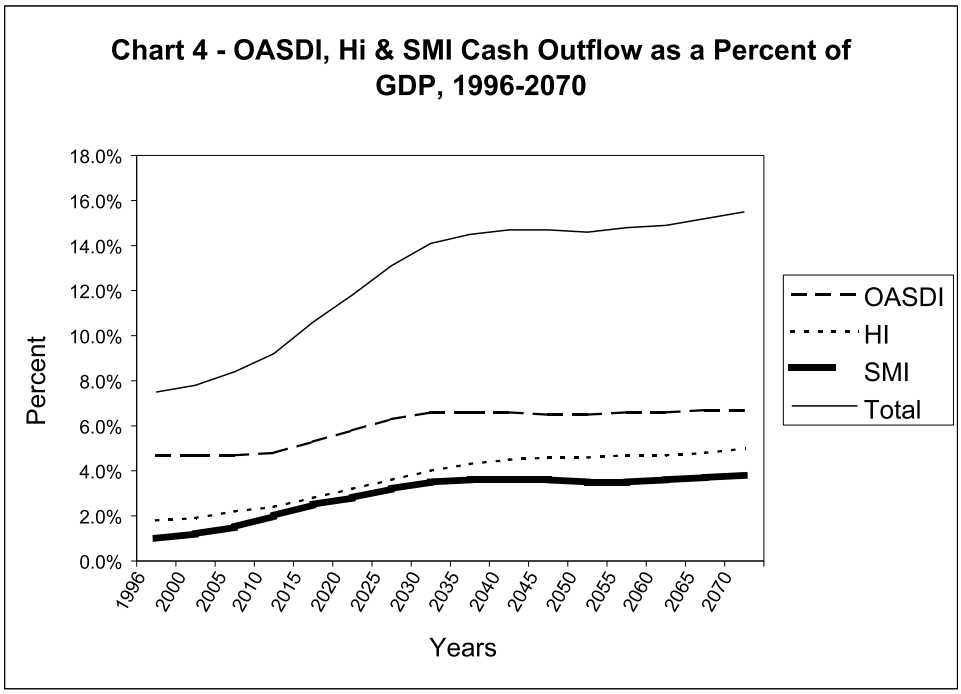
170. Medicare is currently paying and, from 2012 forward, OASDI would pay more to the public than they receive in taxes thereby increasing the government's financing needs. Compared to a situation in which taxes or other financing sources equalled cash outflow, the government will have to finance this difference by increased borrowing from the public, spending cuts, tax increases, or some combination of these measures.

171. ***Growing Disparity Between Rates of Income and Outgo*** - The excess of OASDI and HI cash outflow over inflow and the decreasing percent of SMI cost covered by premiums is due to the increasing cost of existing medical care; the increased utilization of existing and new health care techniques; and, in later years, the retirement of the "baby boom" generation and the relatively small number of people born during the subsequent period of low birth rate. For example, the OASDI Trustees' best estimate shows a long-term actuarial deficit over the next 75 years of 2.17 percent of taxable payroll—in other words, a tax increase today of 1.09 percent of taxable payroll each for employees and employers, over the 6.2 percent they each now pay

would produce enough revenue to pay benefits under current law, over 75 years.[26] Increasing the payroll tax from 12.4 to 14.6 represents a payroll tax increase of about 17 percent. The 2.17 percent deficit represents, in terms of present value, an excess of $3.1 trillion of expenditures over contribution.

172. ***Social Insurance in Relation to the National Economy*** - The security of benefits and the distribution of financing costs for social insurance programs cannot be determined solely on the basis of the financial and actuarial status of the programs by themselves. Sustainability from the governmentwide entity perspective is better measured in terms of a healthy relationship between social insurance programs—and, indeed, the entire budget—and the national economy, as measured by the GDP. Relative to the national economy, federal spending for OASDI, HI, and SMI was 7 percent of GDP in 1996—$550 billion. By 2030, when most baby boomers will have retired, these programs are projected to consume nearly 100 percent more of GDP than they do today—14 percent, as shown in Chart 4.

[26][Please note: the standard does not require information on the total excess of cash outflow over inflow as a percentage of taxable payroll. It requires a cashflow projection as a percentage of taxable payroll as in Chart 3.]



Source: Data from Table III C1, 1996 OASDI Trustee's Report and Table III B1, 1997 HI Trustee's Report.

173. This projected increase needs to be understood in the context of other projected future claims on future resources including general assistance programs (e.g., Medicaid) and other federal programs. Nearly all of the increase between now and 2030 in the OASDI, HI, and SMI programs will occur between 2010 and 2030, as retired baby boomers become eligible for those programs. In terms of the number of workers to beneficiaries in the combined OASDI and HI programs, a decline will occur from about 3.5 per beneficiary in 1995 to 2 per beneficiary in 2030.

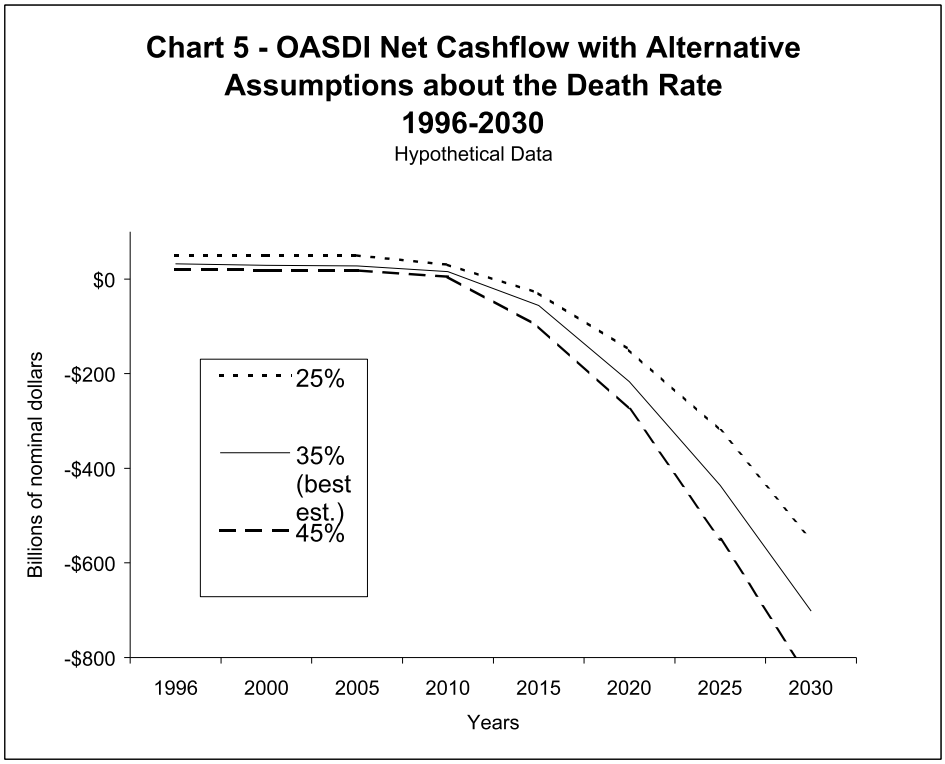
174. ***Sensitivity Analysis***[27] - The future cashflow of the OASDI, Medicare, and other social insurance programs depends on many

[27][Please note: this section provides examples of some of the sensitivity analysis that would be provided at the consolidated level. The consolidated entity would summarize the sensitivity analyses from the individual social insurance entities.]

economic and demographic assumptions. Precise long-range projections of these factors is impossible.

175. This section illustrates the sensitivity of the long-range projections to changes by analyzing six key individual assumptions. For this analysis the "best estimate" cost assumptions are used as the reference point, and each assumption is varied within it individually.

176. *Death Rate* - Chart 5 below shows the estimated OASDI cash inflow and outflow using a death rate above and below the rate used for the projection in Chart 1 above. This analysis was developed by varying the percentage decrease in the death rate assumed to occur during 1996-2030. The rate used for Chart 1 above assumes a 35 percent decrease. Chart 5 assumes 25 percent and 45 percent decreases.



Source: Data for "best estimate" is from Tables III B1, B3, C1, 1996 OASDI Trustee's Report.

177. *Real Interest Rate*—The total excess of OASDI cash outflow over inflow on the basis of the best estimate cost assumptions is

$3.0 trillion over the valuation period of 1996-2070. If the annual real interest rate for Treasury securities is changed from the 2.3 percent used for the best estimate to 1.5 percent, the excess of cash outflow would increase to $3.8 trillion; if the rate were changed to 3 percent, the excess of cash outflow would decrease to $2.5 trillion.

178. *Birth Rate* - Table 1 shows the effect of using birth rates of 1.6 and 2.2 children per woman, instead of the 1.9 rate used for the best estimate projection, on the total excess OASDI cash outflow over inflow over the period 1996-2070. The rate is assumed to increase gradually from its current level to reach the ultimate values in 2070.

Table 1- Estimated Total Excess OASDI Cash Outflow over Inflow with Various Birth Rate Assumptions - Valuation Period: 1996-2070

Dollars in trillions

	Ultimate Birth Rate Per Woman		
Valuation Period: 1996-2070	1.6 births	1.9 births (from best estimate cost assumptions)	2.2 births
Excess of cash outflow over cash inflow	$3.7	$3.0	$2.5

179. *Net Immigration*—Table 2 below shows the total excess of OASDI cash outflow over inflow with various assumptions about the magnitude of net immigration.

Table 2- Estimated OASDI Actuarial Balances with Various Net Immigration Assumptions

Dollars in trillions

	Net immigration per year		
Valuation Period: 1996-2070	750,000	900,000 (from best estimate cost assumptions)	1,150,000
Excess of cash outflow over inflow	$3.2	$3.0	$2.9

180. *Real-Wage Differential* - Table 3 below shows the total excess OASDI cash outflow over inflow with various assumptions about the real-wage differential. The real-wage differential is the difference between

the annual percentage increase in wages in covered employment and the Consumer Price Index.

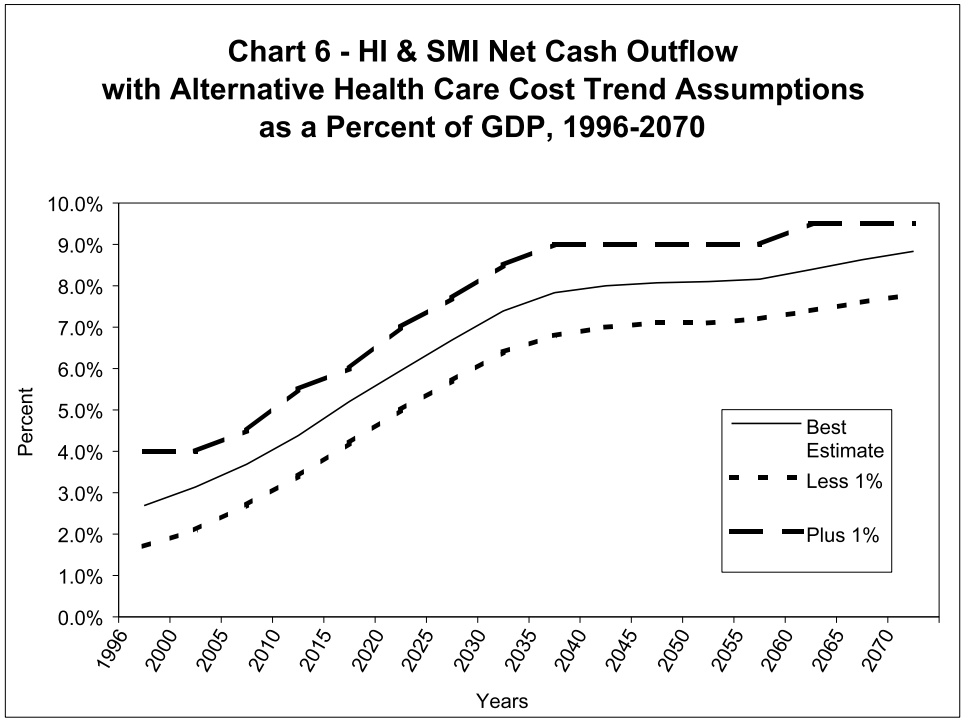
Table 3- Estimated OASDI Actuarial Balances with Various Real-Wage Assumptions - Valuation Period: 1996-2070

Dollars in trillions

	Ultimate percentage in wages-CPI[a]		
Wages-CPI	4.5-4.0	5.0-4.0 (from best estimate cost assumptions)	5.5-4.0
Excess cash outflow over inflow	$3.9	$3.0	$2.3

[a] [The first value in each of the pairs below is the assumed ultimate annual percentage increase in average wages in covered employment. The second value is the assumed ultimate annual percentage increase in the CPI. The difference between the two values is the real-wage differential.]

181. *Health Care Cost Trend*—Chart 6 below shows the estimated HI and SMI net cash outflow using a health care cost factor 1 percent above and 1 percent below that used for the "best estimate" projection. Factors such as wage increases and price increases may simultaneously affect both HI payroll tax income and the costs incurred by hospitals and other providers of medical care to HI and SMI beneficiaries. Other factors, such as the utilization of services by beneficiaries or the relative complexity of the services provided, can affect provider costs without affecting HI payroll tax income. The sensitivity analysis shown in Chart 6 illustrates the financial effect of any combination of such factors that results in aggregate provider costs increasing by 1 percent faster or slower than the "best estimate" assumptions.



Source: Data for “best estimate” is from Table III B1, 1997 HI Trustee’s Report.

Appendix C - Historical Background

182. **Practice Prior to Federal Accounting Standards Advisory Board (FASAB)** - Although this statement is applicable to other social insurance programs, Social Security historically has been the primary focus when considering accounting for social insurance. Over the decades, the debates about Social Security have to some extent paralleled debates in the nonfederal accounting community about how to apply accrual concepts in accounting. During this time, a continual evolution in accounting practice has led to increased recognition on the face of the financial statements and disclosure in notes to financial statements of formerly unreported commitments such as pensions and other postretirement benefits such as health care.

183. Since the 1950s, the Treasury Department and the Office of Management and Budget (OMB) have been furnishing reports on federal contingencies and commitments. From the early 1950s, the reports showed, among other commitments, the face value of loan guarantees and federal insurance but not the actuarial status of social insurance programs.

184. In 1967, Congress began requiring a commitments and contingencies report (*Liabilities and Other Financial Commitments of the United States Government*) that was to include liabilities of federal annuity programs and their actuarial status. The programs in that report included most of the social insurance programs that are the subject of these accounting standards: Social Security, Medicare, Railroad Retirement, Black Lung, and Unemployment Insurance. The report was tied with the regular business-type reporting of federal agencies required by the Treasury Department (e.g., balance sheets, operating statement, supplemental schedules).

185. From 1976 until 1985, the "prototype" *Consolidated Financial Statements of the United States Government* (*CFS*) recognized a liability for Social Security using a calculation similar to that called for in APB 8 (1966), which defined a variety of acceptable actuarial methods for measuring pension expense and required that any accumulated, unfunded pension expense be recognized as a liability. However, the expense shown on the *CFS* operating statement included only cash benefit payments and not what the *CFS* called the "noncash amount"—or the change in the unfunded liability.

186. After 1966 the importance of information about pensions grew due to increases in the number of plans and amounts of pension assets and obligations. Significant changes occurred in both the legal environment (e.g., Employee Retirement Income Security Act) and the economic environment (e.g., higher inflation and interest rates).

187. APB 8 was superseded by FASB Statement of Financial Accounting Standards (SFAS) No. 87, *Employer's Accounting for Pensions*, published in December 1985. FASB noted the years of accounting controversy over measuring costs and liabilities resulting from defined benefit pension plans. After considering the range of comments on its *Preliminary Views* document and on its exposure draft, FASB concluded that, although it did not recognize the full projected benefit obligation on the balance sheet, SFAS 87 represented a worthwhile improvement in financial reporting. SFAS 87 made accounting for pensions more independent of the financing arrangements, provided more standardization in measurement of the pension expense and liability, and required at least a "minimum liability" to be recognized in employers' balance sheets.

188. The Social Security liability was de-recognized in the *CFS* for 1985; but a similar closed group (to new entrants),[28] "liability type" number continued to be disclosed in a footnote along with the open group, "cashflow" or "financing type" number. The closed group population includes all current participants, that is, retirees and covered workers. The "open group" includes all current participants plus all future participants over the next 75 years. Disclosure of the closed group number was discontinued in the *CFS* after 1994.

FASAB Exposure Drafts on Liabilities & Stewardship

189. Social insurance was addressed in the Board's exposure draft (ED) on *Accounting for the Liabilities of the Federal Government* in November 1994. The *Liabilities* ED proposed defining a federal liability in terms generally similar to the definition used by privately owned entities in the United States: a probable and measurable future sacrifice of resources based on a past transaction or event. However, to accommodate the unique circumstances of the Federal Government, both the *Liabilities* ED and the subsequent Statement of Federal Financial Accounting Standards No. 5 distinguished between

[28] "Closed group" will be used synonymously with "closed group (to new entrants)."

exchange and **non**exchange transactions and provided distinct accounting for liabilities resulting from these two types of transactions.

190. Private sector accounting concepts and standards distinguish between reciprocal transactions (such as payments to an employee for services rendered) and non reciprocal transactions (such as contributions pledged to a not-for-profit entity). This is generally analogous to the federal distinction between exchange and nonexchange transactions. Private sector accounting standards, however, do not recognize liabilities differently based upon whether they arise from reciprocal or non reciprocal transactions.

191. For nonexchange transactions, the *Liabilities* ED provided that a liability would be recognized for any unpaid amounts due and payable as of the reporting date. This includes amounts due from the federal entity to pay for benefits, goods, or services provided under the terms of the program, whether or not such amounts have been reported to the federal entity (e.g., estimated Medicare payments due to health providers for service that has been rendered and that will be financed by the federal entity but that have not yet been reported to the federal entity).

192. After much debate, social insurance benefits were classified as nonexchange transactions. The *Liabilities* ED proposed that such programs recognize the following as expense in the statement of net cost: (1) the benefits and expenses paid during the year (except those accrued at the end of the prior year) and (2) the benefits and expenses due and payable at the end of the year. The latter were to be recognized as liabilities on the balance sheet. The *Liabilities* ED noted that the FASAB contemplated a federal reporting model encompassing extensive disclosure and supplementary reporting and that the Board was addressing such reporting for social insurance in a separate project. Also, the *Liabilities* ED contained an alternative view whereby a minimum liability—representing the actuarial present value of total lifetime benefits due to be paid to people eligible to receive social insurance benefits at the balance sheet date—would be recognized on the balance sheet.

193. The Board considered the responses to the *Liabilities* ED in conjunction with its continuing development of supplementary information for social insurance programs. The majority of

respondents favored the alternative view, that is, recognition of a minimum liability. Because the *Liabilities* ED had focused on balance sheet presentation and did not contain any proposed supplementary disclosures and because the magnitude and complexity of the issues were so great, the Board chose to issue a standard on liabilities without any additional requirements for social insurance and to expose the supplementary information for comment. In August 1995, the Board released for comment proposed required supplementary information for social insurance programs in the exposure draft on *Supplementary Stewardship Reporting* ("*Stewardship* ED").

194. The *Stewardship* ED did not change the recognition point for expenses and liabilities published in the *Liabilities* ED. However, it proposed the following three liability-type measures to be reported as required supplementary information accompanying the financial statements: (1) a "minimum liability" (present value of benefits due to all currently eligible to receive them) and (2) the actuarial net present value of benefits and payments to (a) the closed group (that is, current program participants) and (b) the "open group" (current and future program participants) for the next 75 years. In addition, it proposed a "money's worth" measure (data showing the change over time in the ratio of the net present value of actual or estimated average aggregate lifetime benefits paid to and contribution received from and on behalf of similarly aged participants).

195. The response to the *Stewardship* ED's required supplementary stewardship information package regarding social insurance was generally favorable. The majority of respondents said that the information was either very useful or useful. Others, including representatives of the administrative agencies for Social Security and Medicare, objected to reporting any information other than that based on the open group methods and assumptions. Also, opposition arose from the agency administering unemployment insurance and Black Lung benefits, stating that although its programs should be included as social insurance, the RSSI package designed for Social Security did not fit its programs because they involved short-term benefits or had other unique aspects.

196. After deliberating the issues, the Board concluded in May 1996 that additional investigation and further deliberation were required. The Board noted:

- the strength of feelings on the issues (with one side firmly believing that the closed group estimate is a liability that should be recognized on the consolidated balance sheet of the Federal Government and, at the opposite pole, others who firmly believe that the closed group estimate is meaningless, could be misleading, and should not be disclosed at all in federal financial reports);
- the magnitude and complexity of the issues; and
- that changes to social insurance programs were being studied and discussed frequently and seriously within government and by the public.

197. The Board directed the staff to continue researching social insurance accounting, focusing especially on identifying the following:

- the characteristics of such programs, the appropriate display of information in the financial statements, and any additional information that should be required;
- the means for measuring financial data in such information; and
- the desirability of other indicators (ratios of data to Gross Domestic Product (GDP) or "covered payroll") to describe the status of programs.

The Board instructed the staff to be mindful of developments in the policy studies of Social Security in structuring its research and its recommendations.[29] In early 1997, the Board began again to deliberate the issues. The standard is a product of this project.

[29]SFFAS No. 8, *Supplementary Stewardship Reporting*, par. 117. The studies included the 1994-96 Social Security Advisory Council whose report, published in January 1997, reflected the lack of consensus on long-term financing for Social Security. The Council members agreed on how to define the size of the financing problem (by using the Social Security Administration actuaries' "best estimate" projection to derive an actuarial deficit of 2.17 percent of payroll over the next 75 years). They also agreed that two long-range goals should be (1) to eliminate the 2.17 percent 75-year deficit and (2) to have the fund in stable condition at the end of the 75-year period. However, the Council offered three sharply different models for the future of Social Security. These models did contain some common features (e.g., all three would increase from 35 to 38 the number of years used to compute benefits and tax Social Security benefits in the same way that contributory defined-benefit pensions are treated under the federal income tax). In addition to the Advisory Council, academics and scholars were studying, for example, the Chilean and United Kingdom experiments with privatization of public pension plans.

Appendix D - Glossary

See also Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273.

Statement of Federal Financial Accounting Standards No. 18: Amendments to Accounting Standards For Direct Loans and Loan Guarantees in Statement of Federal Financial Accounting Standards No. 2

Status

Issued	May 2000
Effective Date	For fiscal periods beginning after September 30, 2000.
Volume I References	SFFAC No. 2, *Accounting for Direct Loans and Loan Guarantees*
Volume II References	Loans and Loan Guarantees (L60)
Affects	SFFAS No. 2.
Affected by	SFFAS No. 19

Summary

I. This Statement presents amendments to certain portions of Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees*, (SFFAS No. 2), which was issued in August 1993. The objectives of these amendments are to improve financial reporting for subsidy costs and performance of Federal credit programs.

II. During 1998 and early 1999, the Board discussed issues related to reporting the credit subsidy expense and credit subsidy reestimates in general. The Board concluded that certain portions of SFFAS No. 2 should be amended so that more useful information on credit programs' subsidy costs and performance will be provided to citizens, Congress, program managers, and other users of Federal financial information. The amendments were proposed for public comment in an Exposure Draft published in March 1999. After considering comments, the Board decided to adopt the following amendments:

a. **Report subsidy reestimates in two distinct components: the interest rate reestimate and the technical/default reestimate.**

The former is a reestimate due to a change in interest rates from the rate assumed in budget preparation and used in calculating the subsidy expense to the rates that are prevailing at the time the direct or guaranteed loans are disbursed. The latter is a reestimate due to changes made in projected cash flows under the terms of the direct loans or loan guarantees after reevaluating all the risk factors as of the financial statement date, except for the effect of interest rate reestimates.

b. **Display a reconciliation between the beginning and the ending balances of the subsidy cost allowance for direct loans and the liability for loan guarantees, reported in an entity's balance sheet.**

The reconciliation displays activities that affect the subsidy cost allowance or the loan guarantee liability, such as the subsidy expense for direct or guaranteed loans disbursed during the reporting

period, subsidy reestimates, fees received, interest supplements paid, loans written off, claim payments made to lenders, recoveries obtained, and other adjustments.

c. **Provide a description of program characteristics and disclose: (i) the amounts of direct or guaranteed loans disbursed in each program during the reporting year, (ii) the estimated subsidy rates for the total subsidy and the subsidy components at the program level in the current year's budget for the current year's cohorts, (iii) events and changes in economic conditions, other risk factors, legislation, credit policies, and subsidy estimation methodologies and assumptions, that have had a significant and measurable effect on subsidy rates, subsidy expense, and subsidy reestimates, and (iv) events and changes in conditions that have occurred and are more likely than not to have a significant impact but the effects of which are not measurable at the reporting date.**

   Reporting entities should discuss how those events and changes have affected or would affect credit programs' subsidy costs, subsidy reestimates, and the subsidy rates estimated in the budget.

III. In addition to requiring reconciliation for the balances of direct loan allowance and loan guarantee liability on an entity-wide basis as prescribed in this statement, the Board recognizes that reconciliation on a program-by-program basis can better reveal information relevant to program performance. Since the program-by-program reconciliation was not proposed for public comment in the March 1999 ED, the Board has not received input on this option. Because the proposal appears to have merit, the Board has decided to issue an exposure draft to propose program-by-program reconciliation for major programs in addition to the entity-wide reconciliation.

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Introduction

Purpose

1. The purpose of this Statement is to amend accounting standards for direct loans and loan guarantees by adding the following requirements: (a) report subsidy reestimates in two components: interest rate reestimates and technical/default reestimates, (b) display in a note to financial statements a reconciliation between the beginning and ending balances of loan guarantee liability and the subsidy cost allowance for direct loans, and (c) provide disclosure and discussion for changes in program subsidy rates, subsidy expense, and subsidy reestimates.

Background

2. During 1998 and 1999, the Board held discussions on what improvements could be made to financial reporting for credit subsidy rates, subsidy expense, and subsidy reestimates.[1] During the discussions, the Board directed its staff to conduct a survey in two issue areas: (a) How difficult is it for agencies to prepare and report subsidy data, and (b) What subsidy data are useful to users of Federal agency financial reports.

3. In June 1998, representatives of the Small Business Administration and the Department of Education made presentations to the Board on their experience and capabilities for preparing subsidy cost data for direct loans and loan guarantees. The presentations indicated that to meet the budgeting requirements, agencies must have systems and procedures to estimate for each cohort of direct loans or loan guarantees the subsidy rates, subsidy expense, and subsidy reestimates in components as currently required in preparing the budget. The presentations indicated that if a sound system is in place, the information on subsidy rates, subsidy expense, and subsidy

[1]The discussions were initiated by the Credit Reform Task Force of the Accounting and Auditing Policy Committee (AAPC) which proposed that paragraph 25 in SFFAS No. 2 be amended to require disclosure of subsidy rates estimated in the budget for the current year cohorts in lieu of reporting the dollar amounts of the subsidy components. That proposal was discussed in the March 1999 ED. The Board accepted the Task Force proposal for disclosing subsidy rates, but did not remove the requirement for reporting the dollar amounts of subsidy expense components.

reestimates can be retrieved and aggregated on a program or entity basis to meet the financial reporting requirements.

4. A questionnaire on data usefulness was sent to congressional staff members who had been involved in Federal credit programs. Oral and written responses were received from a number of the staff members and were presented to the Board at its October 1998 meeting. All of those who responded indicated that for appropriation and oversight purposes, they needed more rather than less detailed data on subsidy costs for direct loans and loan guarantees. They preferred that subsidy data be reported by component in both rates and dollar amounts. Furthermore, they said that they would like to compare initial budget expectations with current reestimates and to know causes that explain changes in subsidy rates.

5. The Board agreed that the subsidy cost information reported by Federal credit agencies could be improved by adopting the following requirements: (a) report subsidy reestimates by component, (b) display in a note to financial statements a reconciliation between the beginning and ending balances of the subsidy cost allowance for direct loans and the liability for loan guarantees, and (c) provide disclosure and discussion that would help the reader understand the changes in Federal credit programs' subsidy costs and performance. These requirements were proposed in the Exposure Draft issued in March 1999 (the March 1999 ED).

6. The Board received comments from twelve respondents. Of those respondents, ten were from Federal agencies (including the CFO Council of the Federal Government), and two were from the private sector. They were generally in favor of the Board's proposals to improve financial reporting for credit programs' subsidy costs and performance. However, some of them expressed different views on some of the proposals, which are addressed in Appendix A, Basis for Conclusions. After considering the comments, the Board decided to issue in this final statement all of the amendments proposed in the March 1999 ED.

7. The Board considered and agreed with the view that reconciliations for direct loan allowance and loan guarantee liability on a program-by-program basis can better reveal variations in program characteristics and performance. Since the program-by-program reconciliation was not proposed for public comment in the March 1999 ED, the Board has

not received input on this option. Because the proposal appears to have merit, the Board will issue an exposure Draft to propose reconciliation for major programs in addition to the entity-wide reconciliation prescribed in this statement.

Effective Date

8. The accounting standards prescribed in this statement are effective for periods beginning after September 30, 2000. Earlier implementation is encouraged.

Accounting Standards For Direct Loans And Loan Guarantees

Subsidy Reestimates-An Amendment To SFFAS No. 2

9. Paragraph 32 in SFFAS No. 2 is amended to read:

Credit programs should reestimate the subsidy cost allowance for outstanding direct loans and the liability for outstanding loan guarantees as required in this standard. There are two kinds of reestimates: (a) interest rate reestimates, and (b) technical/default reestimates.[2] Entities should measure and disclose each program's reestimates in these two components separately. An increase or decrease in the subsidy cost allowance or loan guarantee liability resulting from the reestimates is recognized as an increase or decrease in subsidy expense for the current reporting period.

(A) An interest rate reestimate is a reestimate due to a change in interest rates <u>from</u> the interest rates that were assumed in budget preparation and used in calculating the subsidy expense <u>to</u> the interest rates that are prevailing during the time periods in which the direct or guaranteed loans are disbursed. Credit programs may need to make an interest rate reestimate for cohorts from which direct or guaranteed loans are disbursed during the

[2]The term "technical/default reestimate" used in this statement is identical in meaning to the term "technical reestimate" used in OMB Circular A-11, as revised in July 1999.

reporting year. If the assumed interest rates that were used in calculating the subsidy expense for those cohorts differ from the interest rates that are prevailing at the time of loan disbursement, an interest rate reestimate for those cohorts should be made as of the date of the financial statements.

(B) A technical/default reestimate is a reestimate due to changes in projected cash flows of outstanding direct loans and loan guarantees after reevaluating the underlying assumptions and other factors that affect cash flow projections as of the financial statement date, except for any effect of the interest rate reestimates explained in (a) above. In making technical/default reestimates, reporting entities should take into consideration all factors that may have affected various components of the projected cash flows, including defaults, delinquencies, recoveries, and prepayments. The technical/default reestimate should be made each year as of the date of the financial statements.

Reconciliation

10. In a note to the financial statements, reporting entities should display a reconciliation between the beginning and ending balances of the subsidy cost allowance for outstanding direct loans and the liability for outstanding loan guarantees reported in the entities' balance sheet. The reconciliation is accomplished by adding to or subtracting from the beginning balance the dollar amounts of the following items: (a) the subsidy expense recognized in the four components as defined in paragraphs 25 through 29 for direct or guaranteed loans disbursed during the reporting year, (b) the two types of subsidy reestimates as defined in paragraph 32, and (c) other adjustments. For direct loans, the other adjustments include loan modifications, fees received, loans written off, foreclosed property or other recoveries acquired, and subsidy allowance amortization. For loan guarantees, the other adjustments include loan guarantee modifications, fees received, interest supplements paid, claim payments made to lenders, foreclosed property or other recoveries acquired, and interest accumulated on the loan guarantee liability. The requirement to display reconciliation applies to direct loans and loan guarantees obligated or committed on or after October 1, 1991, the effective date of the Federal Credit Reform Act of 1990. Reporting entities are encouraged but not required to display reconciliations for direct loans and loan guarantees obligated or committed prior to October 1, 1991,

in schedules separate from the direct loans and loan guarantees obligated or committed after September 30, 1991.

Disclosure And Discussion

11. The disclosure and discussion requirements are prescribed in paragraphs 11(A) through 11(C):

    (A) Reporting entities should provide a description of the characteristics of the programs that they administer, and should disclose for each program: (a) the total amount of direct or guaranteed loans disbursed for the current reporting year and the preceding reporting year, (b) the subsidy expense by components as defined in paragraphs 25 through 29, recognized for the direct or guaranteed loans disbursed in those years, and (c) the subsidy reestimates by components as defined in paragraph 32 for those years.

    (B) Reporting entities should also disclose, at the program level, the subsidy rates for the total subsidy cost and its components for the interest subsidy costs, default costs (net of recoveries), fees and other collections, and other costs, estimated for direct loans and loan guarantees in the current year's budget for the current year's cohorts. Each subsidy rate is the dollar amount of the total subsidy or a subsidy component as a percentage of the direct or guaranteed loans obligated in the cohort. Entities may use trend data to display significant fluctuations in subsidy rates. Such trend data, if used, should be accompanied with analysis to explain the underlying causes for the fluctuations.

    (C) Reporting entities should disclose, discuss, and explain events and changes in economic conditions, other risk factors, legislation, credit policies, and subsidy estimation methodologies and assumptions, that have had a significant and measurable effect on subsidy rates, subsidy expense, and subsidy reestimates. The disclosure and discussion should also include events and changes that have occurred and are more likely than not to have a significant impact but the effects of which are not measurable at the reporting date. Changes in legislation or credit policies include, for example, changes in borrowers' eligibility, the levels of fees or interest rates charged to borrowers, the maturity terms of loans, and the percentage of a private loan that is guaranteed.

Appendix A: Basis For Conclusions

Subsidy Reestimates

12. Paragraph 32 in SFFAS No. 2, as amended, requires that entities measure and disclose reestimates in two components separately; namely, the interest rate reestimate and the technical/default reestimate. The former is a reestimate made for differences between interest rate assumptions at the time of budget formulation (the same assumption is used at the time of obligation or commitment) and the actual interest rates for the years of disbursement.[3] The later is a reestimate due to changes in projected cash flows as reflected in the direct loan allowance and loan guarantee liabilities at the beginning of each fiscal year, after reevaluating the underlying assumptions and other factors that affect cash flow projections as of the financial statement date, except for any effect of interest rate reestimates.

13. As explained in the March 1999 ED, the rationale for separating the two reestimate components lies in the fact that interest rate reestimates and technical/default reestimates differ in nature. The interest rate reestimate depends on how close the assumed interest rate, which is initially used in the budget, is to the actual interest rates prevailing at the time of loan disbursement. The interest rate reestimate does not in itself indicate changes in the quality of loan assets or the overall risk of loan guarantees, nor does it have any implication for the quality of the agency's subsidy estimation process. The technical/default reestimate, on the other hand, reflects the latest developments in risk and program characteristics and thus it indicates changes in the quality of loan portfolio or the overall risk of loan guarantees. In some instances, a large technical/default reestimate may indicate that the credit program management should find ways to improve its subsidy estimation process and/or its portfolio management. Because of the difference in the nature of the two components, separate reporting would provide better information to users of the financial reports.

[3]See OMB Circular A-11, sec. 85.5 (a), revised in July 1999. The interest rate reestimate does not involve any change in original assumptions other than the interest rates.

14. All of the 12 respondents to the March 1999 ED agreed with the Board's proposal for reporting subsidy reestimates in those two components. The respondents believe that reporting the two reestimate components separately will provide information to reveal the causes of the reestimates. They believe that such information can help program managers improve credit program performance and subsidy estimation methodology.

15. Although in support for the proposal, one respondent commented on the controllability argument. Since it was discussed in the March 1999 ED that the magnitude of an interest rate reestimate is beyond agencies' control, the respondent pointed out that some default factors, such as changes in economic conditions and natural disasters, are also beyond the control of credit programs. While it was stated in the March 1999 ED that "the assumed rate is determined by the Administration and is beyond the control of the agency," that statement does not imply that credit programs can control changes in economic conditions or all of the other events that would impact default rates. However, the Board believes that a reliable assessment of the economic changes and other risk factors in making default subsidy reestimates, whether or not controllable by the agency, can help credit programs better manage program costs and performance.

16. Another respondent stated that analyses performed by his agency indicated that in past years, changes in interest rates produced relatively minor changes in that agency's overall subsidy rates. Thus, the respondent suggested that the Board consider whether it is cost-beneficial to separate out the interest rate reestimates.

17. The interest rate reestimates vary in magnitude from year to year. For some years, the assumed and the actual rates may be fairly close, whereas in other years they differ significantly and could produce a material effect on the overall subsidy rate. For example, the subsidy reestimate data provided USDA Rural Development Water and Waste Direct Loan program indicated that for fiscal years 1992 through 1994, the amounts of interest rate reestimates exceeded the amounts of technical/default reestimates. In 1995, the interest rate reestimate accounted for 84 percent of the total subsidy reestimate. In more recent years, the impact of interest rate reestimates was relatively small. In any case, we do not believe one can rely on the past experience for any particular year to make a conclusion about interest variations in future years.

Reconciliation

18. It is prescribed as an accounting standard in this statement that reporting entities display in a note to financial statements a reconciliation between the beginning and ending balances of the subsidy cost allowance for outstanding direct loans and the liability for outstanding loan guarantees reported in the entities' balance sheet.

19. During its discussions about the subsidy expense and subsidy reestimates, the Board held the view that it is not adequate or desirable to report annual subsidy expense and reestimates in an isolated fashion. The Board concluded that additional information is needed to provide a full picture about a credit program's performance. The Board believes that the reconciliation can be used as an effective vehicle to provide such information.

20. As explained in the March 1999 ED, an advantage of displaying the reconciliation is to show in one place the activities that affect the subsidy cost allowance or the loan guarantee liability. In addition to the subsidy expense and reestimates, which are based on projections of future cash flows, the reconciliation schedule also displays data on actual performance, such as fees received, loans written off, claim payments made to lenders, and foreclosed property, loans receivable, or other recoveries acquired during the reporting year. These actual performance data and the data on subsidy cost estimates would be a useful tool to begin assessing the actual performance of a reporting entity's lending or loan guarantee activities against its budget expectations.

21. The Board noted as another advantage that the reconciliation process would enhance credit agencies' internal control. To comply with the requirement, entities must make the subsidy data elements consistent, accurate, and thus reconcilable. In conjunction with credit agencies' loan monitoring systems, the reconciliation process can serve as a tool to foster a discipline in organizing data related to subsidy costs and performance in a systematic manner.

22. A majority of the respondents supported the Board's proposal for displaying the reconciliation. They believed that the reconciliation will provide useful information to Congress, program managers, and other users of financial statements. One respondent stated that once required as a part of the financial statements, the reconciliation will be subject to validation through audit and thus will become a reliable

source of information for those who make decisions and evaluate results for credit activities.

23. Several respondents, however, expressed disagreements or reservations about the proposed reconciliation. Some of them commented that compiling the reconciliation data would be a burdensome process. We believe that performing the reconciliation would initially require some staff training and computer programming. However, the effort will be worthwhile because the process will help agencies organize the necessary data in an orderly manner. When properly programmed, the reconciliation process can become a routine and systematic process. In fact the reconciliation requires no more data than those that are necessary in deriving the ending balances of the subsidy cost allowance and loan guarantee liability from their beginning balances of a reporting period. Thus, all the data necessary for the reconciliation should be available and verifiable if the ending balances are accurate.

24. It should be noted that it is not unusual to require reconciliation in credit activities. In its Industry Guide No. 3, the Securities and Exchange Commission (SEC) requires bank holding companies to provide an analysis of the allowance of loan losses in their financial statements.[4] The analysis is equivalent to the reconciliation of the subsidy cost allowance required in this statement. The SEC Guide requires that the beginning and ending balances of the allowance be reconciled with charge-offs (loans written off), recoveries, and additions charged to operations (equivalent to subsidy reestimates). The charges-offs and recoveries are displayed by type of loans (such as consumer installments, commercial, real estate, and lease financing, as so forth). A similar requirement is prescribed by the Financial Accounting Standards Board (FASB) in paragraph 20, FAS No. 114, as amended by FAS 118, for impaired loans accounted for on a present value basis:

> For each period for which results of operations are presented, a creditor also shall disclose the activity in the total allowance for credit losses related to loans, including the balance in the

[4] *SEC Accounting Rules*, ¶ 8303, 1984 Commerce Clearing House, Inc. [Additional reference: Securities Act Guide 3 adopted in Release No. 34-12784, amended by Release Nos 33-6221, 33-6383, FR-11, FR-13 and FR-27]

allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off. The total allowance for credit losses related to loans includes those amounts that have been determined in accordance with FASB Statement No. 5, Accounting for Contingencies, and with this Statement.

25. Some of those who disagreed with the reconciliation proposal recognized merits in reconciling subsidy cost allowance for direct loans and liability for loan guarantees, but doubted whether the reconciliation on an entity basis would provide useful information. They pointed out that the programs their agencies administer vary in characteristics and subsidy rates, and that the reconciliation at the entity level will aggregate the program data and, as a result, will not reveal the characteristics and operating results of individual programs.

26. The Board was aware that programs administered by an agency often differ in characteristics and subsidy rates. The Board agrees with the view that the entity-wide reconciliation in itself would not reveal variations in program performance. The Board thus decided to issue an exposure draft, soon after issuing this statement, to propose a display of a program-by-program reconciliation for major programs. Nevertheless the Board sees value in the entity-wide reconciliation itself. With respect to the subsidy cost allowance and the loan guarantee liability reported on an entity's balance sheet, the entity-wide reconciliation shows changes in those balances. Those changes indicate the entity's aggregate performance results for all the credit activities under the entity's management.

27. The Board considered two primary reasons for adopting the entity-wide reconciliation in this statement, rather than postpone it until the program-by-program reconciliation is proposed and considered. First, by making the entity-wide reconciliation effective as early as possible, agencies can begin to get their personnel and systems resources ready for implementing the requirement without further delay. Second, by requiring the display of the entity-wide reconciliation, it is likely that program-by-program reconciliation data would be available for users. This is based on the rationale that in order to display the entity level reconciliation, the reporting entity would normally first reconcile the balances of individual programs. If they do so, program managers as well as auditors will have access to the program reconciliation data to

validate the entity-wide reconciliation and to use the program-based data in program analysis and evaluation. If requested by Congress, special reports for any particular program can also be made available to Congress.

28. One respondent pointed out that loan guarantee programs sometimes acquire guaranteed loans for direct collection upon paying default claims for those loans. He asked whether the subsidy cost allowance of those loans should be reconciled in a separate schedule. Under credit reform accounting, guaranteed loans acquired by the loan guarantee program upon paying default claims are carried at their present value and the present value is reestimated annually before the loans are collected or written off. The amount of those loans and their allowance are reported in Note 7 in OMB Bulletin 97-01, *Form and Content of Agency Financial Statements*. Since the acquired loans do not represent a primary line of business for loan guarantee programs, the Board does not believe that a display of reconciliation for those acquired loans should be required.

29. One respondent asked whether the reconciliation requirement applies to pre-credit reform direct loans and loan guarantees as well as post-credit reform direct loans and loan guarantees. The Board considered the issue and concluded that the reconciliation requirement applies only to post-credit reform direct loans and loan guarantees, i.e., direct loan and loan guarantees obligated or committed after September 30, 1991. One of the principal objectives for the reconciliation requirement is to provide information that can be used to compare initial budget expectations with operating results. This is achievable with direct loans and loan guarantees that were obligated or committed after September 30, 1991, because under credit reform, budgeting and financial reporting for credit activities are performed on the same present value basis. This is not the case with pre-credit reform direct loans and loan guarantees.

30. However, aside from the basic objective discussed above, the other advantages of the reconciliation are valid for both pre and post-credit reform direct loans and loan guarantees. Those advantages include: (a) revealing information on activities that affect the balances, and (b) enhancing accounting integrity and internal control. Agencies are encouraged, but not required, to reconcile the direct loan allowance and loan guarantee liability balances for direct loans and loan guarantees obligated or committed prior to October 1, 1991. Since the

measurement bases differ between pre and post-credit reform direct loans and loan guarantees, agencies should use separate reconciliation schedules for pre and post-credit reform direct loans and loan guarantees.

Disclosing Subsidy Rates

31. A disclosure provision has been prescribed in this statement to require that reporting entities disclose, at the program level, the rates for the total estimated subsidy cost and the subsidy cost components in the current year's budget for the current year's cohorts. Each rate equals the amount of the total subsidy or a subsidy component divided by the amount of direct or guaranteed loans obligated in the cohort for the reporting year. The Board members believed that the budget subsidy rates for the reporting year are highly important because they represent budget expectations that reflect the most recent program characteristics.

32. The standard provides that reporting entities may use trend data to display significant fluctuations in a program's subsidy rates. To avoid excessive and purposeless presentation of historical data, the use of trend data should be limited to the subsidy rate for the total subsidy or for a subsidy component of a particular program that has experienced significant fluctuations in recent years. The presentation of trend data should be accompanied by analysis to explain causes of the fluctuations.

33. A majority of the respondents supported the proposal for disclosing the estimated subsidy rates for cohorts of the current year. The arguments for the proposal they presented include: (a) those subsidy rates estimated in the current year's budget "give the reader the most up-to-date information on cohorts as established by appropriation law," (b) those rates reflect the most recent program characteristics, and (c) the subsidy rates reported for a number of recent years can form a trend for comparison and analysis.

34. One respondent requested clarification for the phrase "in the current year's budget for the current year's cohorts." The required disclosure is for budget subsidy rates for the cohorts of the current reporting year, i.e., the year for which the financial reports are published. For example, in the financial reports for the 2001 fiscal year, the budget subsidy rates in the FY 2001 budget for the FY 2001 cohorts should be complied and disclosed at the program level. The standard does not

require disclosure of subsidy rates for cohorts of previous years, although some of the cohorts may continue to disburse loans during the current reporting year. However, as provided in the standard, entities may use trend data to display significant fluctuations in subsidy rates over a number of the most recent years.

35. Those who were opposed to the disclosure for subsidy rates presented the following arguments: (a) budget subsidy rates for all credit programs are published in the *Federal Credit Supplement to the Budget of the U.S. Government*, and it is unnecessary to duplicate the same data in financial reports, (b) the inclusion of budget subsidy rates in financial reports would appear to invite calculation of subsidy costs by applying the subsidy rates to disbursements, and such calculation could produce confusing results, and (c) the subsidy rates in the budget are estimated before all the data concerning the reporting year are available, and are subject to changes.

36. The Board was aware that the budget subsidy rates are published in the *Federal Credit Supplement to the Budget of the U.S. Government*. However, the inclusion of those subsidy rates in the financial reports will provide the reader of the financial statements with an easy access to the budget data. The Board was also aware that one cannot calculate the subsidy expense for the current year by applying the estimated subsidy rates of the current year cohorts to the amount of direct or guaranteed loans disbursed during the current year. Such calculation may give erroneous results because some of the loans disbursed during the current year may belong to previous years' cohorts. The disclosure of budget subsidy rates was initially proposed by the AAPC Credit Reform Accounting Task Force. When proposing the disclosure, the AAPC Credit Reform Accounting Task Force suggested that the disclosure be accompanied by a narrative explaining in conceptual terms how the total subsidy rate differs from the total subsidy expense recognized in the financial statements. The Board believes that it is necessary to have such a narrative to avoid confusion between the subsidy rates of the current year cohorts and the subsidy expense recognized for the current reporting year.

37. It is true that the estimated subsidy rates for a program in the current year's budget reflect budget expectations for that program, and do not reflect the program's operating results for the current reporting year. The actual performance of a program can be viewed from such data as subsidy reestimates, loans written off, default claims paid, and fees

received. One of the purposes for the disclosure of the budget subsidy rates is to provide an indication of budget expectations of the most recent cohorts.

38. The Board believes that the disclosure for the subsidy rates for the cohorts of the current reporting year will prove beneficial as they are important indicators for management's latest expectations reflecting the programs' current characteristics. The disclosure requirement is adopted because the advantages of the disclosure outweigh its disadvantages.

Disclosure And Discussion

39. The Board holds the view that merely reporting the figures for the subsidy expense and subsidy reestimates would not provide complete and understandable information to users of Federal agency financial reports. The Board believes that to make the figures meaningful, significant events and changes in assumptions underlying the cost estimates should be disclosed and their impact should be discussed. The disclosure and discussion should help explain the subsidy cost data. In other words, the Board believes that it is necessary to tell the stories behind the figures.

40. Reporting entities are required to provide a description of the programs that they administer and disclose at the program level the amounts of direct or guaranteed loans disbursed during the reporting year. This information would provide the reader with an indication of the programs' characteristics and the magnitude of their credit activities. With the information on amounts disbursed, analysts can calculate the subsidy expense, or one of its components, as a ratio to the amount of the loans disbursed and compare the ratios among programs or over time.

41. Reporting entities are required to disclose events and changes that have had a significant and measurable effect on subsidy costs. These would include changes in economic conditions and risk factors, changes in legislation and policies regarding direct loans or loan guarantees, and changes in methodologies and assumptions used in making subsidy estimates and reestimates. Credit agencies are also required to disclose and discuss events and changes that have occurred and are more likely than not to have a significant impact on subsidy rates, subsidy expense, and subsidy reestimates but the effects of which are not measurable at the reporting date. These

include events and changes that have occurred after the reestimation cut off date and will be taken into consideration in making reestimates for the following year. Reporting entities should discuss how those events and changes have or would have impacted the various components of subsidy expense, subsidy rates, and subsidy reestimates.

42. The Board noted in particular that changes in legislation and credit policies could significantly alter a program's characteristics and thus affect its subsidy rates. These changes include, for example, changes in borrowers' eligibility, the level of fees or interest rates charged borrowers, the maturity terms of loans, and the percentage of a private loan that is guaranteed. If such a change occurs during a reporting year, the reporting entity should disclose and explain the nature of the change and discuss its impact on program characteristics and its estimated subsidy rates.

43. Most respondents supported the Board proposal. They believed that to make the reported financial figures meaningful, significant events and changes in assumptions underlying those figures should be disclosed and their effect should be discussed. Some of the respondents provided examples of events that can affect default rates. For example, drought, flood, tornadoes, and other natural disasters may affect some regions or some sectors of the economy, and consequently, affect borrowers' ability to make loan payments. Those respondents also noted that changes in economic conditions, such as interest and employment rates, could an also have a significant impact on credit risks and performance. Some of them stated that legislative and policy changes could have a direct impact on the costs and performance of certain affected programs. They contend that without disclosing those events and changes and discussing their impact, the reader cannot fully understand the financial figures, such as subsidy rates, expenses, and reestimates.

44. One respondent noted that the same type of disclosure and discussion that is now required for credit subsidies is not usually required for many other operating costs, such as employees salary, rent, and computer service costs. The respondent questioned why the disclosure and discussion for credit activities are more critical than other costs reported in the statement of net cost. To address this issue, we can provide at least two reasons for this difference. First, unlike salary, rent, or the costs of other services, the credit subsidy costs are

under a greater degree of uncertainty, as they are exposed to many risk factors external to the government. Many factors discussed in the March 1999 ED and by other respondents, such as changes in interest and employment rates and disastrous events, would cause the subsidy costs to vary from their estimates in the budget. Second, unlike most other cost items, the credit subsidy costs are reported in present values of future cash flows projected over the life of the underlying direct loans and loan guarantees. To a large extent, the reliability of the subsidy cost information depends on the factors considered in making the cash flow projections. The reliability is also affected by the quality of the agency's data and its estimation methodology. The narrative disclosure and discussion would help the user to understand the factors that cause significant changes in the subsidy costs during the reporting year, which do not usually occur in salary, rent, or other operating costs.

45. Two respondents, however, were opposed to the narrative disclosure and discussion requirement on the grounds that it would be burdensome for entities with varied programs to present the required information. These respondents may have come under a mis-perception about the disclosure and discussion requirement. They may have perceived that the standard would require an excessively detailed description of all the technical aspects of the subsidy estimation methodologies and assumptions, and an extensive analysis of all risk factors in the programs and even sub-programs administered by the reporting entity. Thus, they concluded the requirement is extremely burdensome. However, such detailed disclosure and discussion were not intended. It was stated in paragraph 50 of the March 1999 ED:

> While the Board members believe that the proposed disclosure and discussion are necessary, they prefer that entity financial reports are not overwhelmed with detailed numbers and ratios that may overburden the reader of the financial reports. The Board members believe that to the extent possible, the narrative discussion should be written in non-technical language so that the average reader can understand the data and the explanations.

46. The primary emphasis of the disclosure and discussion requirement is on significant changes in subsidy rates and reestimates. The disclosure and discussion should be focused on events that have occurred and have caused those significant changes. In addition, the disclosure and discussion should also include events that have occurred and are more likely than not to have a significant impact on subsidy rates and

reestimates but the effects for which are not measurable at the reporting date.

47. Some respondents believed that the narrative disclosure and discussion should more appropriately belong to the Management Discussion and Analysis (MD&A) section of financial reports. The Board disagrees with this view. The narrative disclosure and discussion required in this statement should be specifically tailored to address credit subsidy activities. As such, it differs from the MD&A requirements in breadth, depth, and detail. The Board believes that the disclosure and discussion required in this statement belong in a note to financial statements, such as Note 7 in OMB Bulletin 97-01, *the Form and Content of Agency Financial Statements*, in which all the data on direct loan assets, loan guarantee liabilities, subsidy rates, subsidy expenses, and reestimates are reported. By including the narrative disclosure and discussion in the same note, the reader would find all the information in one place. However, this does not preclude entity management from including a discussion and analysis to highlight credit activities in MD&A, so long as entity management determines that such a discussion and analysis meets the MD&A requirements in SFFAS 15.

48. Audit efforts for information provided in a footnote to financial statements differ from those for information provided in MD&A. MD&A is regarded as required supplementary information (RSI) and is subject to less stringent audit than basic financial statements and their notes.[5] The Board believes that program subsidy data should be reported in a note to agency financial statements because they are directly related to information reported in the financial statements. Those program subsidy data should be audited as basic financial information. Based on the preceding paragraph, it might appear that including the narrative disclosure and discussion in the same footnote with the subsidy data (instead of in MD&A) would expand the audit burden associated with credit subsidies. However, since the auditor already needs to test the reliability of the estimates and reestimates in

[5]See Statement of Recommended Accounting Standards No. 15, *Management Discussion and Analysis*, (April 1999) par. 18.

the context of auditing the basic program subsidy data[6], the Board believes that there would be no substantial increase in audit burden from including the narrative disclosure and discussion in a footnote instead of in MD&A. In fact, the process of generating the required disclosure and discussion for the footnote should provide information on risk factors underlying the subsidy estimates and reestimates and thus should facilitate the audit of the basic subsidy data.

49. One respondent commented that there may not be a basis to audit future events and their effect disclosed in the narrative. The required disclosure is for events that have occurred, but does not include events that are anticipated to occur. Also, the provision does not require quantifying the effect of an event that has occurred but whose effects cannot be measured at the reporting date.

The Effective Date

50. In the March 1999 ED, it was proposed that the amendments be made effective for periods beginning after September 30, 1999. Two respondents requested that the effective date be made for periods beginning after September 30, 2000. They argued that many agencies were still having difficulties in implementing existing credit reform requirements and that the new requirements would require revisions in accounting procedures and systems. The CFO Council stated that many agencies are busy with resolving Y2K problems, and would not be able to initiate new systems changes until some time in year 2000.

51. There were arguments against postponing the effective date. First, the requirements prescribed in this statement do not require any new data. For example, the data needed for the reconciliation schedules should be in the system. Without that data, agencies could not report the ending balances of the subsidy cost allowance and the loan guarantee liability at the end of each fiscal year. Second, the proposed effective date, beginning with fiscal year 2000, provides adequate time because

[6]For example, Federal Financial Accounting and Auditing Technical Release No. 3, *Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act* (July 1999), requires auditors to identify significant external and internal factors that may affect the credit subsidy estimates and reestimates. External factors include economic conditions, current political climate, and relevant legislation. Internal factors include the size of the agency's budget and accounting staff qualifications of key personnel, turnover of key personnel, and system capabilities.

financial statements for that year will be issued in early calendar year 2001.

52. On the other hand, the Board recognizes that staff training and computer re-programming may be necessary to implement the new requirements. Therefore, the Board considered and granted a delay for the effective date to periods beginning after September 30, 2000. However, the Board emphasizes that this should not be considered a precedent for postponing implementation of adopted accounting standards. The Board encourages early implementation of the standards.

Vote For Approval

53. The accounting standards prescribed in this statement are approved by the Board unanimously.

Appendix B: Illustrative Reporting Formats

The following two schedules illustrate the reconciliation between beginning and ending balances of the subsidy cost allowance for direct loans and the liability for loan guarantees.

A: Schedule for Reconciling Subsidy Cost Allowance Balances

Dollars in thousands		
Beginning Balance, Changes, and Ending Balance	**FY 2000**	**FY 2001**
Beginning balance of the subsidy cost allowance	$	$
Add: subsidy expense for direct loans disbursed during the reporting years by component:		
(a) Interest subsidy costs		
(b) Default costs (net of recoveries)		
(c) Fees and other collections		
(d) Other subsidy costs		
Total of the above subsidy expense components		
Adjustments:		
(a) Loan modifications		
(b) Fees received		
(c) Foreclosed property acquired		
(d) Loans written off		
(e) Subsidy allowance amortization		
(f) Other		
Ending balance of the subsidy cost allowance before reestimates		
Add or subtract subsidy reestimates by component		
(a) Interest rate reestimate		
(b) Technical/default reestimate		
Total of the above reestimate components		
Ending balance of the subsidy cost allowance		

B: Schedule for Reconciling Loan Guarantee Liability Balances

Dollars in thousands

Beginning Balance, Changes, and Ending Balance	**FY 2000**	**FY 2001**
Beginning balance of the loan guarantee liability	$	$
Add: subsidy expense for guaranteed loans disbursed during the reporting years by component:		
(a) Interest subsidy costs		
(b) Default costs (net of recoveries)		
(c) Fees and other collections		
(d) Other subsidy costs		
Total of the above subsidy expense components		
Adjustments:		
(a) Loan guarantee modifications		
(b) Fees received		
(c) Interest supplements paid		
(d) Foreclosed property and loans acquired		
(e) Claim payments to lenders		
(f) Interest accumulation on the liability balance		
(g) Other		
Ending balance of the loan guarantee liability before reestimates		
Add or subtract subsidy reestimates by component:		
(a) Interest rate reestimate		
(b) Technical/default reestimate		
Total of the above reestimate components		
Ending balance of the loan guarantee liability		

Appendix C: The Accounting Standards in SFFAS No. 2

See "Statement of Federal Financial Accounting Standards No. 2: Accounting for Direct Loans and Loan Guarantees" on page 202.

Appendix D: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273.

Statement of Federal Financial Accounting Standards No. 19: Technical Amendments to Accounting Standards For Direct Loans and Loan Guarantees in Statement of Federal Financial Accounting Standards No. 2

Status

Issued	March 2001
Effective Date	For periods ending after September 30, 2002
Volume I References	SFFAS 2, Accounting for Direct Loans and Loan Guarantees SFFAS 18, Amendments to Accounting Standards for Direct Loans and Loan Guarantees in SFFAS No. 2
Volume II References	Loans and Loan Guarantees (L60)
Interpretations and Technical Releases	Technical Release No. 3, Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act
Affects	SFFAS 2 and SFFAS 18
Affected by	None

Summary

In this Statement the Board adopts a number of technical amendments to certain portions of the Statement of Federal Financial Accounting Standards No. 2, Accounting for Direct Loans and Loan Guarantees (SFFAS No. 2), which was issued in August 1993.

The technical amendments serve the following purposes:

(A) Clarify that the cash flow discount method used in the accounting standards prescribed in SFFAS No. 2 is consistent with the method required in the Federal Credit Reform Act of 1990, as amended in July 1997.

(B) Clarify that the effective interest rate of a cohort of direct loans or loan guarantees is the interest rate adjusted for the interest rate re-estimate, as defined in paragraph 9(A), SFFAS No. 18, *Amendments to Accounting Standards for Direct Loans and Loan Guarantees in SFFAS No. 2*.

(C) Clarify the measurement principle for the default costs of direct loans and loan guarantees.

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Introduction

Background and Purposes

1. In this Statement the Board adopts a number of technical amendments to certain portions of the Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees* (SFFAS No. 2), which was issued in August 1993. These amendments were proposed for public comment in an Exposure Draft (ED) issued in May 2000. The title of that ED is "*Credit Program Reconciliation and Technical Amendments to Accounting Standards for Direct Loans and Loan Guarantees in Statements of Federal Financial Accounting Standards No. 2 and No. 18.*" (Hereinafter the ED is referred to as the May 2000 ED.)

2. The technical amendments serve the following purposes:

   (A) Clarify that the cash flow discount method used in the accounting standards prescribed in SFFAS No. 2 is consistent with the method required in the Federal Credit Reform Act of 1990, as amended in July 1997.

   (B) Clarify that the effective interest rate of a cohort of direct loans or loan guarantees is the interest rate adjusted for the interest rate re-estimate, as defined in paragraph 9(A), SFFAS No. 18, *Amendments to Accounting Standards for Direct Loans and Loan Guarantees in SFFAS No. 2*.

   (C) Clarify the measurement principle for the default costs of direct loans and loan guarantees.

3. The Board received nine responses to the ED. All of the respondents were in support for the technical amendments, except for two respondents who commented on the proposed technical amendments related to the measurement of default costs. Based on the comments, the Board made a minor modification to the proposed measurement of default costs for direct loans. This modification is discussed in this Statement's Appendix A, Basis for Conclusions.

4. In addition to the technical amendments, the Board proposed a standard in the May 2000 ED, requiring that entities display a program-by-program reconciliation for major credit programs between the

beginning and ending balances of subsidy cost allowance for direct loans and the liability for loan guarantees. The Board decided not to adopt that proposal based on cost-benefit considerations.

Effective Date

5. The technical amendments adopted in this Statement are effective for periods beginning after September 30, 2002. Early implementation of the amendments is encouraged.

Technical Amendments To SFFAS No. 2

Cash Flow Discount Method

6. The amendments in (a) and (b) below are made to clarify that the accounting standards in SFFAS No. 2 are consistent with the cash flow discount method required by the amendment enacted in July 1997 to the Federal Credit Reform Act of 1990. Sec. 502 (5)(E) of the Act, as amended, provides that "In estimating net present values, the discount rate shall be the average interest rate on marketable Treasury securities of similar maturity to the cash flows of the direct loan or loan guarantee for which the estimate is being made."

   (a) In paragraph 24, SFFAS No. 2, the phrase "with a similar maturity term" is changed to "with similar maturity to the cash flows."

   (b) In footnotes 3, 4, 6, and 7, SFFAS No. 2, the phrase "the remaining maturity" is replaced with the phrase "the remaining cash flows."

Effective Interest Rate

7. The following amendments are made to clarify that the effective interest rate of a cohort of direct loans or loan guarantees is the interest rate adjusted for the interest rate re-estimate, as defined in paragraph 9(A), SFFAS No. 18. The adjusted rate should be used for amortizing subsidy cost allowance, accruing and compounding interest on the liability for loan guarantees, determining the book value of modified direct loans and the book value of the liability for modified loan guarantees, and calculating the present value of assets acquired through foreclosure.

(a) In paragraph 30, SFFAS No. 2, the first sentence is changed to:

"The subsidy cost allowance for direct loans is amortized by the interest method using the interest rate that was used to calculate the present value of the direct loans when the direct loans were disbursed, after adjusting for the interest rate re-estimate."

(b) In paragraph 31, SFFAS No. 2, the first sentence is changed to:

"Interest is accrued and compounded on the liability for loan guarantees at the interest rate that was used to calculate the present value of the loan guarantee liabilities when the guaranteed loans were disbursed, after adjusting for the interest re-estimate."

(c) In paragraph 46, SFFAS No. 2, the phrase in the parentheses is changed to "the rate that was originally used to calculate the present value of the direct loans, when the direct loans were disbursed, after adjusting for the interest rate re-estimate."

(d) In paragraph 50, SFFAS No. 2, the phrase in the parentheses is changed to "the rate that was originally used to calculate the present value of the liability, when the guaranteed loans were disbursed, after adjusting for the interest rate re-estimate."

(e) In paragraphs 57 and 59, SFFAS No. 2, the words "adjusted for the interest rate re-estimate" are added immediately after the words "the original discount rate."

Measuring Default Costs

8. Paragraph 27 in SFFAS No. 2 is replaced with the following two paragraphs:

(a) The default cost of direct loans results from projected deviations by the borrowers from the payment schedules for principal, interest, and fee payments in the loan contracts. However, the measurement of default costs does not include prepayments. The default cost is measured at the present value of projected payment deviations due to defaults minus projected net recoveries. Projected net recoveries include the amounts that would be collected from borrowers at a later date or the proceeds

from the sales of acquired assets minus the costs of foreclosing, managing, and selling the assets.

(b) The default cost of loan guarantees results from paying lenders' claims upon default of the guaranteed loans. The default cost of loan guarantees is measured at the present value of projected payments to lenders required by the guarantee, plus uncollected fees, minus interest supplements not paid as the result of the default, and minus projected net recoveries as defined in paragraph 8(a).

appendix A: Basis For Conclusions

Program-by-Program Reconciliation

9. In the May 2000 ED, the Board proposed a standard requiring that entities display a program-by-program reconciliation for major credit programs between the beginning and ending balances of the subsidy cost allowance for direct loans and the liability for loan guarantees. Nine respondents to the ED commented on the proposal. Five of them supported the proposal and the remaining four were opposed to the proposed standard.

10. Those who supported the proposal believed that the display of a program-by-program reconciliation would enhance disclosure for program costs and performance. One of the respondents said that the program-by-program reconciliation would reveal actual program performance information, such as direct loans written off, default claims paid, fees received, and interest supplements paid. Reporting this kind of information on a program-by-program basis is not required by the existing standards. If the data were reported, they could be useful in analyzing a program's operating results and providing feedback to the program's budget expectations. Another respondent pointed out that when program data are aggregated, increases and decreases in program costs would offset each other. Thus, without a display of program-by-program reconciliation, entity-wide reconciliation alone would not disclose variations in program performance.

11. Among those who were opposed to the proposal, the Chief Financial Officer (CFO) of US Department of Agriculture (USDA) said that the proposed standard was unnecessary because USDA has reported subsidy costs by credit areas. The USDA CFO and several other respondents expressed their concern that the proposed display of program-by-program reconciliation would make the disclosure too lengthy and complex and thus reduce its information value to the users of general-purpose financial reports.

12. After considering the comments, the Board decided not to adopt the proposed standard. The Board concluded that SFFAS No. 2 and SFFAS No. 18 already require sufficient program information.

Paragraph 32 in SFFAS No. 2, as amended by SFFAS No. 18, requires that entities disclose each program's interest rate re-estimates and technical/default re-estimates. More extensive disclosure is required in SFFAS No. 18. Paragraph 11(a) in SFFAS No. 18, for example, requires that entities provide a description of the characteristics of the programs that they administer. It also requires disclosure of the amount of direct or guaranteed loans disbursed for each program during the reporting year as well as each program's subsidy expense, and subsidy re-estimates. Paragraph 11(b) requires disclosure of each program's subsidy rates for direct loans and loan guarantees in the current year's cohort. Furthermore, paragraph 11(c) requires that reporting entities disclose, discuss, and explain events and changes in economic conditions, other risk factors, legislation, credit policies, and subsidy estimation methodologies and assumptions, that have had a significant and measurable effect on subsidy rates, subsidy expense, and subsidy re-estimates. The Board believes that in the process of producing the program-based information required by paragraph 11(c), an entity will naturally describe important changes in the actual performance of its credit programs; e.g., default claims paid, loans written off, etc. Thus, the Board concluded that the program-based disclosure and discussion required by the existing standards should provide sufficient information about credit activities at the program level. In addition, although the incremental cost of producing the program-based reconciliation would be quite small for most agencies, the Board believes that requiring the display of program-based reconciliation would add length and complexity to the financial reports that are already detailed and complex. As a result of these benefit and cost considerations, the Board concluded that requiring the display of a program-by-program reconciliation was not justified.

Technical Amendments

13. The Board adopted three groups of technical amendments to SFFAS No. 2. The first group affects paragraph 24 and footnotes 3, 4, 6, and 7 of SFFAS No. 2. These amendments clarify that the accounting standards are consistent with the cash flow discount method required by the Federal Credit Reform Act of 1990, as amended in July 1997.[1] As required in Section 502 (5)(E) of the Act, the amended standards

[1] Office of Management and Budget (OMB) has implemented the amendment in Circular A-11, Preparation and Submission of Budget Estimates, July 1999 and in its recent release of a new credit subsidy calculator.

require using as the discount rate the average interest rate on Treasury securities of similar maturity to the cash flows of a direct loan or loan guarantee. None of the respondents to the ED objected to these amendments.

14. The second group of amendments affects paragraphs 30, 31, 46, 50, 57, and 59 of SFFAS No. 2. These amendments are related to interest rate re-estimates. The amendments clarify that the effective interest rate of a cohort of direct loans and loan guarantees is the interest rate adjusted by the interest rate re-estimate, as defined in paragraph 9(a), SFFAS No. 18. The adjusted rate should be used for amortizing subsidy cost allowance, accruing and compounding interest on the liability for loan guarantees, determining the book value of modified direct loans and the book value of the liability for modified loan guarantees, and calculating the present value of assets acquired through foreclosure. None of the respondents to the ED objected to these amendments.

15. The third group of amendments, proposed in ED paragraphs 10(A) and 10(B), concerns the measurement of default costs discussed in paragraph 27, SFFAS No. 2. ED paragraph 10(A) addressed the default costs of direct loans. The proposed amendment in that paragraph would include the effect of short-term delinquencies in the "other costs" category, rather than the "default costs" category.

16. The USDA CFO and IG objected to the exclusion of short-term delinquencies from default costs. They said that the Commodity Credit Corporation (an USDA unit) uses the Inter-Agency Country Risk Assessment System (ICRAS) to estimate default costs. The ICRAS, used for lending to foreign countries, includes short-term delinquencies in measuring default costs. Thus, the proposed amendment would create a difference from that practice.

17. The Board understands that practices differ among lending institutions in treating delinquencies. They may or may not regard a payment delay within a certain time frame as default. The Board is of the view that the variation would not distort the measurement of credit subsidy costs, if each practice is followed consistently. In this regard, it is better that the accounting standard leaves some leeway for the agencies that are responsible for developing subsidy estimate models and methodologies. Thus, the Board deleted the words related

to "delinquencies" in paragraph 8(a) of this Statement on default costs of direct loans.

18. Paragraph 8(b) of this Statement addressed the measurement of default costs for loan guarantees. The paragraph reads as follows:

    The default cost of loan guarantees results from paying lenders' claims upon default of the guaranteed loans. The default cost of loan guarantees is measured at the present value of projected payments to lenders required by the guarantee, plus uncollected fees, minus interest supplements not paid as the result of the default, and minus projected net recoveries as defined in paragraph 10(A).

19. The USDA CFO commented on the requirement for including uncollected fees and "interest supplements not paid" in measuring default costs. The USDA CFO stated that although those cash flow components are specified in the OMB credit subsidy calculator, OMB would give agencies flexibility in implementation with regard to those cash flow components. The USDA CFO pointed out that realigning those cash flow components might entail substantial changes in agencies' credit subsidy models. She also indicated problems with private lender restrictions and workload increases. She suggested that agencies be allowed flexibility to determine whether those cash flow components are to be included in default costs.

20. The Board believes the amended standard provides a sound methodology for measuring the default costs for loan guarantees. Uncollected fees are a direct result of default itself and therefore should be included in measuring the default costs. The interest supplements not paid are also a direct result of defaults. When a guaranteed loan is in default, the government pays the default claim to the lender and stops paying interest supplement for that loan. Thus, the interest supplements that are saved due to default should be subtracted from the default costs. The Board concluded that the categorization of these cash flow components should be uniform across the government so that they can be comparable among programs. However, as discussed in the following paragraph, the Board has decided to delay the implementation of the technical amendments for one year. This delay should help resolve some of the problems raised by the USDA CFO.

Effective Date

21. The proposed effective date for the technical amendments was for periods beginning after September 30, 2001, which means FY 2002. The Board realized that that the subsidy expenses to be reported for FY 2002 would be based on the budget submission for that year. However, there would not be sufficient time to implement the amendments for the FY 2002 budget. Therefore, the Board decided to make the effective date for periods beginning after September 30, 2002, and the Board encourages earlier implementation.

Board Approval

23. This Statement was approved by the Board with a vote of eight members in approval of its issuance. One member submitted a written dissent, which is available for inspection at the FASAB office.

Appendix B: The Accounting Standards In SFFAS No. 2

Presented in this Appendix are the standards originally prescribed in SFFAS No. 2. The paragraphs and their numbers reproduced in this Appendix are the same as those that appear in SFFAS No. 2, and are presented here for reference purposes only. The bolded words, paragraphs, and footnotes are those that have been amended by SFFAS No. 18[2] or by this Statement.

Explanation

21. These standards concern the recognition and measurement of direct loans, the liability associated with loan guarantees, and the cost of direct loans and loan guarantees. The standards apply to direct loans and loan guarantees on a group basis, such as a cohort or a risk category of loans and loan guarantees. Present value accounting does not apply to direct loans or loan guarantees on an individual basis, except for a direct loan or loan guarantee that constitutes a cohort or a risk category.

Accounting Standards Post-1991 Direct Loans

22. Direct loans disbursed and outstanding are recognized as assets at the present value of their estimated net cash inflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance.

Post-1991 Loan Guarantees

23. For guaranteed loans outstanding, the present value of estimated net cash outflows of the loan guarantees is recognized as a liability. Disclosure is made of the face value of guaranteed loans outstanding and the amount guaranteed.

Subsidy Costs of Post-1991 Direct Loans and Loan Guarantees

24. For direct or guaranteed loans disbursed during a fiscal year, a subsidy expense is recognized. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows, discounted at the interest rate of marketable Treasury securities with **a similar maturity term** applicable to the period during which the loans are

[2] SFFAS No. 18 amended paragraph 32 in SFFAS No. 2.

disbursed (hereinafter referred to as the applicable Treasury interest rate).

25. For the fiscal year during which new direct or guaranteed loans are disbursed, the components of the subsidy expense of those new direct loans and loan guarantees are recognized separately among interest subsidy costs, default costs, fees and other collections, and other subsidy costs.

26. The interest subsidy cost of direct loans is the excess of the amount of the loans disbursed over the present value of the interest and principal payments required by the loan contracts, discounted at the applicable Treasury rate. The interest subsidy cost of loan guarantees is the present value of estimated interest supplement payments.

27. **The default cost of direct loans or loan guarantees results from any anticipated deviation, other than prepayments, by the borrowers from the payments schedule in the loan contracts. The deviations include delinquencies and omissions in interest and principal payments. The default cost is measured at the present value of the projected payment delinquencies and omissions minus net recoveries. Projected net recoveries include the amounts that would be collected from the borrowers at a later date or the proceeds from the sale of acquired assets minus the costs of foreclosing, managing, and selling those assets.**

28. The present value of fees and other collections is recognized as a deduction from subsidy costs.

29. Other subsidy costs consist of cash flows that are not included in calculating the interest or default subsidy costs, or in fees and other collections. They include the effect of prepayments within contract terms.

Subsidy Amortization and Reestimation

30. **The subsidy cost allowance for direct loans is amortized by the interest method using the interest rate that was originally used to calculate the present value of the direct loans when the direct loans were disbursed**. The amortized amount is recognized as an increase or decrease in interest income.

31. **Interest is accrued and compounded on the liability of loan guarantees at the interest rate that was originally used to calculate the present value of the loan guarantee liabilities when the guaranteed loans were disbursed**. The accrued interest is recognized as interest expense.

32. **The subsidy cost allowance for direct loans and the liability for loan guarantees are reestimated each year as of the date of the financial statements. Since the allowance or the liability represents the present value of the net cash outflows of the underlying direct loans or loan guarantees, the reestimation should take into account all factors that may have affected the estimate of each component of the cash flows, including prepayments, defaults, delinquencies, and recoveries. Any increase or decrease in the subsidy cost allowance or the loan guarantee liability resulting from the reestimates should be recognized as a subsidy expense (or a reduction in subsidy expense). Reporting the subsidy cost allowance of direct loans (or the liability of loan guarantees) and reestimates by component is not required**.

Criteria for Default Cost Estimates

33. The criteria for default cost estimates provided in this and the following paragraphs apply to both initial estimates and subsequent reestimates. Default costs are estimated and reestimated for each program on the basis of separate cohorts and risk categories. The reestimates take into account the differences in past cash flows between the projected and realized amounts and changes in other factors that can be used to predict the future cash flows of each risk category.

34. In estimating default costs, the following risk factors are considered: (1) loan performance experience; (2) current and forecasted international, national, or regional economic conditions that may affect the performance of the loans; (3) financial and other relevant characteristics of borrowers; (4) the value of collateral to loan balance; (5) changes in recoverable value of collateral; (6) newly developed events that would affect the loans' performance; and (7) improvements in methods to reestimate defaults.

35. Each credit program should use a systematic methodology, such as an econometric model, to project default costs of each risk category. If

individual accounts with significant amounts carry a high weight in risk exposure, an analysis of the individual accounts is warranted in making the default cost estimate for that category.

36. Actual historical experience of the performance of a risk category is a primary factor upon which an estimation of default cost is based. To document actual experience, a database should be maintained to provide historical information on actual payments, prepayments, late payments, defaults, recoveries, and amounts written off.

Revenues and Expenses

37. Interest accrued on direct loans, including amortized interest, is recognized as interest income. Interest accrued on the liability of loan guarantees is recognized as interest expense. Interest due from Treasury on uninvested funds is recognized as interest income. Interest accrued on debt to Treasury is recognized as interest expense.

38. Costs for administering credit activities, such as salaries, legal fees, and office costs, that are incurred for credit policy evaluation, loan and loan guarantee origination, closing, servicing, monitoring, maintaining accounting and computer systems, and other credit administrative purposes, are recognized as administrative expense. Administrative expenses are not included in calculating the subsidy costs of direct loans and loan guarantees.

Pre-1992 Direct Loans and Loan Guarantees

39. The losses and liabilities of direct loans obligated and loan guarantees committed before October 1, 1992, are recognized when it is more likely than not that the direct loans will not be totally collected or that the loan guarantees will require a future cash outflow to pay default claims. The allowance of the uncollectible amounts and the liability of loan guarantees should be reestimated each year as of the date of the financial statements. In estimating losses and liabilities, the risk factors discussed in the previous section should be considered. Disclosure is made of the face value of guaranteed loans outstanding and the amount guaranteed.

40. Restatement of pre-1992 direct loans and loan guarantees on a present value basis is permitted but not required.

Modification of Direct Loans and Loan Guarantees

41. The term modification means a federal government action, including new legislation or administrative action, that directly or indirectly alters the estimated subsidy cost and the present value of outstanding direct loans, or the liability of loan guarantees.

42. Direct modifications are actions that change the subsidy cost by altering the terms of existing contracts or by selling loan assets. Existing contracts may be altered through such means as forbearance, forgiveness, reductions in interest rates, extensions of maturity, and prepayments without penalty. Such actions are modifications unless they are considered reestimates, or workouts as defined below, or are permitted under the terms of existing contracts.

43. Indirect modifications are actions that change the subsidy cost by legislation that alters the way in which an outstanding portfolio of direct loans or loan guarantees is administered. Examples include a new method of debt collection prescribed by law or a statutory restriction on debt collection.

44. The term modification does not include subsidy cost reestimates, the routine administrative workouts of troubled loans, and actions that are permitted within the existing contract terms. Workouts are actions taken to maximize repayments of existing direct loans or minimize claims under existing loan guarantees. The expected effects of workouts on cash flows are included in the original estimate of subsidy costs and subsequent reestimates.

A. Modification of Direct Loans

45. With respect to a direct or indirect modification of pre-1992 or post-1991 direct loans, the cost of modification is the excess of the pre-modification value[3] of the loans over their post-modification

[3] The term "pre-modification value" is the present value of the net cash inflows of direct loans estimated at the time of modification under pre-modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to **the remaining maturity** of the direct loans under pre-modification terms (simply stated, the pre-modification terms at the current rate).

value[4]. The amount of the modification cost is recognized as a modification expense when the loans are modified.

46. When post-1991 direct loans are modified, their existing book value is changed to an amount equal to the present value of the loans' net cash inflows projected under the modified terms from the time of modification to the loans' maturity and discounted at the original discount rate (**the rate that was originally used to calculate the present value of the direct loans, when the direct loans were disbursed**).

47. When pre-1992 direct loans are directly modified, they are transferred to a financing account and their book value is changed to an amount equal to their post-modification value. Any subsequent modification is treated as a modification of post-1991 loans. When pre-1992 direct loans are indirectly modified, they are kept in a liquidating account. Their bad debt allowance is reassessed and adjusted to reflect amounts that would not be collected due to the modification.

48. The change in book value of both pre-1992 and post-1991 direct loans resulting from a direct or indirect modification and the cost of modification will normally differ, due to the use of different discount rates or the use of different measurement methods. Any difference between the change in book value and the cost of modification is recognized as a gain or loss. For post-1991 direct loans, the modification adjustment transfer[5] paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

[4] The term "post-modification value" is the present value of the net cash inflows of direct loans estimated at the time of modification under post-modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to **the remaining maturity** of the direct loans under post-modification terms (simply stated, the post-modification terms at the current rate).

[5] OMB instructions provide that if the decrease in book value exceeds the cost of modification, the reporting entity receives from the Treasury an amount of "modification adjustment transfer" equal to the excess; and that if the cost of modification exceeds the decrease in book value, the reporting entity pays to the Treasury an amount of "modification adjustment transfer" to offset the excess. (See OMB Circular A-11.)

B. Modification of Loan Guarantees

49. With respect to a direct or indirect modification of pre-1992 or post-1991 loan guarantees, the cost of modification is the excess of the post-modification liability[6] of the loan guarantees over their pre-modification liability[7]. The modification cost is recognized as modification expense when the loan guarantees are modified.

50. The existing book value of the liability of modified post-1991 loan guarantees is changed to an amount equal to the present value of net cash outflows projected under the modified terms from the time of modification to the loans' maturity, and discounted at the original discount rate (**the rate that was originally used to calculate the present value of the liability when the guaranteed loans were disbursed**).

51. When pre-1992 loan guarantees are directly modified, they are transferred to a financing account and the existing book value of the liability of the modified loan guarantees is changed to an amount equal to their post-modification liability. Any subsequent modification is treated as a modification of post-1991 loan guarantees. When pre-1992 direct loan guarantees are indirectly modified, they are kept in a liquidating account. The liability of those loan guarantees is reassessed and adjusted to reflect any change in the liability resulting from the modification.

52. The change in the amount of liability of both pre-1992 and post-1991 loan guarantees resulting from a direct or indirect modification and the cost of modification will normally differ, due to the use of different discount rates or the use of different measurement methods. The difference between the change in liability and the cost of modification is recognized as a gain or loss. For post-1991 loan guarantees, the

[6] The term "post-modification liability" is the present value of the net cash outflows of the loan guarantees estimated at the time of modification under the post-modification terms, and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to **the remaining maturity** of the guaranteed loans under post-modification terms (simply stated, the post-modification terms at the current rate).

[7] The term "pre-modification liability" is the present value of the net cash outflows of loan guarantees estimated at the time of modification under the pre-modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to **the remaining maturity** of the guaranteed loans under pre-modification terms (simply stated, the pre-modification terms at the current rate).

modification adjustment transfer[8] paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

C. Sale of Loans

53. The sale of post-1991 and pre-1992 direct loans is a direct modification. The cost of modification is determined on the basis of the pre-modification value of the loans sold. If the pre-modification value of the loans sold exceeds the net proceeds from the sale, the excess is the cost of modification, which is recognized as modification expense.

54. For a loan sale with recourse, potential losses under the recourse or guarantee obligations are estimated, and the present value of the estimated losses from the recourse is recognized as subsidy expense when the sale is made and as a loan guarantee liability.

55. The book value loss (or gain) on a sale of direct loans equals the existing book value of the loans sold minus the net proceeds from the sale. Since the book value loss (or gain) and the cost of modification are calculated on different bases, they will normally differ. Any difference between the book value loss (or gain) and the cost of modification is recognized as a gain or loss.[9] For sales of post-1991 direct loans, the modification adjustment transfer[10] paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

D. Disclosure

56. Disclosure is made in notes to financial statements to explain the nature of the modification of direct loans or loan guarantees, the discount rate used in calculating the modification expense, and the basis for recognizing a gain or lose related to the modification.

[8] OMB instructions provide that if the increase in liability exceeds the cost of modification, the reporting entity receives from the Treasury an amount of "modification adjustment transfer" equal to the excess; and that if the cost of modification exceeds the increase in liability, the reporting entity pays to the Treasury an amount of "modification adjustment transfer" to offset the excess. (See OMB Circular A-11.)

[9] If there is a book value gain, the gain to be recognized equals the book value gain plus the cost of modification.

[10] See footnote No. 7 for an explanation for "modification adjustment transfer".

Foreclosure of Post-1991 Direct and Guaranteed Loans

57. When property is transferred from borrowers to a federal credit program, through foreclosure or other means, in partial or full settlement of post-1991 direct loans or as a compensation for losses that the government sustained under post-1991 loan guarantees, the foreclosed property is recognized as an asset at the present value of its estimated future net cash inflows discounted **at the original discount rate.**

58. If a legitimate claim exists by a third party or by the borrower to a part of the recognized value of the foreclosed assets, the estimated amount of the claim is recognized as a special contra valuation allowance.

59. At a foreclosure of guaranteed loans, a federal guarantor may acquire the loans involved. The acquired loans are recognized at the present value of their estimated net cash inflows from selling the loans or from collecting payments from the borrowers, discounted **at the original discount rate.**

60. When assets are acquired in full or partial settlement of post-1991 direct loans or guaranteed loans, the present value of the government's claim against the borrowers is reduced by the amount settled as a result of the foreclosure.

Write-off of Direct Loans

61. When post-1991 direct loans are written off, the unpaid principal of the loans is removed from the gross amount of loans receivable. Concurrently, the same amount is charged to the allowance for subsidy costs. Prior to the write-off, the uncollectible amounts should have been fully provided for in the subsidy cost allowance through the subsidy cost estimate or reestimates. Therefore, the write-off would have no effect on expenses.

Statement of Federal Financial Accounting Standards No. 20: Elimination of Certain Disclosures Related to Tax Revenue Transactions by the Internal Revenue Service, Customs, and Others, Amending SFFAS 7, Accounting for Revenue and Other Financing Sources

Status

Issued	September 2001
Effective Date	For periods ending after September 30, 2000
Volume I References	SFFAS 7, *Accounting for Revenue and Other Financing Sources*
Volume II References	Revenue (R60)
Interpretations and Technical Releases	None.
Affects	SFFAS 7
Affected by	None.

Summary

a. Statement of Federal Financial Accounting Standards (SFFAS) 7, *Accounting for Revenue and Other Financing Sources*, became effective in fiscal year 1998 and included detailed provisions that apply to entities collecting taxes on behalf of the Federal Government. The two entities collecting the vast marjority of federal taxes are the Internal Revenue Service (IRS) and the U.S. Customs Service (Customs).

b. The Board is issuing this standard to rescind paragraph 65.2 of SFFAS 7. Absent very detailed explanations, the provisions of paragraph 65.2 could result in information being given to readers of the financial statements that they might misinterpret. The Board believes that paragraph 65.2 would not accomplish what it purports to accomplish, and would impose costs unnecessarily on both the preparer and auditor without a significant benefit. The Board's reasoning is explained more fully in Appendix A, Basis for Conclusions.

c. This amendment is effective for periods beginning after September 30, 2000.

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Introduction

Purpose

1. This standard rescinds paragraph 65.2 of Statement of Federal Financial Accounting Standards (SFFAS) 7 and makes other conforming changes.

Background

2. SFFAS 7 became effective in fiscal year 1998 and included, along with other provisions, detailed provisions that apply to entities collecting taxes on behalf of the Federal Government. Paragraph 65.2 of that standard required disclosure of "revenue-related transactions affecting the beginning and end-of-period balances of accounts receivables, accounts payable for refunds, and the allowance for uncollectible amounts."

3. Subsequent to the issuance of the standard questions arose as to the usefulness of the information as well as to the practicality of producing it. After discussing the issues and options, the Board issued, in November 1998, an exposure draft of a standard rescinding paragraph 65.2. Ultimately, the Board agreed that more study was needed, and in January 1999 it deferred the effective date of paragraph 65.2 until October 1, 2000 (SFFAS 13, *Deferral of Paragraph 65.2 – Material Revenue-Related Transactions Disclosures)*.

4. In November 2000, the Board issued a second exposure draft, *Elimination of Disclosures Related to Tax Revenue Transactions by the Internal Revenue Service*, *Customs*, *and Others*, *Amending SFFAS 7*. Based on comments received and further consideration, the Board is now rescinding paragraph 65.2.

Effective Date

5. This amendment is effective for periods beginning after September 30, 2000.

Accounting Standard

6. Paragraph 65.2 of SFFAS 7 is repealed and rescinded.

7. Other conforming changes:

a. The last sentence of paragraph 107 of SFFAS 7 is changed to delete “65.2 and” from the parenthesis.

b. The last sentence of footnote 41, paragraph 187.1 of SFFAS 7 is changed to delete “in its disclosures required by para. 65.2”.

Appendix A: Basis For Conclusions

8. This appendix summarizes some of the considerations deemed significant by the Board in reaching the conclusions in this Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.

9. The Board issued an exposure draft in November 1998 proposing to rescind paragraph 65.2. Comments were received during a minimal comment period that ended December 12, 1998. In January 1999, the Board deferred the effective date of paragraph 65.2, SFFAS 7, until October 1, 2000.[1]

10. In December 1998, the Board agreed that further study was needed regarding the relevance of the information discussed in paragraph 65.2. Additionally, the Board was concerned about the relatively short exposure period (approximately 30 days) for the ED. The Board decided to defer the effective date for implementing paragraph 65.2 and revisit the issue of eliminating the requirement at a later date.

11. Following the decision to defer the disclosure requirement, the Board did not take up research on the issue immediately. In December 1999, the Board reviewed its agenda and weighed whether it should devote scarce resources to this issue or simply allow the provisions of paragraph 65.2 to take effect for fiscal year 2001 financial statements. To assist in making this decision, the Board sent a letter to the Internal Revenue Service (IRS) asking what additional information might be available to aid the Board in considering the issue.

12. The IRS responded with additional information based on its two additional reporting years' experience with SFFAS 7 requirements. In addition, the IRS provided a briefing to the Board regarding its collections process and systems modernization. The IRS renewed the request that the Board rescind the provisions of paragraph 65.2. Its auditor, the General Accounting Office, supported this rescission.

[1] SFFAS 13, *Deferral of Paragraph 65.2 – Material Revenue-Related Transactions Disclosures*, *Amending SFFAS 7* Accounting for Revenue and Other Financing Transactions, January 1999.

13. In November 2000, the Board issued a second exposure draft, *Elimination of Disclosures Related to Tax Revenue Transactions by the Internal Revenue Service, Customs, and Others, Amending SFFAS 7*, that proposed to eliminate paragraph 65.2. Because of the interest in the relevance of this information, the Board mailed copies to potential users, for example, Congresspersons and staff directors of key committees. The Board received comment letters on the exposure draft from the following sources:

	Federal (internal)	Nonfederal (external)
Users, academics, others		2
Auditors	2	1
Preparers and financial managers	4	

Responses to the Exposure Draft

14. The respondents were closely divided with the majority supporting the proposed elimination of paragraph 65.2. It is important to note that the Board did not rely on the number in favor or opposed to a given position. Information about the majority view is provided only as a means of summarizing the comments. The Board considered the arguments in each response and weighed the merits of the points raised. The Board summarizes the respondents' arguments below.

Respondents Supporting the ED

15. Several respondents stated that paragraph 65.2 disclosures would not be useful, and could be misleading, to general purpose readers. A respondent stated that any attempt to reconcile the elements required by paragraph 65.2 could be misleading due to timing differences between assessments and collections and the definitions of revenue receipts and taxes receivable.

16. Some respondents said that the IRS currently provides sufficient detailed information about federal tax revenues, unpaid assessments, and refunds in its annual financial report through footnote disclosures, supplementary information and in its management's discussion and analysis (MD&A). Other respondents said that the disclosure requirements of paragraph 65.2 far exceed what should be required in general purpose financial statements. Another respondent concurring with the elimination of paragraph 65.2 stated that FASAB clearly documented its case in the ED's basis for conclusions.

Respondents Opposing the ED

17. Other respondents had a different view. One respondent stated that the disclosure in SFFAS 7 was intended to overcome some of the practical limitations of the tax collection system and make the tax revenue recognition closer to what would be reported with fuller accrual accounting. He submitted that the information required in paragraph 65.2 is relevant and useful in assessing the efficiency and effectiveness of the tax system, not merely the administrative practices, and can be explained satisfactorily so as not to be misleading.

18. Several respondents stated that insufficient evidence has been offered regarding the lack of relevance and understandability of the information to warrant eliminating the paragraph 65.2 disclosures, and doing so would weaken SFFAS 7. These respondents recommended extending the deferral period for the standard, further research, and a hearing, as necessary, prior to the issuance of a final standard. One respondent stated that the ED did not convincingly explain why the information called for in paragraph 65.2 is so complex that it could not be clearly explained. The respondent stated that SFFAC 1, par. 158, provides that general purpose financial reports should not exclude essential information merely because it is difficult to understand or because some report users choose not to use it.

The Board's Discussion

19. In conjunction with re-deliberating the issues presented in the exposure draft and carefully considering the respondents' comments, the Board notes that SFFAS 7 represents a major accomplishment in establishing federal accounting standards. SFFAS 7 presents standards for classifying, recognizing, and measuring resource inflows as well as concepts for financial reporting and makes other significant contributions. Many provisions of that statement are now fundamental to federal accounting. However, the Board believes that paragraph 65.2 of SFFAS 7 is flawed because the information required therein might be misinterpreted, would not accomplish what it purports to accomplish, and would be difficult to produce.

Information that Could Be Misinterpreted

20. Paragraph 65.2 requires disclosure of information about the beginning and ending balances of accounts receivable and related accounts, as well as material types of revenue transactions that relate to the collecting entity's custodial responsibilities. The minimum information required would include "assessments by the entity," "penalties," "interest," and "abatements." In the two exposure drafts

on this issue (November 1998 and November 2000) the Board has discussed the complexity of the assessment and abatement process. The Board has discussed the various IRS-initiated tax collection actions, including compliance assessments; the enforcement work-in-process status of the assessment database; the possible timing difference between the period to which the tax relates, the eventual assessment of the tax and penalties and interest, and the final collection or abatement of the assessment; and other complicating factors. Many assessments, penalties, and interest are made for enforcement purposes, are often overstated due to incomplete information, and are subject to change based on receipt of additional information from the taxpayer. Thus, they do not always precede a receivable[2] in an accounting sense. The Board believes that the user could misinterpret assessment reporting because increases or decreases in assessments do not lead necessarily to increases or decreases in receivables or revenue. Further, developing meaningful categories of assessments that would permit a user to analyze whether enforcement assessments are likely to lead to revenues would not be cost-beneficial when one considers the remaining reporting required under SFFAS 7 as amended.

21. The Board also has discussed the complications of the abatement process. Abatement is a reduction or cancellation of an assessed tax. Abatements are made for myriad reasons and in some cases there is no correlation between the original assessment and the final reason for the abatement. For example, taxpayers can carry back losses to prior years and reduce prior year taxes that were correctly assessed by the IRS. Such reductions are classified as abatements but are not the same as abatements where the tax assessment itself was in error.

22. Moreover, taxpayers also file amended returns that can require abatement of the original amount they reported, including taxpayer requests to abate particular types of penalty assessments due to reasonable causes. For example, during 1998 a new law required the IRS to disallow certain dependents and credits claimed if the taxpayer did not include a social security number for a dependent child or a taxpayer identification number for a child-care provider. In each case

[2]Per SFFAS 7, paragraph 53, accounts receivable should be recognized when a collecting entity establishes a specifically identifiable, legally enforceable claim to cash or other assets through its established assessment process to the extent the amount is measurable.

the IRS posted an assessment, accrued penalties and interest pending provision of the information, and subsequently abated the assessment when the taxpayer provided the required verification. This change in law increased the total assessments, interest, penalties, and abatements to enforce a reporting requirement rather than to collect additional tax revenue. One could be misled since both assessments and abatements were "overstated" in the sense that it was anticipated at the time of assessment that, in the majority of cases, the assessment would be abated.

23. There are many different reasons for abatements with varying transactions potentially covering 10 years of assessments, each affecting the balances to be disclosed under paragraph 65.2. The Board believes that reporting on total assessments, including penalties and interest thereon, and abatements could be misinterpreted in the context of disclosures purporting to be transactions affecting the beginning and ending balances of accounts receivable and related accounts. Moreover, the Board believes that attempts to reconcile the elements required in paragraph 65.2 could be misinterpreted due to timing differences between assessments and collections and the definitions of revenue receipts and taxes receivable.

24. The Board concludes that the paragraph 65.2 information is not relevant for reconciling the beginning and ending balances of accounts receivable and related accounts, which paragraph 65.2 purports to do. Some of the required information is beyond the scope of those accounts since activity does not result in or relate to revenue or receivables, precedes the recognition of taxes receivable, or relates solely to tax administration or enforcement.

25. When considering whether to retain paragraph 65.2, the Board considered the materiality of taxes receivable. The IRS' taxes receivable are not large in relation to annual tax revenue. For FY2000, approximately $20 billion in IRS receivables represent three days of collections.

Other Information Required

26. The Board calls attention to other SFFAS 7 paragraphs and to other FASAB standards that require disclosures and supplemental information that the Board believes accomplish the objectives of SFFAS 7 as stated in paragraph 187.1 and elsewhere. Paragraph 65.1 requires disclosure of factors affecting collectability and timing of categories of accounts receivable and the amounts involved.

Paragraph 65.3 requires disclosure of cumulative cash collections and refunds by tax year and tax type. Paragraph 67 requires supplemental information about the estimated realizable value of compliance assessments and pre-assessment work-in-process; about other claims for tax refunds that are not yet accrued but are likely to be accrued when administrative actions are completed; and, about the amount of assessments that the entity still has statutory authority to collect but that have been written off and thus excluded from accounts receivable. SFFAS 15, *Management's Discussion and Analysis*, requires discussion, among other things, of performance goals, objectives, results, systems, controls, and legal compliance.

Conclusion

27. The Board actively sought comments from potential users. In addition to the FASAB distribution list, the Board sent the ED to all those who had commented on the prior ED of November 1998 and to potential decision-makers, including especially House and Senate committees and sub-committees. Also, in setting February 16, 2001, as the cut-off date for comments, the Board provided an extended period for respondents to submit comments. Despite the Board's efforts to reach users the response to the ED did not demonstrate a demand from users to have the information. Only one respondent said the information was useful and necessary. Other respondents who oppose eliminating paragraph 65.2 at this time said that the Board did not offer enough evidence regarding relevance and understandability to warrant eliminating paragraph 65.2, not that they themselves found it useful or relevant and for what purposes. Due to the cost of the information, the availability of other information on this topic, the requests from the preparer and auditor communities, and lack of a response from users of the information, the Board does not believe the paragraph should be retained.

28. The Board believes that sufficient evidence has been produced to conclude that the information required by paragraph 65.2 could be misinterpreted by users of general purpose financial statements and that it does not accomplish what it purports to accomplish. The Board does not exclude essential information merely because it is difficult to understand or because some report users choose not to use it. In this instance, however, the complexity of the tax collection process in conjunction with the context of accounts receivable reconciliation renders paragraph 65.2 defective and, therefore, not relevant. The objective of SFFAS 7 is to tell users what is happening at the tax collection entities, and the Board believes the standard is achieving

this objective without paragraph 65.2, and that paragraph 65.2 could in fact be misinterpreted. This amendment of SFFAS 7 is limited to the problem of disclosures in paragraph 65.2 being misinterpreted.

Vote for Approval

29. The amendment of SFFAS 7 prescribed in this statement is approved by a vote of seven members in favor and one member dissenting (only eight members voted due to a vacancy on the Board). The dissent is available for review at the FASAB offices.

Appendix B: Paragraph 65 of SFFAS 7

65. Entities that collect taxes and duties should disclose the following relating to future cash flows, revenue-related transactions, and custodial responsibilities:

65.1 Accounts **receivable.** Factors affecting collectibility and timing of categories of accounts receivable and the amounts involved.

65.2 Material **revenue-related transactions.** Revenue-related transactions affecting the beginning and end-of-period balances of accounts receivable, accounts payable for refunds, and the allowance for uncollectible amounts should be disclosed. All material types of revenue transactions which relate to the custodial responsibilities of the collecting entities should be disclosed. The disclosure should be comprehensive enough to include as a minimum: self-assessments by taxpayers (or importers); assessments by the entity; penalties; interest; cash collections applied to taxpayer accounts and unapplied collections; refunds, refund offsets, and drawbacks; abatements; accounts receivable written off during the reporting period as uncollectible; and provisions made to the allowance for uncollectible amounts.

65.3 Cumulative **cash collections and refunds by tax year and type of tax.** Cash collections and refunds by tax year and type of tax should include cash collections and cash refunds for the reporting period and for sufficient prior periods to illustrate (1) the historical timing of tax collections and refunds, and (2) any material trends in collection and refund patterns. Sufficient prior periods for each type of tax are the periods which end when the statutory period for collection ends. Collecting entities may shorten these periods if evidence for prior tax years indicates that a shorter period would reflect at least 99 percent of the collectible taxes.

Statement of Federal Financial Accounting Standards No. 21: Reporting Correction of Errors and Changes in Accounting Principles, Amendment of SFFAS 7, Accounting for Revenue and Other Financing Sources

Status

Issued	October 2001
Effective Date	For periods ending after September 30, 2001
Volume I References	SFFAS 7, *Accounting for Revenue and Other Financing Sources*
Volume II References	Revenue (R60)
Interpretations and Technical Releases	None.
Affects	SFFAS 7
Affected by	None.

Summary

I. This Statement amends the standard on Prior Period Adjustments contained in Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources* (SFFAS No. 7), which was issued in April 1996.

II. Paragraph 76 of SFFAS No. 7, entitled Prior Period Adjustments, addresses accounting changes and errors that affect prior period financial statements. It does not permit reporting entities, when presenting prior period financial statements for comparative purposes, to restate prior period financial statements to show the effect of the accounting errors.

III. The unforeseen result is that reporting entities that have material errors in their prior period financial statements are unable to present them for comparative purposes without creating both a dilemma for auditors and confusion for users. The dilemma for the auditors is that they would have to qualify their opinion on the prior period financial statements whether or not they had been restated. If prior period statements were presented that contained a material error, auditors would have to qualify their opinion. On the other hand, if prior period statements were presented and balances had been corrected for an error, auditors would still have to qualify their opinion because such restatement would not be in accordance with the existing standard. The confusion for the user derives from the difficulty inherent in comparing the financial statements for two or more periods when the effect of the error is not shown in the prior periods' financial statements.

IV. To correct this situation, the amendment requires that when material errors are discovered in prior period financial statements, all statements presented must be restated to correct the error.

V. The Board has retained the current requirement that prior period financial statements not be restated for changes in accounting principles, unless otherwise specified in the transition instructions section of a new FASAB standard. The language addressing the requirements, however, has been revised to improve clarity and to require certain disclosures.

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Introduction

1. Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources*, became effective for fiscal year 1998. It includes a section describing how reporting entities should handle prior period adjustments.

2. The Section on Prior Period Adjustments states:

> 76. Prior period adjustments should be limited to corrections of errors and accounting changes with retroactive effect, including those occasioned by the adoption of new federal financial accounting standards, and should be recognized and measured under applicable standards. Adjustments should be recognized as a change in cumulative results of operations (rather than as an element of net results of operations for the period). Prior period financial statements should not be restated for prior period adjustments recognized in the current period.

3. When SFFAS No. 7 was issued, the Board believed that having reporting entities restate prior period financial statements for prior period adjustments would create an unnecessary burden at a time when FASAB was still establishing a basic framework of standards.

4. However, disallowing restatement of prior period financial statements has had the effect of preventing reporting entities from presenting comparative financial statements when the prior period financial statements contain a material error that is discovered in the current period.

5. The Board has amended the standard to require that reporting entities restate prior period financial statements for material errors discovered in the current period, if such statements are provided for comparative purposes, and if the effect of the error would be material to the financial statements in either period.

6. The Board has chosen to retain the current methodology that prior period financial statements not be restated for changes in accounting principles, unless otherwise specified in the transition instructions section of a new FASAB standard. The language addressing the requirements, however, has been revised to improve clarity and to require certain disclosures.

7. The language in the standard has also been revised to distinguish between corrections of errors and changes in accounting principles. A change in accounting principle should be identified as such and no longer reported as a prior period adjustment.

Effective Date

8. This amendment would be effective for periods beginning after September 30, 2001, with earlier implementation encouraged.

Accounting Standard

9. Paragraph 76 of SFFAS No. 7, *Accounting for Revenue and Other Financing Sources*, Section Prior Period Adjustments, is superceded and replaced by Paragraphs 10 through 14 below.

Corrections of Errors

10. "Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared."[1] When errors are discovered after the issuance of financial statements, and if the financial statements would be materially misstated absent correction of the errors, corrections should be made as follows:

    (a) If only the current period statements are presented, then the cumulative effect of correcting the error should be reported as a prior period adjustment. The adjustment should be made to the beginning balance of cumulative results of operations, in the statement of changes in net position.

    (b) If comparative financial statements are presented, then the error should be corrected in the earliest affected period presented by correcting any individual amounts on the financial statements. If the earliest period presented is not the period in which the error occurred and the cumulative effect is attributable to prior periods, then the cumulative effect should be reported as a prior period adjustment. The adjustment should be made to the beginning balance of cumulative results of operations, in the statement of changes in net position for the earliest period presented.

    (c) The nature of an error in previously issued financial statements and the effect of its correction on relevant balances should be disclosed. Financial statements of subsequent periods need not repeat the disclosures.

11. Prior period financial statements should only be restated for corrections of errors that would have caused any statements presented to be materially misstated.

[1] Accounting Principles Board Opinion No. 20, par. 13.

Changes in Accounting Principles

12. A change in accounting principle is a change from one generally accepted accounting principle to another one that can be justified as preferable. For the purposes of this standard, changes in accounting principles also include those occasioned by the adoption of new federal financial accounting standards.

13. Unless otherwise specified in the transition instructions section of a new FASAB standard, for all changes in accounting principles that would have resulted in a change to prior period financial statements:

    (a) The cumulative effect of the change on prior periods should be reported as a "change in accounting principle." The adjustment should be made to the beginning balance of cumulative results of operations in the statement of changes in net position for the period that the change is made.

    (b) Prior period financial statements presented for comparative purposes should be presented as previously reported; and

    (c) The nature of the changes in accounting principle and its effect on relevant balances should be disclosed in the current period. Financial statements of subsequent periods need not repeat the disclosure.

> The provisions of this statement need not be applied to immaterial items.

Appendix A: Basis For Conclusions

14. This appendix summarizes some of the considerations deemed significant by the Board in reaching the conclusions in this Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.

15. The Board received sixteen responses to the ED. All but one respondent were in support of the amendment. The Board did not rely on the number in favor of or opposed to a given position. Information about the respondent's majority view is provided only as a means of summarizing the comments. The Board considered the arguments in each response and weighed the merits of the points raised. The respondent's comments are summarized below.

	Federal	Non-federal
Users, academics, others		2
Auditors	2	
Preparers and financial managers	12	

16. Seven respondents approved the amendment without further comment. Four approved the amendment but requested clarifying language, which has been incorporated into the standard. Two approved the amendment but would have preferred that the standard allow restatement for changes in accounting principles.

17. One respondent disapproved of the amendment because they believe the amendment will create additional confusion regarding the closing of prior period accounts and the subsequent issuance of financial statements.

Corrections of Errors

18. When SFFAS No. 7 was issued, the Board believed that having reporting entities restate prior period financial statements for prior period adjustments would create an unnecessary burden at a time when FASAB was still establishing a basic framework of standards. Changes in the federal accounting environment in the ensuing years have lessened these concerns. With the government's increasing ability to produce accurate and sophisticated financial statements, the Board is more concerned with encouraging reporting entities to

produce financial statements that are most useful to managers and other users.

19. Although comparative financial statements are not required by any of the accounting standards setting boards, it is generally held that "the presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise."[2]

20. Reporting entities also recognize that presenting comparative statements greatly enhances the overall usefulness of financial statements. Despite the advantages of providing comparative statements, however, at least one governmental entity has been constrained from presenting its prior year statements because they contain a material error.

21. The Board has deliberated on the effects of the existing standard precluding restatement to correct errors on presentation of comparative financial statements. Although it believes that the considerations in effect at the time the existing standard was issued were valid, it has concluded that potentially losing or delaying the benefit of comparative statements now outweighs these considerations.

22. The Board concluded that the standard for Prior Period Adjustments should be amended to specifically require that prior period financial statements presented for comparative purposes be restated to correct material errors, and that restatement should be limited to only material errors.

Changes in Accounting Principles

23. Although the Board has chosen to retain the current methodology for reporting changes in accounting principle, it has revised the language to improve clarity and to require certain disclosures. The Board may consider exceptions to this decision, if warranted, for accounting standards issued in the future. It may also further examine issues raised by respondents regarding changes in accounting principles.

[2] Accounting Research Bulletin 43, Chapter 2A, paragraph 101.

Other Accounting Changes

24. Although accounting estimates and changes in reporting entity are identified as accounting changes in other accounting literature, the Board did not address these issues because they require further study and were not addressed in paragraph 76 of SFFAS No. 7.

Board Approval

25. This statement was approved by unanimous vote of the Board.

Statement of Federal Financial Accounting Standards No. 22: Change in Certain Requirements for Reconciling Obligations and Net Cost of Operations, Amendment of SFFAS 7, Accounting for Revenue and Other Financing Sources

Status

Issued	October 2001
Effective Date	For periods ending after September 30, 2000
Volume I References	SFFAS 7, *Accounting for Revenue and Other Financing Sources*
Volume II References	Revenue (R40)
Interpretations and Technical Releases	None.
Affects	SFFAS 7
Affected by	No other statements.

Summary

a. Statement of Federal Financial Accounting Standards (SFFAS 7) 7, *Accounting for Revenue and Other Financing Sources*, requires a reconciliation of budgetary and financial accounting information. The reconciliation explains the relationship between budgetary resources obligated by the entity during the period and the net cost of operations as derived from the entity's proprietary accounting system.

b. This standard amends SFFAS 7 by deleting a requirement regarding an element of the reconciliation. SFFAS 7, paragraph 80, requires increases and decreases in receivables from the public related to exchange revenue to be reported as a nonbudgetary resource. This standard deletes this requirement and makes other necessary conforming changes.

c. The effect of this change is that the location of this reconciling item is no longer specified by the standard.

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Introduction

1. Statement of Federal Financial Accounting Standards (SFFAS 7) 7, *Accounting for Revenue and Other Financing Sources*, paragraphs 80-82, requires a reconciliation explaining the relationship between budgetary obligations incurred by the entity during the period and the net cost of operations. Paragraphs 95-102 in the concepts section of SFFAS 7 presents the statement of financing (SOF) as the vehicle for reporting the reconciliation.

2. Paragraph 80, SFFAS 7, requires, among other things, increases and decreases in receivables from the public related to exchange revenue to be reported as nonbudgetary resources. The Board is deleting, by means of this amendment, the sentence in paragraph 80 that requires such reporting, and making other conforming changes.

3. The effect of this change is that the location of this reconciling item in the statement of financing is no longer specified by the standard.

Materiality

4. The provisions of this accounting standard need not be applied to immaterial items.

Effective Date

5. This amendment is effective for periods beginning after September 30, 2000.

Accounting Standard

Changes for SFFAS 7

6. SFFAS 7 is amended as follows:

Delete the following sentence from paragraph 80:

> Further, it should include decreases (increases) in receivables from the public related to exchange revenue when only the cash amount is included in budgetary resources.

Other conforming changes:

- Delete the following sentence from paragraph 97:

  This amount would also include decreases (increases) in receivables related to revenue accrued from the public because, while the cash collected for exchange revenue is a budgetary resource, the accrual amount is not.

- Delete the following line item from Appendix 1- G, Example Financial Statements Formats, Statement of Financing

  Exchange revenue not in the budget

Appendix A: Basis For Conclusions

7. This appendix summarizes some of the considerations deemed significant by the Board in reaching the conclusions in this Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.

8. As stated in previous sections, the Statement of Federal Financial Accounting Standards (SFFAS 7) 7, Accounting for Revenue and other Financing Sources, requires budgetary obligations incurred by the entity to be reconciled with the entity's net cost of operations.[1] The concept section of SFFAS 7 presents the statement of financing (SOF) as the vehicle for reporting the reconciliation.[2] A primary objective of the Board in creating the SOF is that readers of the financial statements are able to understand the difference between obligations, as reported in the budget, and the net cost of operations as reported in the statement of net cost. [3]

9. The Board issued an exposure draft in April 2001 proposing to delete the requirement in SFFAS 7, paragraph 80, that "decreases (increases) in receivables from the public related to exchange revenue" be reported as a nonbudgetary resource on the SOF. There are instances where reporting the change in "receivables from the public related to exchange revenue" as a resource, as is currently required by SFFAS 7, may be inappropriate. This amended standard would permit flexibility.

10. The effect of this change is that the location of this reconciling item in the statement of financing is no longer specified by the standard.

Respondents' Comments

11. The respondents' comments are summarized below. The Board does not rely on the number of respondents in favor of or opposed to a given position. Information about the respondents' majority view is provided only as a means of summarizing the comments. The Board

[1] SFFAS 7, paragraphs 80-82.

[2] SFFAS 7, paragraphs 95-102. See the Implementation Guide to Statement of Federal Financial Accounting Standards No. 7, Accounting for Revenue and Other Financing Sources, pars. 72-95 for a discussion and illustrations of the statement of financing.

[3] Implementation Guide for SFFAS 7, par. 72.

considers the arguments in each response and weighs the merits of the points raised.

	Federal	Non- federal
Users, academics,others	1	3
Auditors	2	1
Preparers and financial managers	7	

12. Nine respondents either said they agreed with or had no objection to the amendment. One respondent agreed with the change but disagreed with the decision to issue the standard allowing flexibility. Four respondents reviewed the exposure draft but chose not to comment or offered a comment beyond the scope of the issue addressed by the exposure draft. Respondents made the following individual comments:

    a. placement of the line item should be made mandatory now, rather than allowing flexibility

    b. optional presentations reduce understandability

    c. adding a brief discussion of the alternative presentations to the basis for conclusions would make the amendment more understandable

    d. a reference to the discussion of the SOF in the FASAB's Implementation Guide to SFFAS 7 (April 1996) would be helpful

    e. the SOF is useful; encourage further improvements

    f. the title of the SOF should include the word "reconciliation"

    g. consider making the SOF supplementary information

    h. users would use either budgetary or accrual information, not both, so a reconciliation of obligations and net costs as in the SOF is not useful.

Conclusion

13. In light of the comments received from respondents, the Board believes there is support for proceeding with this amendment. The

Board considered the comments from several respondents that the basis for conclusions contain a brief discussion of alternative SOF presentations, but continues to believe that such a discussion must be postponed until a fuller review of the statement of financing is undertaken. The SOF is complex, and the narrative and illustrations necessary to present a full discussion of and rationale for the alternatives should be undertaken during a comprehensive updating of the implementation guidance.

Vote for Approval

14. All members of the Board approved this statement.

Appendix B: Paragraphs 80 and 97 of SFFAS 7

The current paragraphs are as follows:

80. Budgetary and financial accounting information are complementary, but both the types of information and the timing of their recognition are different, causing differences in the basis of accounting. To better understand these differences, a reconciliation should explain the relationship between budgetary resources obligated by the entity during the period and the net cost of operations. It should reference the reported "obligations incurred" and related adjustments as defined by OMB Circular A- 34. It also should include other financing sources not included in "obligations incurred" such as imputed financing, transfers of assets, and donations of assets not included in budget receipts. Further, it should include decreases (increases) in receivables from the public related to exchange revenue when only the cash amount is included in budgetary resources. The total of these items comprises obligations and nonbudgetary resources.

97. **Nonbudgetary resources** represent the net amount of resources received by the entity that are not included in budgetary resources. These items could include donations of assets, transfers of assets from (to) other federal entities, and financing imputed for cost subsidies. This amount would also include decreases (increases) in receivables related to revenue accrued from the public because, while the cash collected for exchange revenue is a budgetary resource, the accrual amount is not.

Statement of Federal Financial Accounting Standards No. 23: Eliminating the Category National Defense Property, Plant, and Equipment

Rescinding SFFAS No. 11, *Amendments to Property, Plant, and Equipment -- Definitional Changes*
Amending SFFAS No. 8, *Supplementary Stewardship Reporting*
Amending SFFAS No. 6, *Accounting for Property, Plant, and Equipment*

Status

Issued	May 8, 2003
Effective Date	This Statement is effective for accounting periods beginning after September 30, 2002, with earlier implementation encouraged.
Volume I References	SFFAS No. 6, *Accounting for Property, Plant and Equipment* (for additional PP&E discussion and cleanup cost standards)
Volume II References	Consolidated Financial Report of the U. S. Government (C60), General Property, Plant, and Equipment (G20), Land (L10)
Interpretations and Technical Releases	None
Affects	• SFFAS No. 6, *Accounting for Property, Plant and Equipment* (for additional PP&E discussion and cleanup cost standards) • SFFAS No. 8, *Supplemental Stewardship Reporting* (Rescinds the prefatory box preceding paragraph 52 of SFFAS No. 8 and paragraphs 52 through 70 of SFFAS No. 8.)
Affected by	No other statements

Summary

I. Prior to this amendment, the acquisition costs for items classified as national defense (ND) property, plant, and equipment (PP&E) were expensed in the period incurred. In addition, valuation (using either an historical or latest acquisition cost valuation method), condition, and deferred maintenance information for these items was to be presented off-balance sheet.

II. The amendments in this Statement make the following changes. The term "ND PP&E" is rescinded. All items previously considered ND PP&E are classified as general PP&E. Accordingly, the cost of these items should be capitalized and, with the exception of the cost of land and land improvements that produce permanent benefits, depreciated. This Statement also notes that all entities are permitted to use the composite or group depreciation methodology to calculate depreciation.

III. The amendments in this Statement take effect for accounting periods beginning after September 30, 2002.

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Introduction

1. The purpose of this Statement is to amend certain standards with regard to national defense (ND) property, plant, and equipment (PP&E). The standards being amended are contained in Statement of Federal Financial Accounting Standards (SFFAS) No. 11, *Amendments to Accounting for Property, Plant, and Equipment -- Definitional Changes* (December 1998); SFFAS No. 8, *Supplementary Stewardship Reporting* (June 1996); and, SFFAS No. 6, *Accounting for Property, Plant, and Equipment* (November 1995).

Background

2. Pursuant to SFFAS No. 6, costs to acquire, replace or improve ND PP&E[1] were recognized[2] as an expense in the period incurred. Consistent with the treatment of the acquisition cost of ND PP&E, SFFAS No. 6 also required that the total estimated cleanup cost be recognized as an expense and a liability established in the period the ND PP&E item is placed in service. A further requirement of SFFAS No. 6, as amended by SFFAS No. 14, is that deferred maintenance amounts be presented as Required Supplementary Information (RSI).[3]

3. The Supplementary Stewardship Reporting standards in SFFAS No. 8 required presenting a valuation of ND PP&E. The following values were to be presented:

   a. a beginning value balance for ND PP&E;

   b. the dollar values for ND PP&E acquired during the reporting period;

[1] Originally, ND PP&E was defined in SFFAS No. 6 as Federal mission PP&E. Subsequent to the issuance of SFFAS No. 6, many agencies suggested that the Federal mission PP&E category would be appropriate for agency PP&E not considered by the Board in developing the category. To prevent confusion, inconsistency, and unintended application, the Board replaced the definition of Federal mission PP&E with the definition of ND PP&E currently contained in SFFAS No. 11 to clarify that only DoD and the Maritime Administration's National Defense Reserve Fleet PP&E would be categorized as ND PP&E.

[2] "Recognize" means to record an amount in entity accounts and to report a dollar amount on the face of the Statement of Net Costs or the Balance Sheet either individually or so that the amounts are aggregated with related amounts.

[3] This amendment does not change any requirements for deferred maintenance.

c. the dollar values for ND PP&E withdrawn during the reporting period;

d. the increase or decrease in values resulting from revaluation of assets using the latest acquisition cost (LAC); and,

e. the end-of-year values by major type or category of ND PP&E.

The values were to have been determined using either an historical or LAC valuation method.

4. In addition to the values, condition information was required. The valuation and condition information was presented as Required Supplementary Stewardship Information (RSSI) – that is, outside of the principal financial statements.

5. Current Board members acknowledge that the stewardship approach was adopted, not as a convenience or temporizing expedient, but as a technically desirable approach. However, an increasing government-wide focus on the cost of operations and operating performance in relation to the implications of the Government Performance and Results (GPRA) Act, combined with the Board's and Department of Defense's (DoD) extensive study and greater understanding about National Defense PP&E, provide a clear indication that the operating performance objective is relevant for ND PP&E. Accordingly, the Board rescinds SFFAS No. 11 and amends SFFAS Nos. 6 and 8.

Summary of Amendments

6. The amendments in this Statement:

a. Rescind the term "ND PP&E" and its definition ;

b. Classify all assets previously considered to be ND PP&E as general PP&E and, the provisions for general PP&E and associated cleanup costs for general PP&E contained in SFFAS No. 6, as amended, are to be applied; and,

c. Continue to permit the composite or group depreciation methodology to depreciate general PP&E.

Effective Date

7. This Statement is effective for accounting periods beginning after September 30, 2002, with earlier implementation encouraged.

Accounting Standards

Amendments to Existing Standards

8. The amendments to accounting standards for assets previously identified as national defense (ND) property, plant, and equipment (PP&E) and implementation guidance are presented in paragraphs 9 through 18 that follow.

9. The amendments affect existing standards, for periods beginning after September 30, 2002 or upon early implementation of this Statement, in the following manner:

   a. SFFAS No. 11 is rescinded in its entirety;

   b. The prefatory box preceding paragraph 52 of SFFAS No. 8 is rescinded;

   c. Paragraphs 52 through 70 of SFFAS No. 8 are rescinded;

   d. Paragraph 21 of SFFAS No. 6 is amended by rescinding the category name "Federal mission property, plant, and equipment;"

   e. Paragraphs 46 through 56 of SFFAS No. 6 and the accompanying heading "Federal mission property, plant, and equipment;" which precedes these paragraphs, are rescinded;

   f. SFFAS No. 6 is amended by adding the following sentence to paragraph 35 as a separate bulleted line item:

- A composite or group depreciation methodology[4], whereby the costs of PP&E are allocated using the same allocation rate, is permissible.

Implementation Guidance

Initial Capitalization

10. The initial capitalization amount for assets previously considered ND PP&E should be based on historical cost in accordance with the asset recognition provisions of SFFAS No. 6, as amended, and should be the initial historical cost for the items, including any major improvements or modifications.

11. This standard recognizes that determining initial historical cost may not be practical for items acquired many years prior to the effective date of this standard in an environment in which the historical records were not required to be retained and may therefore be inadequate.

12. If obtaining initial historical cost is not practical, estimated historical cost may be used. Other information such as but not limited to budget, appropriation, or engineering documents and other reports reflecting amounts expended may be used as the basis for estimating historical cost.

13. Alternatively, estimates of historical cost may be derived by estimating the current replacement costs of similar items and deflating those costs, through the use of price-level indexes, to the acquisition year or estimated acquisition year if the actual year is unknown. Other reasonable approaches for estimating historical cost may also be utilized. For example, latest acquisition cost may be substituted for current replacement cost in some situations.

[4] The composite methodology is a method of calculating depreciation that applies a single average rate to a number of heterogeneous assets that have dissimilar characteristics and service lives. The group methodology is a method of calculating depreciation that applies a single, average rate to a number of homogeneous assets having similar characteristics and service lives.

14. A contra asset account--accumulated depreciation--for the assets should be calculated under the provisions provided in paragraphs 41, 42, and 43 of SFFAS No. 6, as amended.

15. For military equipment that is in service upon implementation of this standard, cleanup cost liabilities should be adjusted, as needed.[5]

Adjustment to Cumulative Results of Operations

16. The cumulative effect of adopting this accounting standard should be reported as a "change in accounting principle." The adjustment should be made to the beginning balance of cumulative results of operations in the statement of changes in net position, for the period the change is made.

17. Prior year financial statements presented for comparative purposes should be presented as previously reported.

18. The nature of the changes in accounting principle and its effect on relevant balances should be disclosed in the current period. Financial statements of subsequent periods need not repeat the disclosures.[6]

The provisions of this statement need not be applied to immaterial items.

[5] Under the provisions of SFFAS No. 6, paragraph 97, a portion of the estimated total cleanup costs shall be recognized as expense during each period that general PP&E is in operation and a liability accumulated over time as expense is recognized. This adjustment may be needed because the DoD may have already recognized the total estimated cleanup costs as a liability and expense for some military equipment per paragraph 101 of SFFAS No. 6, as amended.

[6] SFFAS 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, paragraphs 12 and 13.

Appendix A: Basis For Conclusions

19. This appendix summarizes some of the considerations deemed significant by the Board in reaching the conclusions in this Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.

Introduction

20. The Board issued an exposure draft (ED), *Eliminating the Category National Defense Property, Plant, and Equipment*, to rescind SFFAS No. 11, *Amendments to Property, Plant, and Equipment -- Definitional Changes* and to amend SFFAS No. 8, *Supplementary Stewardship Reporting* and SFFAS No. 6, *Accounting for Property, Plant, and Equipment* in March of 2002. Twenty comment letters were received during a comment period that ended May 20, 2002. The majority of respondents supported the proposals presented in the ED. Concerns raised by the respondents dealt mostly with providing additional guidance for the valuation and consumption of items. Two other concerns dealt with the impact of the Statement on contractor costs and the effective date of the Statement. Background information pertaining to the development of this Statement and discussions on the concerns raised by respondents are addressed in the following paragraphs.

Background

21. The Federal Accounting Standards Advisory Board (FASAB) has studied accounting and reporting approaches for Property, Plant, and Equipment (PP&E) for a number of years. FASAB's initial standards for PP&E began with the development of SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, and followed with SFFAS No. 8, *Supplementary Stewardship Reporting*.

22. SFFAS No. 6 requires that general PP&E be recognized as assets in the basic financial statements and, except for land and land improvements that produce permanent benefits, be charged to expense through depreciation over their useful life. SFFAS No. 6, paragraph 122, states that "allocation of the cost of general PP&E, excluding land, among accounting periods was essential to assessing operating performance." The Board's federal financial reporting objectives concept statement, Statement of Federal Financial Accounting Concepts (SFFAC) No.1, focuses on relating costs to accomplishments in reporting an entity's operating performance. To meet the operating performance objective

for general PP&E, the Board sought to provide accounting standards that would result in:

a. relevant and reliable cost information for decision-making by internal users;

b. comprehensive, comparable cost information for decision-making and program evaluation by the public; and,

c. information to help assess the efficiency and effectiveness of asset management.

23. The Board, however, found that for some PP&E, the depreciation effect of the asset on operating performance was not the predominant reporting objective. Instead, stewardship was important. Therefore, three categories of assets (i.e., national defense PP&E (ND PP&E),[7] heritage assets, and stewardship land) are referred to collectively as stewardship PP&E.

24. The purpose of SFFAS No. 8 was to establish standards for reporting on the Federal Government's stewardship over certain resources entrusted to it, and certain responsibilities assumed by it. Among these standards are standards for reporting on stewardship PP&E. "Stewardship PP&E" consists of items whose physical properties resemble those of general PP&E traditionally capitalized in financial statements. However, the nature of these Federal physical assets that are classified as stewardship PP&E differs from general PP&E in that their values may be indeterminable or may have little meaning (e.g., museum collections, monuments, assets acquired in the formation of the nation) or that allocating the cost of such assets (e.g., ND PP&E) to accounting periods that benefit from the ownership of such assets is not meaningful. Specifically, for ND PP&E the majority of the Board did not believe applying depreciation accounting for these assets would contribute to measuring the cost of outputs produced, or to assessing operating performance, in any given accounting period. The Board believed that these assets were developed, used, and retired in a

[7] Prior to the issuance of SFFAS No. 11, *Amendments to Accounting for Property, Plant, and Equipment – Definitional Changes*, (amending SFFAS Nos. 6 and 8) the Board referred to ND PP&E as Federal Mission PP&E. The reasons leading to that change are not relevant to this ED but may be understood by reading SFFAS No. 11. This document uses the amended title and definition in referring to the existing provisions.

manner that did not lend itself to a "systematic and rational" assignment of costs to accounting periods (i.e., depreciation accounting) and, ultimately, to outputs.

25. Accordingly, one result of SFFAS Nos. 6 and 8 was to remove the PP&E components of ND PP&E from the balance sheet. To accomplish this, SFFAS No. 6 (as amended) required that the cost to acquire ND PP&E components be expensed when incurred. SFFAS No. 8 (as amended), required presenting ND PP&E as stewardship information and included the following information by major type or category of ND PP&E:

    a. a beginning value balance, using either a historical or latest acquisition cost (LAC) valuation method;

    b. the dollar value acquired during the reporting period;

    c. the dollar value withdrawn during the reporting period;

    d. the increase or decrease in value resulting from revaluation of assets using the LAC; and,

    e. the end-of-year value.

26. In addition to presenting values, SFFAS No. 8 required that condition information be presented. The presentation of value and condition information was done off-balance sheet as Required Supplementary Stewardship Information (RSSI). In addition to value and condition, SFFAS No. 6, as amended, required deferred maintenance information to be presented as Required Supplemental Information (RSI) for ND PP&E.

February 1998 ED

27. In early 1998, the FASAB issued an exposure draft (ED) to amend SFFAS Nos. 6 and 8. The exposure draft was initiated (1) to refine the definition of ND PP&E, and (2) in recognition of the need to provide a transition plan due to the DoD's inability to comply with the provisions of SFFAS No. 8. During the process, the Board reconsidered whether SFFAS No. 8 was an appropriate end goal. Ultimately, the 1998 exposure draft included, among other suggestions, proposals to replace the requirement to present cumulative cost information in the supplementary stewardship report with a requirement to present ND PP&E annual acquisition costs for each of the previous five years (i.e.,

annual trend information rather than cumulative costs), quantities, and condition information.

28. Besides considering the written comments in response to this 1998 ED, the Board held a public hearing on these proposals to explore further the concerns expressed by some respondents. Because of the divergent views of both respondents and Board members, the Board did not reach a final conclusion on revisions to the reporting requirements for ND PP&E in SFFAS No. 8. The Board's continued deliberations on the proposed standards highlighted the differences of opinion on this subject among the Board members. Since neither the standards in SFFAS No.8 nor the proposed amendments were acceptable to a majority of the Board members, the Board decided that the accounting for and reporting on ND PP&E requirements should be revisited. DoD voluntarily undertook a study to address (1) users information needs relative to ND PP&E, (2) the current systems capabilities within DoD, and (3) an assessment of alternative means to meet the reporting objectives set by the Board.

29. The Board acknowledges that the SFFAS No. 8 stewardship approach was adopted, not as a convenience or temporizing expedient, but as a technically desirable approach. However, an increasing government-wide focus on the cost of operations and operating performance in relation to the implications of the Government Performance and Results (GPRA) Act, combined with the Board's and DoD's extensive study and greater understanding about National Defense PP&E, provides a clear indication that the operating performance objective is relevant for ND PP&E.

September 2001 ED

30. In September 2001, the FASAB issued an ED that proposed incremental movement from the stewardship reporting of SFFAS No.8 towards information focused on operating performance. The amendments proposed in that ED would have made the following changes. The definition of ND PP&E would have been amended. ND PP&E would have consisted of 2 separate categories of items within the amended definition: (a) Major End Items and (b) Mission Support Items. Major End Items would have been subject to a presentation of the number of units and condition assessment information by asset type or category. In addition, Major End Items would have been capitalized but not depreciated, while Mission Support Items would have been capitalized and depreciated. Also, data for the ten largest current acquisition programs would have been disclosed.

31. The Board issued the 2001 ED because it believed that the proposals in that ED were the best that could be achieved given the acknowledged shortcomings of DoD accounting and other management information systems, as well as DoD's firm belief that certain information would not be useful for management purposes. The 2001 ED would have achieved one of the current Board's objectives, which was to establish monetary accountability over military assets. However, because the 2001 ED did not require depreciation of some major assets, the September 2001 FASAB ED on NDPP&E fell short of comprehensive PP&E accounting. In addition, it would not have fully achieved the objective of SFFAS No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, to account for the full cost of programs with a focus on relating costs to accomplishments in reporting an entity's operating performance.

March 2002 ED

32. While there were divergent views on the proposals in the September 2001 ED, many respondents believed ND PP&E should be capitalized and depreciated as is general PP&E. Many Board members had wanted to make this change for some time. This caused the Board to reconsider the proposals presented in the September 2001 ED. The outcome from the deliberations was a consensus of the Board to make the proposal in the March 2002 ED to classify, capitalize, and depreciate ND PP&E as general PP&E. The Board believed its proposal would put discipline into the asset management process. Many members of the Board believe depreciation, impairment, deferred maintenance, and condition are interrelated judgments that should result jointly from periodic estimation of the remaining useful service potential of assets. The Board believes periodic analysis of the sources of asset diminution is as important, perhaps more so, for national defense assets than for other assets.

33. The Board also notes that a second purpose of depreciation accounting is to provide information for measuring the full cost of producing outputs (e.g., deterrence, readiness, training). Full cost, including the depreciation of ND PP&E, would be available for use in assessing the operating performance of responsibility segments for producing outputs and to meet the goals of SFFAC No. 1 and SFFAS No. 4. In addition, the Board believes that classifying all DoD PP&E as general PP&E would improve the public's understanding of federal accounting, add consistency to the application of standards throughout the Federal government, reduce the DoD's cost of development and operation of accounting systems, and preclude the

standard setting costs that would be necessary to resolve on-off balance sheet questions. Accordingly, the Board proposed to rescind SFFAS No.11 and amend SFFAS Nos. 6 and 8.

34. Although the September 2001 ED on ND PP&E proposed three special disclosures for ND PP&E, the Board decided not to include them in the March 2002 ED. The three special disclosures proposed in the September 2001 ED were:

    a. unit information by type or category of Major End Item[8];

    b. condition assessment information for Major End Items; and,

    c. actual and planned acquisition program costs and unit information for the ten largest current national defense PP&E[9] acquisition programs.

35. These proposed information requirements were developed and proposed after years of deliberation and with varying recognition and measurement requirements for the principal financial statements. The Board decided not to propose these three special information requirements as part of the March 2002 ED after reviewing responses to the September 2001 ED. The Board concluded that these areas may deserve further study or development for the following reasons:

    a. Unit information as originally proposed was tied to the Major End Item definition. Respondents questioned the definition's effectiveness.

[8] The *Accounting for National Defense PP&E and Associated Cleanup Costs* ED, dated September 2001, defined Major End Items to be: 1) items that launch, release, carry, or fire a particular piece of ordnance, and 2) items that carry weapons systems-related property, equipment, materials, or personnel. Major End Items (a) have an indeterminate or unpredictable useful life due to the manner in which they are used, improved, modified, or maintained and (b) are subject to premature destruction or obsolescence (e.g., aircraft, ships, combat vehicles, etc.) Also, included in this category are vessels held in a preservation status by the Maritime Administration's National Defense Reserve Fleet.

[9] SFFAS No. 11 defined ND PP&E as being "PP&E [that] are (1) the PP&E components of weapons systems and support PP&E owned by the Department of Defense or its component entities for use in the performance of military missions and (2) vessels held in a preservation status by the Maritime Administration's National Defense Reserve Fleet."

b. Unit and condition information has been determined to be "sensitive" information[10].

c. Many respondents suggested that further research in the area of condition and deferred maintenance presentation is needed to develop consistent and comparable measurement and reporting criteria. However, respondents found condition information to be a useful supplement to deferred maintenance.

d. One respondent suggested that the proposed reporting on the ten largest acquisition programs would confuse users since the cost of assets recognized on the balance sheet would be different from budget cost measurements.

36. Given the resources that have been devoted to resolving the fundamental recognition and measurement guidance for ND PP&E and the substantial efforts underway at DoD to modernize its systems, the Board does not believe it would be useful to withhold this Statement while it deliberates on the merits of any further PP&E information.

37. In the meantime, the Board does not believe the absence of the previously proposed special information requirements would outweigh the benefits to be gained through this Statement. With regard to the stewardship objective and the need for unit information, the Board notes that the stewardship objective is being met for general PP&E without this special disclosure. Through the course of the audit, existence of PP&E and the completeness of PP&E records are verified. This satisfies the basic stewardship function that the double entry system offers.

38. With regard to condition information, the Board notes that deferred maintenance information is currently required. Further, the assessment of useful life needed to assure depreciation is reasonable would result in greater discipline in information associated with the condition of PP&E.

[10] Any information, the loss, misuse, or unauthorized access to which would or could adversely affect the organizational and/or national interest but which does not meet classification criteria specified in DoD 5200.1-R (reference (c)). Source: DoD 5200.1-M; Acquisition Systems Protection Program; 16 March 1994.

39. The Board expects to revisit these areas as it considers a project on integrating depreciation, impairment, and deferred maintenance reporting and other fixed asset accounting issues at a future date. The effort would be a government-wide undertaking.

Concerns with March 2002 ED

Valuation and Consumption

40. Various respondents suggested that additional guidance be included in this Statement for the valuation and consumption or use of items previously classified as national defense (ND) property, plant, and equipment. Examples of the types of additional guidance suggested include the following:

    a. The cost elements of research, testing, development, and evaluation (RTD&E) should be described and specific guidance provided on capitalization.

    b. Definitions for terms such as modifications, modernizations, and improvements are needed.

    c. More discussion of the desired accounting for the losses of items considered part of a group asset account of ND PP&E during testing, development, or evaluation phases is needed.

    d. More guidance for determining the capitalized costs to be removed from a group asset account when a unit is destroyed, becomes obsolete, or is otherwise disposed of is needed.

    e. The role of subordinate systems needs to be addressed, along with a description of how the costs of the subordinate systems would be relieved of costs assigned to the higher level system.

    f. A discussion of appropriate treatment for the costs of a discontinued subordinate system is needed.

    g. The use of depreciation to reflect the full cost of operating ND PP&E items has to be tailored to the unique attributes and uses of ND PP&E.

h. The useful lives of certain classes of ND PP&E should be defined and measured in units such as operating hours.

i. Additional guidance and criteria is needed regarding the use of composite and group depreciation methodologies.

j. Specific reference to abnormal disposition issues should be added to the standard.

41. In response to these issues, the Board members reiterated that the Board is responsible for promulgating accounting standards and that it is the responsibility of individual entities to set policy and provide operating guidance on how to implement the standards. The Board believes these issues can and should be addressed by individual entities in the context of existing basic principles and practices. Composite and group depreciation methodologies are already considered acceptable methods under generally accepted accounting principles. The existing principles and practices are used by many different industries, including the airline, electrical cooperative, railroad, real estate, and cruise line industries.

42. The Board also expects that many of these concerns raised by respondents will be addressed by DoD as the standards are implemented. One example may be on the cost elements of research, testing, development, and evaluation (RTD&E) to be capitalized. Determining whether to include a particular cost in the capitalized cost of PP&E should be guided by general guidance in SFFAS Nos. 4 and 6 regarding the types of costs to capitalized. In the event, however, that DoD is unable to resolve issues , the Board and its staff will be available to consider implementation guidance.

Contractor Costs

43. Two respondents raised concerns regarding application of existing general PP&E accounting standards to PP&E formerly classified as National Defense PP&E but held by contractors. Since the current PP&E definition explicitly includes PP&E in the hands of others (paragraph 18), SFFAS Nos. 6 and 8 (as amended) created reporting requirements for general PP&E and National Defense PP&E. Both existing standards require cost information.

44. One respondent, apparently unaware of the aforementioned provisions of SFFAS Nos. 6 and 8, encouraged the Board to develop standards that address this property. The respondent asserted,

"accounting control over this property is deplorable." Information provided by the respondent shows that as early as 1981 issues were raised regarding the need to improve accountability for assets including PP&E provided by the Government at no cost to the contractor for use in contract performance.

45. Another respondent, an industry group including major defense contractors, suggests that the elimination of the National Defense PP&E category "will impose costly accounting change requirements on government contractors that will increase the costs of goods and services acquired by the government." The respondent raised concerns about (1) application of standards to immaterial items, (2) provisions for accounting for software modifications, (3) requirements for work-in-process reporting, and (4) designation of specific cost elements for capitalization (SFFAS No. 6, para 26). Some aspects of these and other issues raised by the respondent appear to the Board to be based on misinterpretations of the existing standards. Therefore, the Board does not believe there are insurmountable issues raised.

46. Rather, the Board believes that significant efforts are needed to clarify the standards for contractors and to determine specific reasonable policies for providing information. It is clear that, despite the existence of standards for contractor held assets since late 1995, little progress has been made in resolving the issue. The Board does not believe that deferral of standards related to vast amounts of PP&E will facilitate resolution of the contractual and administrative details needed to reasonably comply with generally accepted accounting principles.

Effective Date

47. One respondent commented that the effective date, for periods beginning after September 30, 2002, is unrealistic. The Board acknowledges that full implementation of the standards will require time and commitment. The Board understands that DoD is currently developing systems needed to fully implement any PP&E standards, comprehensive training needs to be provided, policies and procedures need to be revised and contractors may need to modify how they do things. However, the Board believes DoD financial statements will be incomplete without consistent and comparable accounting for PP&E. In addition, a practical issue arises. DoD has not yet identified property as National Defense PP&E. Therefore, it would be problematic to determine which components of general PP&E were

not yet subject to the provisions of SFFAS No. 6, which became effective for fiscal year 1998.

Board Approval

48. The Board approved this recommendation by a vote of 6 members approving its issuance and 1 member opposing its issuance. Although the Board is comprised of 9 members, only 7 members cast a vote. This is because the term of two Board members had expired and the appointment of successors had not been finalized. The dissent of the Board member who opposed the issuance of this Statement is presented in paragraphs 49 through 51.

49. Mr. Calder dissents from this standard because (1) more guidance on asset capitalization and use of composite or group depreciation methods is needed and (2) additional disclosures are important to meeting reporting objectives for National Defense PP&E.

50. Mr. Calder believes that deliberations uncovered serious issues regarding identification of costs to be capitalized and application of composite or group depreciation methods to complex weapons systems. Comments showed there is diversity of understanding among financial statement users, preparers and auditors on these issues. He believes additional guidance should have been provided regarding the components of asset cost that should be capitalized; especially the accounting treatment for research, development, testing and evaluation. He does not believe the guidance in this regard in Statement Nos. 4 and 6 is adequate to resolve complex and diverse situations unique to defense assets. He also believes the new statement lacks guidance regarding the appropriate use of composite or group depreciation and could result in unacceptable diversity in its application.

51. In addition, Mr. Calder believes that the statement should have required disclosure of unit information for significant categories of assets and budget/actual data on major acquisitions programs in progress. Unit information has been deliberated at length by the Board over a number of years because some members and commentators believed the unit information is critical to an understanding of whether DoD has assets sufficient to carry out its mission. Information on budget/actual data on major acquisitions programs is considered by many to be vital to assessing performance in acquiring assets through complex and lengthy acquisition programs. In addition, tracking

progress against plans would aid in determining the financial status of the programs. These two additional disclosures would enhance users' understanding of the nation's financial condition and future security.

Statement of Federal Financial Accounting Standards No. 24: Selected Standards for the Consolidated Financial Report of the United States Government

Status

Issued	January 2003
Effective Date	For periods ending after September 30, 2001
Volume I References	SFFAC 2, *Entity and Display*, SFFAS 1, *Accounting for Selected Assets and Liabilities of the Federal Government*, and SFFAS 8, *Supplementary Stewardship*
Volume II References	Consolidated Financial Report of the US Government (C60)
Interpretations and Technical Releases	None.
Affects	None.
Affected by	None.

Summary

Most Statements of Federal Financial Accounting Standards (SFFAS) do not state whether they apply to the Government as a whole or components thereof, or both. This standard clarifies that all parts of all SFFAS apply to all Federal entities (including the consolidated entity) unless a standard specifically provides otherwise.

In addition, certain requirements of SFFAS 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, are not relevant for the Consolidated Financial Report of the United States Government (CFR). SFFAS 7 requires information on budgetary resources and a reconciliation of obligations and other resources used with the net cost of operations. These requirements, while relevant for agencies executing the budget, are not required for the CFR.

This standard requires that new statements be presented in the CFR, but not agency or departmental financial statements, regarding net operating revenue (or cost), budget surplus (or deficit), and cash. The new statements are principal CFR financial statements, and they are to be presented on a comparative basis.

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Introduction

1. Statements of Federal Financial Accounting Standards (SFFAS) usually do not state explicitly whether they apply to the Government as a whole, its component entities (e.g., departments, agencies, etc.), or both. Statement of Federal Financial Accounting Concepts (SFFAC) 1, *Objectives of Federal Financial Reporting*, uses the term "entity" generically to refer, depending on the context, to the U.S. Government as a whole, organizational component units of the Government, e.g., an agency, or to other kinds of potential reporting units such as programs.

2. Some have assumed that the standards apply to both component entities and the Government as a whole, unless otherwise stated. SFFAS 1, *Accounting for Selected Assets and Liabilities of the Federal Government*, states that it applies to the Government and its departments and agencies, as does SFFAS 8, *Supplementary Stewardship Reporting*. SFFAC 2, *Entity and Display*, states that Federal entities aggregate into the Government entity, which encompasses all the resources and responsibilities existing within the component entities.

3. This standard clarifies that all existing and future standards apply to all federal entities unless a standard specifically provides otherwise.

4. This standard also exempts the CFR from certain provisions of SFFAS 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requiring information about budgetary resources and a reconciliation of budgetary obligations with the cost of operations from the proprietary accounting system. Such information is relevant and meaningful for entities financed with budgetary resources but not for the Government as a whole.

5. In addition, this standard requires new information for the CFR (but not component entity financial statements) that reconciles the annual proprietary net cost with the unified budget surplus (or deficit), and explains the changes in the Government's cash balance. The information is to be presented in new CFR principal financial statements that are to be presented on a comparative basis.

Materiality

6. The provisions of this accounting standard need not be applied to immaterial items.

Effective Date

7. This amendment is effective for periods beginning after September 30, 2001.

Accounting Standard

Standards for the Consolidated Financial Report of the U.S. Government

8. Statements of Federal Financial Accounting Standards (SFFAS) apply to all federal entities, that is, to the Government as a whole and to **component entities** (terms defined in the glossary appear initially in **boldface**), unless provision is made for different accounting treatment in a current or subsequent SFFAS.

Budgetary Information Not Required for the Government as a Whole

9. SFFAS 7, paragraphs 77-82, requires certain information about **budgetary resources** and about the relationship between **budget obligations** and proprietary **net cost of operations**. Such information is reported in the Statement of Budgetary Resources and Statement of Financing, respectively.[1] This information is not required in the consolidated financial report of the Government as a whole, and accordingly such statements are not required.

Reconciliation Information

10. The financial report of the Government as a whole should provide a financial statement reconciling **net operating revenue (or cost)** and the annual **unified budget surplus (or deficit)**. The financial statement should highlight:

    - The components of net operating revenue (or cost) that are not part of the unified budget surplus (or deficit), including the

[1] See Appendices D and E for illustrations of the statement of budgetary resources and statement of financing from the Office of Management and Budget's Bulletin 01-09, *Form and Content*.

accrued and amortized expenses not included in **budget outlays** and the accrued or other revenue not included in **budget receipts**; and

- The components of the unified budget surplus (or deficit) that are not part of net operating revenue (or cost), including budget receipts and outlays that are not included in net operating revenue (or cost).

11. Appendix B provides an illustration of how the reconciliation data could be displayed. The illustration is not intended to be prescriptive.

Information about the Unified Budget Surplus or Deficit and Cash

12. The Government as a whole should provide a financial statement explaining how the annual unified budget surplus or deficit relates to the change in the Government's cash. The financial statement should highlight:

    - The components of the unified budget surplus or deficit that are not part of the annual change in cash, including non-cash budget outlays; and
    - Items affecting the Government's cash balance that are not included in the budget outlays or receipts. The statement should prominently display the cash inflow and outflow related to the changes in debt held by the public and interest accrued and interest paid on debt held by the public.

13. Appendix C provides an illustration of how this information could be displayed. The illustrations are not intended to be prescriptive.

Principal Financial Statements Presented on a Comparative Basis

14. The financial statements required in paragraphs 10-13 immediately above are **principal financial statements**. These statements and all other principal financial statements in the consolidated financial report of the Government as a whole should be presented on a comparative basis. The current fiscal year amounts should be presented in a column adjacent to the amounts for the previous fiscal year.

Appendix A: Basis for Conclusions

15. This appendix summarizes some of the considerations deemed significant by the Board in reaching the conclusions in this Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.

16. FASAB published the exposure draft Selected Standards for the Consolidated Financial Report of the United States Government, in March 2002. The exposure draft included questions about each of the three areas of interest: (1) whether standards should apply to the Government as a whole as well as to component entities; (2) whether the CFR should be exempt from the requirement for a Statement of Budgetary Resources and a Statement of Financing; and (3) whether new statements should be required for the Government as a whole.

17. The Board received 16 responses as follows:

Category	Federal (Civilian)	Federal (Military)	Non-Federal
Users, academics, and others[2]			5
Auditors	1	1	
Preparers and financial managers	8	1	

Standards Apply to the Government as a Whole as Well as to Component Entities

18. In Statement of Federal Financial Accounting Concepts (SFFAC) 1 *Objectives of Federal Financial Reporting*, the Board uses the term "entity" generically to refer, depending on the context, to the Government as a whole, organizational component units of the Government, e.g., an agency, or to other kinds of potential reporting units such as programs.[3] SFFAC 2, *Entity and Display*, states that Federal entities aggregate into the Federal Government entity, which encompasses all the resources and responsibilities existing within the component entities.[4]

[2] This category includes professional organizations, academics, and private citizens.

[3] SFFAC 1, fn. 2-3, and par. 212.

[4] SFFAC 2, par. 38.

19. Although Statement of Federal Financial Accounting Standards (SFFAS) 1, *Accounting for Selected Assets and Liabilities of the Federal Government*, states that it is applicable to both the Government as a whole and component entities[5], other standards have not explicitly addressed the subject unless different treatment was specified. SFFAS 6, *Accounting for Property, Plant, and Equipment*, refers the reader to SFFAC 2, *Entity and Display*, for guidance on the general applicability of federal accounting standards. SFFAS 8, *Supplementary Stewardship Reporting*,[6] explicitly states that it applies to the Government and its departments and agencies; and sets an effective date for its applicability to component entities but not for the Consolidated Financial Report of the U.S. Government (CFR) because more time is needed to delineate how the stewardship information would be aggregated. SFFAS 8 also requires a "current services assessment" for the CFR but not for individual reports of its component units. Likewise in SFFAS 17, *Social Insurance*, applicability is addressed because certain requirements for component entities are not applicable to, and summarization of certain data is allowed for, the CFR.

20. This standard clarifies that SFFAS apply to all Federal entities unless a current or subsequent standard specifically provides otherwise. All of the respondents who addressed the issue agreed that the FASAB standards should apply to the CFR. Several respondents requested more guidance regarding whether the proposed standard affected the FASAB policy whereby "financial statements [prepared] in accordance with accounting standards published by [the Financial Accounting Standards Board (FASB)] also may be regarded as in accordance with GAAP for those entities that have in the past issued such financial statements."[7] The Board did not intend to change and is not changing this policy at this time.

[5] SFFAS 1, par. 14.

[6] SFFAS 8, par. 38-39.

[7] *FASAB News*, Jan.-March 2000, p. 2.

Consolidated Financial Report Exemption from Requirements to Report Certain Budgetary Information

21. All but one of the respondents who addressed the issue agreed that the CFR should be exempt from certain provisions of SFFAS 7, Accounting for Revenue and *Other Financing Sources and Concepts for Budgetary and Financial Accounting*, requiring a Statement of Budgetary Resources (SBR) and the Statement of Financing (SOF). One respondent disagreed, saying that the same information, based on one single set of standards, required for components should be required for the CFR, and vice versa. That respondent believes that the CFR should present the SBR and SOF, because such combined budgetary information is relevant and useful to the user of the CFR. Likewise, the component entities should be required to prepare the new statements, the necessary changes being made, as well as the SBR and SOF.

22. SFFAS 7 requires entities "whose financing comes wholly or partially from the budget" to provide information on budgetary resources and the status of resources, which is presented in the SBR.[8] It also calls for a reconciliation of budgetary resources obligated by the entity with the net cost of operations, which is presented in the SOF.[9]

23. The Board continues to believe that such information is less relevant or meaningful at the level of the CFR. Resources differ between the Government as a whole and individual component entities. The exchange and non-exchange revenue and borrowing from the public are the main sources of financing for the Government as a whole.[10] For component reporting entities, however, the sources of financing

[8] SFFAS 7 (pars. 77-79) requires information, which is presented in the SBR, that includes (1) total budgetary resources available, (2) the status of the budgetary resources, including obligations incurred, the available **appropriation**, **borrowing** and **contract authority** at the end of the period, any restrictions on the use of unobligated balances of **budget authority**, the amount of any capital infusion during the period, etc.; and (3) **outlays**. In addition, the entities are required to provide this information for each of their major budget accounts as supplementary information.

[9] SFFAS 7 (pars. 80-82) also requires a reconciliation of budgetary obligations and proprietary accounting information, which is presented in the SOF. The reconciliation explains the relationship between (1) budgetary resources obligated by the entity during the period and **other financing sources** such as **imputed financing**, transfers of assets, etc., not included in budget receipts, and (2) the net cost of operations.

[10] "Exchange revenue" arises when an entity provides goods and services for a price. "Non-exchange revenue" arises primarily from the exercise of the government's sovereign power to demand payment from the public, such as taxes, duties, fines, etc.

are provided through the budget process and are largely **financing sources** other than revenue. **Appropriations** and other budget authority provide an agency with the authority to incur obligations to acquire goods and services or to provide benefits and grants. Budgetary resources are not earned by an entity's operations and have a different character than both exchange revenue and non-exchange revenue.[11] Federal entities report as an asset their fund balance with Treasury, which is the aggregate amount of funds in the entity's accounts with Treasury for which the entity is authorized to make expenditures and pay liabilities. This is an intra-government item. From the perspective of the Government as a whole, it is not an asset. It represents a commitment to make resources available to federal departments, agencies, programs, etc.[12]

24. The budget process provides the principal basis for planning and controlling obligations and outlays by Government entities. Budget execution tracks the flow of budgetary resources from the congressional authorizing and appropriating process, to **apportionment**, **allotment**, and obligation of the budgetary resources, to the outlay of cash to satisfy those obligations. For the most part, obligations and cash, rather than **accrual accounting**, are the bases for budgeting and reporting on budget execution.[13]

25. Accrual accounting is the basis for **proprietary accounting** in the Federal Government. Proprietary accounting and **budgetary accounting** are complementary. Proprietary accounting provides an understanding of the entity's net position and cost of operations during a period. Federal Government financial statements have not been used for planning and control as much as they might be. In part, this is because general purpose financial reports have not presented budget information with the financial statements in a way that helped users relate these two important, but different, types of financial information.[14] The Board's objective in requiring new statements in the CFR addresses this issue.

[11] SFFAS 7, par. 24.

[12] SFFAS 1, par. 31.

[13] SFFAS 7, par. 25.

[14] SFFAS 7, par. 26.

The Government as a Whole Should Provide Information about Net Operating Revenue (or Cost), the Budget Surplus (or Deficit), and Cash

26. The information now required in two new statements serves the basic objectives of federal accounting. Objective 1[15] provides that federal financial reporting should assist in fulfilling the Federal Government's duty to be publicly accountable for the money raised through taxes and other means, and for their expenditure in accordance with the appropriation laws. Sub-objective 1C provides that federal financial reporting should provide information that helps the reader to determine how information on the use of budgetary resources relates to information on the costs of program operations and whether information on the status of budgetary resources is consistent with other accounting information on assets and liabilities.

27. In a new statement of concepts issued contemporaneously with this standard, the Board recognizes that the CFR should be understandable to the average citizen. The new statements required in this standard were designed with this objective in mind.

28. Although budgetary and proprietary accounting information are complementary, both the types of information and the timing of their recognition are different, caused by differences in the basis of accounting.[16]

29. The new statements required by this standard focus on three important elements: (1) the net operating revenue (or cost) from the proprietary accounting system, (2) the unified budget surplus (or deficit), and (3) the change in the Government's cash during the period. The information is presented in two parts: (1) a reconciliation of the net operating revenue (or cost) to the unified budget surplus (or deficit), and (2) a statement of changes in cash balance from budget and other activities.

30. The purpose of the reconciliation information is to report how the proprietary net operating revenue (or cost) and the unified budget surplus (or deficit) relate to each other. The premise of the reconciliation is that the proprietary and budget accounting bases share much data. The reconciliation presents the differences between

[15] SFFAC 1, pars. 112, 119.

[16] SFFAC 7, par. 80.

the two systems as reconciling items while moving from the proprietary amount to the unified budget surplus or deficit.

31. The primary purpose of the statement of changes in cash balance from budget and other activities is to report how the annual unified budget surplus/deficit relates to the change in the Government's cash balance and debt held by the public. It explains why the unified budget surplus or deficit normally would not result in an equivalent change in the Government's cash balance.

32. All of the respondents who addressed the issue agreed that the new information should be required. Most of these respondents offered some comments on one or both of the proposed illustrations.

33. With respect to the terminology used in the statements, several respondents said that the term "budget" was unclear. One respondent noted that the statements use the unified budget concept, i.e., both on- and off-budget activity is included. The respondent noted that there are several other alternatives approaches, including on-budget only, the President's proposed budget, and the enacted budget. Another respondent noted that, in the non-Federal environment, a budget is a plan, but for the illustrative statements it indicates actual results on a budget accounting basis. Also, several respondents objected to the use of the term "budget surplus" as being inaccurate since there is no surplus on hand to finance future activities at the reporting date, as the statement illustrates; and, that the word "surplus" has been eliminated from private sector accounting terminology.

34. The Board has modified the terminology based on these comments. The word "unified" now accompanies "budget surplus or deficit" wherever that phrase is used. In addition, the word "actual" has been added to the budget line items in the statements.

35. With respect to the term "budget surplus," the Board notes that the term is used pervasively in Federal finance and in the popular media. It is defined comprehensively in budget publications. The Board believes that most users of the CFR have at least a working understanding of the term as an excess of the fiscal year's budget receipts over budget outlays. The statement of changes in cash balance from budget and other activities will illustrate how the surplus (or deficit) and other activity affected the Government's cash balance. The glossary for this standard will provide the definition.

36. With respect to the illustrative statement about changes in the cash balance (Appendix C in the exposure draft of March 2002, Versions A and B therein), most respondents who addressed the question preferred Version B. They said that it would be more understandable to the intended users because its groupings and subtotal were more logical.

37. One respondent said the FASAB should provide detailed authoritative guidance regarding the format of the reconciliation and cash statements before requiring them. The respondent was concerned that the reporting requirements are not fully developed, and that the FASAB should not require such information until it develops and prescribes an authoritative format. The Board weighed the benefits of prescribing the format of the statements against the drawbacks of placing constraints on the Treasury Department's future development of the statements. The Board believes that it is better at this time to be flexible so that the most meaningful display can evolve.

38. Another respondent asked the Board to clarify that the new statements would be principal financial statements. Additional wording to this effect has been added to the standard.

39. Several respondents urged the Board to tie the change in cash on the new statement of changes in cash balance to the balance sheet line item and accompanying note disclosure, and/or to include beginning and ending cash balances on the statement. The Board decided that such information would improve the statement and has included it in the illustration in the standard, but does not believe that it is necessary to require it as part of the standard.

40. One respondent said there should be some direct reference to the stewardship information on the balance sheet similar to the reference to the notes because this would inform the reader about important information not included on the balance sheet. Also, this respondent submitted that the term "National Debt" is unclear. Although the Board does not view this standard as a vehicle to address these concerns, it acknowledges the need for additional clarity and user friendliness for the CFR. The Board notes that the Treasury Department continues to improve the CFR, including the presentation of stewardship information.

Implementation Date

41. Several respondents said that the FY 2002 implementation date for the statements would afford insufficient time to prepare the new statements. However, since the Treasury Department was a leader in developing the statements and is able to prepare them in FY 2002, and since no additional information is required from component entities, this should not be an issue.

Appendix B: Illustrative Statement: Reconciliation

(Hypothetical data)		
RECONCILIATION OF NET OPERATING REVENUE (OR COST)		
AND UNIFIED BUDGET SURPLUS (OR DEFICIT)		
for the period ending Sept. 30, 20X2		
(in billions of dollars)		
[Footnotes below would be to notes to the financial statements and are not provided for this illustration.]		
	FY 20X2	FY 20X1
Net operating revenue or (cost)	46.0	(50.0)
Components of net operating revenue (or cost) not part of the of the budget surplus:		
Add excess of accrual-basis expenses over budget outlays:		
Civilian & military employee benefits (Note X1)		
Pensions and retired pay	75.5	74.0
Retiree health benefits	14.6	14.7
Other benefits	4.7	4.6
Subtotal -- civilian & military employee benefits	94.8	93.3
Veteran compensation (Note X1)	62.5	59.0
Environmental clean-up (Note X2)	19.6	18.5
Other benefit programs (Note X3)	4.0	4.5
Other	18.5	17.5
Subtotal -- excess of accrual-basis expenses over budget outlays	199.4	192.8
Add amortized expenses not included in budget outlays:		
Depreciation (Note X7)	15.4	15.0
Add other expenses that are not reported as budget outlays:		
Premiums paid on buyback of Treasury debt (Note X10)	5.5	1.6
Subtract excess of accrual-basis revenue over budget receipts:		
Accrued tax revenue (Note X5)	(0.6)	(0.7)
Other accrued revenue (Note X8)	-	1.0
Subtract other revenue and gains that are not budget receipts:		
Other revenue and gains	(2.3)	(2.2)
Subtotal: components of net operating revenue (cost) not part of budget surplus	217.4	207.5
Components of the budget surplus that are not part of net operating revenue (or cost):		
Add budget receipts not included in net operating revenue (or cost):		
Principal repayments on pre-credit reform loans	24.0	24.5
Decrease in accounts receivable (Note X3)	2.7	3.0
Subtract budget outlays not included in net operating revenue (or cost):		
Acquisition of capital assets (Note X7)	(31.6)	(43.0)
Acquisition of inventory (Note X6)	(11.9)	(12.0)
Acquisition of other assets	(5.4)	(7.0)
Subtotal -- components of the budget surplus that are not part of net operating revenue (or cost)	(22.2)	(34.5)
Other:		
Prior period adjustment (Note X17)	(4.2)	-
Unified budget surplus (deficit) -- actual	237.0	123.0

Appendix C: Illustrative Statement: Statement of Changes in Cash Balance

STATEMENT OF CHANGES IN CASH BALANCE		
FROM UNIFIED BUDGET AND OTHER ACTIVITIES		
for the Years Ended September 30, 20X2 and 20X1		
(in billions of dollars)		
[Hypothetical Data]		
[Footnotes below would be to notes to the financial statements and are not provided for this illustration.]		
	20X2	20X1
CASH FLOW FROM UNIFIED BUDGETED ACTIVITIES		
Total unified budgetary receipts -- actual	2,025.0	1,827.0
Total unified budgetary outlays -- actual	(1,788.0)	(1,703.0)
Unified budget surplus (or deficit) -- actual	237.0	124.0
Adjustments for non-cash outlays included in the unified budget:		
Interest accrued on Treasury debt held by the public	186.0	185.0
Subsidy expense accrued under direct loan & guarantee programs (Note X1)	3.0	4.0
Subtotal - adjustment for non-cash transactions in unified budget	189.0	189.0
CASH FLOW FROM ACTIVITIES NOT INCLUDED IN UNIFIED BUDGET		
Inflows:		
Repayment of principal on direct loans	19.0	15.0
Decrease/(increase) in miscellaneous assets (Note X2)	1.6	(1.6)
Seignorage	2.3	2.2
Outflows:		
Interest paid by Treasury on debt held by the public	(184.4)	(187.8)
New direct loans disbursed	(40.0)	(34.0)
Other direct loan transactions	(0.7)	(1.0)
Premium on buyback of Treasury debt held by the public (Note X3)	(5.5)	-
Default payments on guaranteed loans	(4.3)	(5.0)
Other guaranteed loan transactions	(0.5)	(0.3)
Increase/(decrease) in deposit fund liability balances (Note X4)	(1.2)	0.1
Increase/(decrease) in miscellaneous liabilities (Note X4)	(0.9)	0.5
Cash flow from non-budget activities	(214.6)	(211.9)
Cash Flow from Monetary Transactions		
Decrease in reserve position in the IMF (Note X5)	6.3	1.2
Decrease in loans to the IMF	-	0.5
Increase in special drawing rights (Note X5)	(4.0)	(2.2)
(Increase)/decrease in other monetary assets (Note X5)	(0.9)	0.4
Cash flow from monetary transactions	1.4	(0.1)
Cash Flow from Financing		
Borrowing from the public (Note X6)	2,010.8	2,002.0
Repayment of debt held by the public (Note X6)	(2,233.5)	(2,090.0)
Cash flow from financing	(222.7)	(88.0)
Increase (decrease) in cash balance	(9.9)	13.0
Beginning cash balance (Note X7)	52.7	39.7
Ending cash balance (Note X7)	42.8	52.7

Appendix D: Statement Of Budgetary Resources (from OMB Bulletin 01- 09, September 25, 2001)

APPENDIX D: STATEMENT OF BUDGETARY RESOURCES (***from OMB Bulletin 01- 09, September 25, 2001)***

Department/Agency/Reporting Entity
COMBINED STATEMENT OF BUDGETARY RESOURCES (page 1 of 2)
For the Years Ended September 30, 20x2 and 20x1
(in dollars/millions)

	20x2 Budgetary	20x2 Non-Budgetary Credit Program Financing Accounts	20x1 Budgetary	20x1 Non-Budgetary Credit Program Financing Accounts
Budgetary Resources:				
1. Budget authority:				
1a. Appropriations received	$ xxx	$ xxx	$ xxx	$ xxx
1b. Borrowing authority	xxx	xxx	xxx	xxx
1c. Contract authority	xxx	xxx	xxx	xxx
1d. Net transfers (+/-)	xxx	xxx	xxx	xxx
1e. Other	xxx	xxx	xxx	xxx
2. Unobligated balance:				
2a. Beginning of period	xxx	xxx	xxx	xxx
2b. Net transfers, actual (+/-)	xxx	xxx	xxx	xxx
2c. Anticipated Transfers balances	xxx	xxx	xxx	xxx
3. Spending authority from offsetting collections:				
3a. Earned				
1. Collected	xxx	xxx	xxx	xxx
2. Receivable from Federal sources	xxx	xxx	xxx	xxx
3b. Change in unfilled customer orders				
1. Advance received	xxx	xxx	xxx	xxx
2. Without advance from Federal sources	xxx	xxx	xxx	xxx
3c. Anticipated for rest of year, without advances	xxx	xxx	xxx	xxx
3d. Transfers from trust funds	xxx	xxx	xxx	xxx
3e. Subtotal	xxx	xxx	xxx	xxx
4. Recoveries of prior year obligations	xxx	xxx	xxx	xxx
5. Temporarily not available pursuant to Public Law	xxx	xxx	xxx	xxx
6. Permanently not available	xxx	xxx	xxx	xxx
7. Total Budgetary Resources	$ x,xxx	$ x,xxx	$ x,xxx	$ x,xxx

Department/Agency/Reporting Entity
COMBINED STATEMENT OF BUDGETARY RESOURCES (page 2 of 2)
For the Years Ended September 30, 20x2 and 20x1
(in dollars /millions)

	20x2 Budgetary	20x2 Non-Budgetary Credit Program Financing Accounts	20x1 Budgetary	20x1 Non-Budgetary Credit Program Financing Accounts
Status of Budgetary Resources:				
8. Obligations incurred:				
8a. Direct	$ xxx	$ xxx	$ xxx	$ xxx
8b. Reimbursable	xxx	xxx	xxx	xxx
8c. Subtotal	xxx	xxx	xxx	xxx
9. Unobligated balance:				
9a. Apportioned	xxx	xxx	xxx	xxx
9b. Exempt from apportionment	xxx	xxx	xxx	xxx
9c. Other available	xxx	xxx	xxx	xxx
10. Unobligated balance not available	xxx	xxx	xxx	xxx
11. Total Status of Budgetary Resources	x,xxx	x,xxx	x,xxx	x,xxx
Relationship of Obligations to Outlays:				
12. Obligated balance, net, beginning of period	xxx	xxx	xxx	xxx
13. Obligated balance transferred, net (+/-)	xxx	xxx	xxx	xxx
14. Obligated balance, net, end of period:				
14a. Accounts receivable	xxx	xxx	xxx	xxx
14b. Unfilled customer orders from Federal sources	xxx	xxx	xxx	xxx
14c. Undelivered orders	xxx	xxx	xxx	xxx
14d. Accounts payable	xxx	xxx	xxx	xxx
15. Outlays:				
15a. Disbursements	xxx	xxx	xxx	xxx
15b. Collections	xxx	xxx	xxx	xxx
15c. Subtotal	xxx	xxx	xxx	xxx
16. Less: Offsetting receipts	xxx	xxx	xxx	xxx
17. Net Outlays	$ x,xxx	$ x,xxx	$ x,xxx	$ x,xxx

Appendix E: Statement Of Financing (from OMB Bulleting 01-09,September 25, 2001)

APPENDIX E: STATEMENT OF FINANCING ***(from OMB Bulleting 01-09, September 25, 2001)***

Department/Agency/Reporting Entity
CONSOLIDATED STATEMENT OF FINANCING (Page 1 of 2)
For the Years Ended September 30, 20x2 and 20x1
(in dollars /millions)

	20x2	20x1
Resources Used to Finance Activities:		
Budgetary Resources Obligated		
1. Obligations incurred	$ xxx	$ xxx
2. Less: Spending authority from offsetting collections and recoveries	xxx	xxx
3. Obligations net of offsetting collections and recoveries	xxx	xxx
4. Less: Offsetting receipts	xxx	xxx
5. Net obligations	xxx	xxx
Other Resources		
6. Donations and forfeitures of property	xxx	xxx
7. Transfers in/out without reimbursement (+/-)	xxx	xxx
8. Imputed financing from costs absorbed by others	xxx	xxx
9. Other (+/-)	xxx	xxx
10. Net other resources used to finance activities	xxx	xxx
11. *Total resources used to finance activities*	x,xxx	x,xxx
Resources Used to Finance Items not Part of the Net Cost of Operations		
12. Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided (+/-)	xxx	xxx
13. Resources that fund expenses recognized in prior periods	xxx	xxx
14 .Budgetary offsetting collections and receipts that do not affect net cost of operations		
14a. Credit program collections which increase liabilities for loan guarantees or allowances for subsidy	xxx	xxx
14b. Other	xxx	xxx
15. Resources that finance the acquisition of assets	xxx	xxx
16. Other resources or adjustments to net obligated resources that do not affect net cost of operations (+/-)	xxx	xxx
17. *Total resources used to finance items not part of the net cost of operations*	xxx	xxx
18. *Total resources used to finance the net cost of operations*	x,xxx	x,xxx

Department/Agency/Reporting Entity
CONSOLIDATED STATEMENT OF FINANCING (Page 2 of 2)
For the Years Ended September 30, 20x2 and 20x1
(in dollars /millions)

	20x2	20x1
Components of the Net Cost of Operations that will not Require or Generate Resources in the *Current Period:*		
Components Requiring or Generating Resources in Future Periods:		
19. Increase in annual leave liability	xxx	xxx
20. Increase in environmental and disposal liability	xxx	xxx
21. Upward/Downward reestimates of credit subsidy expense (+/-)	xxx	xxx
22. Increase in exchange revenue receivable from the public	xxx	xxx
23. Other (+/-)	xxx	xxx
24. Total components of Net Cost of Operations that will require or generate resources in future periods	xxx	xxx
Components not Requiring or Generating Resources:		
25. Depreciation and amortization	xxx	xxx
26. Revaluation of assets or liabilities (+/-)	xxx	xxx
27. Other (+/-)	xxx	xxx
28. Total components of Net Cost of Operations that will not require or generate resources	xxx	xxx
29. *Total components of net cost of operations that will not require or generate resources in the current period*	x,xxx	x,xxx
30. *Net Cost of Operations*	x,xxx	$ x,xxx

Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273.

Statement of Federal Financial Accounting Standards No. 25: Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment

Status

Issued	July 2003
Effective Date	Reclassifies "Risk Assumed" information and eliminates the "Current Services Assessment" for reporting periods that begin after September 30, 2002. Reclassifies the "Statement of Social Insurance" and other information about social insurance for reporting periods that begin after September 30, 2004.
Volume I References	SFFAS 5, Accounting for Liabilities of the Federal Government, SFFAS 8, Supplementary Stewardship Reporting, and SFFAS 17, Accounting for Social Insurance.
Volume II References	Current Services Assessment (C80), Social Insurance (S40), Risk Assumed (I40)
Interpretations and Technical Releases	None
Affects	• SFFAS No. 5, summary, paragraph 106, paragraph 186, paragraph 190 • SFFAS No. 8 summary, paragraph 14-16; appendix B • SFFAS No. 17 summary, paragraph 27 (3), paragraph 32(3)
Affected by	None

Summary

This Statement of Federal Financial Accounting Standards (SFFAS) changes the classification of information about stewardship responsibilities required by federal accounting standards. It also eliminates the requirement to present certain information about stewardship responsibilities, known as the "Current Services Assessment," previously required by SFFAS 8.

Scope of this Statement

This Statement deals with

- **Risk Assumed** information required by SFFAS 5, *Accounting for Liabilities of the Federal Government*
- The **Current Services Assessment** (CSA) required by SFFAS 8, *Supplementary Stewardship Reporting*, and
- **Social Insurance** information required by SFFAS 17, *Accounting for Social Insurance*.

Information about stewardship responsibilities is currently designated Required Supplementary Stewardship Information (RSSI), a category unique to federal financial reporting. Pursuant to this SFFAS, information about Risk Assumed will become required supplementary information (RSI). The Statement of Social Insurance (SOSI) will become a basic financial statement, while the remaining information about Social

Insurance required by SFFAS 17 will be reported as RSI except for information the preparer elects to report in notes.

Reasons for Issuing this Statement

For reasons explained in Appendix A, the Board decided to review the classification of all RSSI required by federal accounting standards. The Board eliminated use of RSSI to report information about weapons systems when it issued SFFAS 23, Eliminating the Category "National Defense Property, Plant, and Equipment." Classification of other items of information currently designated RSSI (stewardship land, stewardship investments, and heritage assets) may be dealt with in one or more future exposure drafts. The Board also decided to eliminate the requirement to present the CSA now, because timely issuance of federal financial reports, a practice that was not possible when SFFAS 8 was published, will make it infeasible to present the CSA in the Government's annual financial report. The same information will, however, continue to be publicly available in the Budget of the United States Government.

How the Changes in this Statement Improve Federal Financial Reporting

These changes will improve the clarity and significance of federal financial reporting in two ways: (1) by defining the SOSI as essential to fair presentation and (2) by using reporting categories that are well defined in existing professional literature and familiar to report users.

The Effective Date

The requirement to report the CSA will be eliminated effective for reporting periods beginning after September 30, 2002. Information about Risk Assumed shall be presented as RSI for reporting periods beginning after September 30, 2002. The information required by paragraphs 27(3) and 32(3) of SFFAS 17 shall be presented as a basic financial statement rather than as RSSI for periods beginning after September 30, 2004, with earlier implementation encouraged. Other information required by SFFAS 17 shall be presented as RSI rather than as RSSI, except to the extent that the preparer elects to include some or all of that information in notes that are presented as an integral part of the basic financial statements, for periods beginning after September 30, 2004.

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Abbreviations

AGA	Association of Government Accountants
AICPA	American Institute of Certified Public Accountants
AT	Attestation Standards codified and published by AICPA
AU	Audit Standards codified and published by AICPA
CBO	Congressional Budget Office
CFR	Consolidated Financial Report of the U.S. Government (formerly the "CFS")
CMS	Centers for Medicare and Medicaid Services (formerly HCFA)
CSA	Current Services Assessment
FASAB	Federal Accounting Standards Advisory Board
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GAO	General Accounting Office
GASB	Governmental Accounting Standards Board
OAI	Other Accompanying Information (also known as "other supplementary information" – i.e., supplementary information not required by GAAP)
OMB	Office of Management and Budget
PCIE	President's Council on Integrity and Efficiency (Inspectors General)
RSI	Required Supplementary Information (as used in SFAS 25 and other accounting standards and in AU Section 558)
RSSI	Required Supplementary Stewardship Information (as used in SFFAS 5, 8 and 17)
SFAC	Statement of Financial Accounting Concepts
SFFAC	Statement of Federal Financial Accounting Concepts
SFAS	Statement of Financial Accounting Standards
SFFAS	Statement of Federal Financial Accounting Standards
SSA	Social Security Administration

Introduction

1. Federal accounting standards require the following information to be reported regarding stewardship responsibilities:

- **Risk Assumed** information required by SFFAS 5, *Accounting for Liabilities of the Federal Government*,
- The **Current Services Assessment** (CSA) required by SFFAS 8, *Supplementary Stewardship Reporting*, and
- **Social Insurance** information required by SFFAS 17, *Accounting for Social Insurance.*

2. This information is currently designated Required Supplementary Stewardship Information (RSSI). RSSI is a reporting category unique to federal accounting. Pursuant to this Statement, Risk Assumed information will become required supplementary information (RSI)[1], and the CSA will not be required after FY 2002. For FY 2005 the Statement of Social insurance (SOSI) will become a basic financial statement, essential for fair presentation in conformity with generally accepted accounting principles (GAAP). Other Social Insurance information required by SFFAS 17 shall be presented as RSI rather than as RSSI, except to the extent that the preparer elects to include some or all of that information in notes that are presented as an integral part of the basic financial statements. Appendix A presents background information and the reasons for these changes.

3. This Statement amends SFFAS 5 and SFFAS 17 by reclassifying Risk Assumed information and Social Insurance information. Those standards would remain unchanged in all other respects. The requirement in SFFAS 8 to report the CSA is rescinded.

[1] RSI was added to the accounting literature by Statement of Financial Accounting Standards (SFAS) 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies*, published by the Financial Accounting Standards Board (FASB) in 1979. That Statement has been amended, but the RSI category continues to be used in a variety of standards published by the FASB, the Governmental Accounting Standards Board (GASB), and the FASAB. The auditor's responsibility for RSI is discussed in section AU 558 of the codification of professional auditing standards published by AICPA.

Standards of Federal Financial Accounting

Risk Assumed

4. Information about Risk Assumed, required by SFFAS 5 and previously designated required supplementary stewardship information (RSSI), shall be designated required supplementary information (RSI).

Current Services Assessment

5. Chapter 8 and paragraphs 14-16 of SFFAS 8 are rescinded, as is the associated illustration of the Current Services Assessment in Appendix B of SFFAS 8.

Social Insurance

6. The information required by paragraphs 27(3) and 32(3) of SFFAS 17 shall be presented as a basic financial statement rather than as required supplementary stewardship information (RSSI). Other information required by SFFAS 17 shall be presented as RSI, except to the extent that the preparer elects to include some or all of that information in notes that are presented as an integral part of the basic financial statements,

Effective Date

7. Chapter 8 and paragraphs 14-16 of SFFAS 8 are rescinded, as is the associated illustration of the Current Services Assessment in Appendix B of SFFAS 8, effective for reporting periods beginning after September 30, 2002. Information about Risk Assumed shall be presented as RSI for reporting periods beginning after September 30, 2002. The information required by paragraphs 27(3) and 32(3) of SFFAS 17 shall be presented as a basic financial statement for periods beginning after September 30, 2004, with earlier implementation encouraged. Other information required by SFFAS 17 shall be presented as RSI, except to the extent that the preparer elects to include some or all of that information in notes that are presented as an integral part of the basic financial statements, for periods beginning after September 30, 2004.

The provisions of this statement need not be applied to immaterial items.

Appendix A: Basis for Conclusions

This appendix summarizes the considerations deemed significant by the Board in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background

8. In SFFAS 8, FASAB stated:

> A key aspect of the stewardship objective requires that Federal reporting provide information that helps users determine (1) whether the Government's financial condition improved or deteriorated over the period and (2) whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due.
>
> Information on 'stewardship responsibilities' will aid in these determinations. It will provide an essential perspective on the Government's commitment to discretionary and mandatory programs.[2]

These objectives have not changed. However, for reasons discussed below, the Board believes that information about stewardship responsibilities should be reported in the context of the basic financial statements, the associated notes,[3] and required supplementary information, rather than as RSSI. The Board eliminated use of RSSI to report information about weapons systems when it issued SFFAS 23, *Eliminating the Category "National Defense Property, Plant, and Equipment."* The Board will consider in other projects the proper classification of other items that are now classified as RSSI.

9. The Board originally contemplated that GAO and OMB would provide special guidance regarding the audit procedures or "fieldwork" to be performed on RSSI. At the same time, the Board expected that the auditor would report on this information in much the same way as on the basic financial statements, in the sense that the auditor would qualify or disclaim an opinion when the RSSI was omitted or

[2] SFFAS 8, paragraphs 14 and 15.

[3] The notes are regarded as an integral part of the basic financial statements, essential for fair presentation in conformity with GAAP.

materially misstated. The category was seen as a response to the unique aspects of the federal accounting and reporting environment, and to the broad objectives of federal financial reporting. It was intended to permit flexibility on the part of preparers and auditors that would facilitate reporting relevant, reliable information, including nonfinancial and nonhistorical information.[4]

10. Some members became concerned that users: (1) may pay insufficient attention to some important information because it is called "supplementary," and (2) may be confused by complicated reports in which information is reported in various places. They believed this might impede users' understanding and reduce the credibility of federal financial reports. Some members believed that FASAB's use of the RSSI category invites suspicion of accounting in which items that are as important as the basic financial statements are labeled "supplementary." Accordingly, in *Preliminary Views on Eliminating the Category "Required Supplementary Stewardship Information"* (December 2000), the Board proposed to eliminate the RSSI category by reviewing and reconsidering the appropriate classification of each item classified as RSSI.

11. In deciding to review the classification of components of RSSI, some members were influenced by the fact that existing audit standards do not discuss RSSI. Therefore, auditors do not know what to do with respect to information in this category without consulting federal publications that provide additional guidance on how to conduct or contract for audits of federal financial statements. Furthermore, as practice evolved, it was not clear that auditors would qualify or disclaim their opinion on the basic financial statements when RSSI was missing or misstated, because it was not clear to everyone that the information was essential to fair presentation in conformity with GAAP. Some FASAB members were concerned that, under these circumstances, even sophisticated users might not understand fully the significance of certain information classified as RSSI. Some members believed that it would be desirable for FASAB to use categories that are widely understood by the broader accounting and

[4]See the *Implementation Guide to Statement of Federal Financial Accounting Standards No. 7: Accounting for Revenue and Other Financing Sources*, June 1996, paragraphs 22-24, the diagram on page 15, and minutes of associated Board discussions. See also SFFAS 8, *Supplementary Stewardship Reporting*, June 1996, paragraphs 21, 34, 111-115, and minutes of associated Board discussions.

auditing professions, particularly now that FASAB has been recognized by AICPA as the body that promulgates generally accepted accounting principles for the federal government.

12. The Board received 29 written comments on its December 2000 *Preliminary Views* from the following sources:

- 16 preparers (all federal),
- 8 auditors (three nonfederal, including AICPA),
- 5 others. (This category includes academics, retired federal employees, and the Association of Government Accountants (AGA), a professional association of federal and nonfederal accountants and auditors.)

13. The comments reflected the views of more than 29 people. Comments from the President's Council on Integrity and Efficiency (PCIE), AGA, federal agencies, and AICPA were the work of numerous individuals. Twenty of the respondents would have retained the RSSI category, at least for some period. Some typical concerns expressed include the following:

- Elimination of the category would provide less stewardship information to users, lead to a qualified opinion that would send a less-clear signal to users than is available with current and potential alternatives, and raise audit costs. The category provides a clear and unique method to prominently display stewardship information essential to meeting taxpayer accountability. The category has been successful in communicating our financial condition.
- The separate category and section of the report is an effective and practical means of reporting. It is appropriate for the unique environment and objectives of federal financial reporting. Approaches to providing audit assurance over RSSI are evolving. FASAB should work with specialists in the relevant disciplines to define common units of reporting for items not expressed in monetary terms.
- Unique aspects of the federal financial reporting environment and objectives led the Board to create the new category. If used properly, the category should be a mechanism to provide much-needed information to decision makers, including citizens, when they consider the consequences of decisions relating to public lands, heritage assets, and similar items.

14. In April 2001 the Board held a public hearing to discuss the *Preliminary Views* proposal with interested parties. Fourteen individuals, representing seven organizations, made presentations and discussed issues with the Board. Comments were similar to those expressed in the 29 comment letters.

15. After considering these comments, the Board continued to believe that federal accounting standards may be able to address the objectives of federal financial reporting, including accountability and reporting on stewardship, without a unique category. The Board noted that eliminating the RSSI category need not result in a reduction of information required by existing standards. (The Board subsequently decided to rescind the requirement to present the CSA in the annual consolidated financial report of the U.S. Government (CFR) for other reasons, which are explained on page, but the information will continue to be available to the public). Furthermore, the Board noted, preparers will continue to have the option of voluntarily presenting supplementary information beyond what is required. This "other accompanying information" would be unaudited, unless special arrangements were made to extend the auditor's work in the context of a particular audit.

16. The Board continued to believe that avoiding use of the RSSI category where it is not essential would eliminate some potential confusion and ambiguity. In particular, it should clarify the Board's expectation that when material information that is essential to fair presentation is missing or materially misstated, the auditor should consider whether a qualified or adverse opinion is appropriate regarding whether the basic financial statements are prepared in conformity with GAAP. After consultation with AICPA staff, the Board concluded that this result could best be assured by designating such information as an integral part of the basic financial statements.

17. Accordingly, in February 2002, the Board published an exposure draft entitled *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*. The exposure draft proposed to eliminate the Current Services Assessment, reclassify information about Risk Assumed as RSI, and reclassify all Social Insurance information as an integral part of the basic financial statements. The Board received 22 comment letters from the following sources:

- 11 preparers (all federal),
- 7 auditors (6 federal and AICPA),
- 4 others. (This category includes an academic, two former Board members, and the AGA.)

18. Some letters reflected the views of an organization, while others were from individuals. Comments generally supported or did not oppose eliminating the CSA and reclassifying Risk Assumed information as RSI. Some letters did express concern about the feasibility of auditing Social Insurance information as an integral part of the basic financial statements and/or questioned whether the benefit of doing so would outweigh the cost. In response to these concerns, the Board consulted with representatives of AICPA, and decided (1) to designate only the SOSI as a basic financial statement, while classifying other Social Insurance information as RSI, and (2) to extend the time allowed to implement this change. More detailed explanation of the basis for the Board's conclusions follows.

Conclusions Regarding Each Type of Stewardship Responsibility Information

19. Figure 2 on page 1056 presents a list of general factors that one or more Board members considered relevant for the classification choices. Specific decisions on each of the three types of stewardship responsibility information are discussed in the remainder of this Appendix.

Risk Assumed

20. The Board agreed that information about Risk Assumed should be RSI rather than an integral part of the basic financial statements, because the amounts are not sufficiently reliable and measurement methods are still experimental. This information is potentially valuable, but it is not yet a suitable basis for recognition or disclosure.[5] The Office of Management and Budget (OMB), the General Accounting Office (GAO), and the Congressional Budget Office (CBO) have considered

[5] FASAB uses the term "disclosure" to refer to information that is not recognized on the face of the basic financial statements but is regarded as an integral part of the basic financial statements, essential for fair presentation in conformity with generally accepted accounting principles (GAAP). Normally such disclosures are presented in footnotes, but federal accounting standards published by FASAB do not currently prescribe the format for presentation of such disclosures. GAAP does not prohibit formatting or combining pieces of information in appropriate ways to direct the reader's attention, provided that the results are not misleading.

the use of Risk Assumed information as a basis for budgeting for insurance programs. These agencies have concluded that more experience is needed before the measurements can be regarded as sufficiently reliable for budgeting. Similar considerations lead the FASAB to conclude that information about Risk Assumed should be included in financial reports as RSI, at least until agencies and auditors have more experience with this information.

21. The Board believes that analogies with insurance offered by private insurers, (where, for example, an expected premium deficiency on long-duration contracts such as life insurance is recognized), may be misleading due to differences in the length of the policy coverage, nature of insured risk, or other relevant variables. The Board believes that additional guidance from FASAB on definition and measurement of "Risk Assumed" would be necessary before it would be feasible to require recognition or disclosure of this information as an integral part of the basic financial statements. Developing and promulgating such guidance would require a separate project. Before the Board undertakes such a project, it is desirable to encourage continued improvement in agencies' data systems and modeling capabilities to support reporting Risk Assumed. The RSI requirement has the effect of providing this encouragement in an appropriate, cost-beneficial manner. The Board notes that the "state of the art" for such projections is constantly evolving. Should the Board in the future decide that it would be desirable to develop more specific criteria for reporting Risk Assumed, the Board will be able to learn from this ongoing experience.

Current Services Assessment (CSA)

22. The CSA provides receipt and outlay data on the basis of the President's projections of future activities pursuant to current law. It is relevant for assessing the sustainability of programs established by current law; that is, relevant for assessing the sufficiency of future resources to sustain public services and to meet obligations as they come due. The CSA focuses on the totality of government operations rather than on individual programs. It provides an analytical perspective on the Government because it shows the short- and long-term direction of current programs.

23. SFFAS 8 defines the CSA by reference to what is published in the President's Budget. The Board did not then foresee the possibility that the CFR would be published before the Budget. Because the Board now expects that within a few years the CFR will be published before

the President's Budget is available, the requirement to include the CSA in the CFR will expire in FY 2002 (i.e., the CSA will not be required in the CFR after FY 2002). In order to continue to require something comparable to the CSA as part of the CFR when the CFR is published before the Budget, federal accounting standards would need to define the CSA in some way other than by reference to the Budget. Developing the criteria for such a projection is beyond the scope of this project.

24. The Board considered the alternative of including OMB's current services estimates prepared for the "midsession review." The Board concluded that certain technical problems would make this alternative problematic. Furthermore, supplementary reporting on this basis would not add value, because the estimates are publicly available in any event, and because the base year actual data published in the budget would not be subject to review by the auditor.

25. The Board notes that OMB, CBO, and others regularly publish similar projections; therefore, similar information will continue to be available, regardless of whether it is required to be part of the CFR. The Board also notes that the "state of the art" for such projections is constantly evolving. Should the Board in the future decide that it would be desirable to develop criteria for such a projection as a part of federal financial reporting, the Board will be able to learn from this ongoing experience.

Social Insurance

26. The Board believes that the SOSI should be treated as a basic financial statement because it is essential to fair presentation and is important to achieve the objectives of federal financial reporting. The related stewardship objectives include helping users to assess the impact on the country of the Government's activities, determine whether the Government's financial position improved or deteriorated over the period, and predict whether future budgetary resources will likely be sufficient to sustain public services and meet obligations as they come due. In that regard, the multi-trillion dollar obligations associated with Social Insurance over the next 75 years could significantly exceed the largest liabilities currently recognized in the U.S. Government Balance Sheet.

27. The Board acknowledges that there is great uncertainty inherent in long term projections, but believes that if the uncertainty is suitably

disclosed--as is required by SFFAS 17--it need not preclude designating the information as a basic financial statement, essential for fair presentation in conformity with GAAP. The Board rejects the idea that information based on projections cannot be an integral part of the basic financial statements. FASAB has not limited the content of federal financial statements to historical information.

28. Even within the context of historical financial reporting, the Board notes that accrual-basis "historical" financial statements include many measurements that involve assumptions about the future. The distinction between reporting on the financial effects of events that have occurred and the effects of future events depends, obviously, upon the definition of the event. The information required by SFFAS 17 reports on the financial effects of existing law and demographic conditions and assumptions, just as the pension obligation at a point in time is based on existing conditions. In that sense, Social Insurance information can be viewed as reflecting events that have occurred and, therefore, as "historical."

29. Measuring the future effects of existing law and conditions for Social Insurance involves projections of economic and demographic trends, just as measuring the pension benefit obligation at a point in time involves assumptions about future salary progression. It is true that SFFAS 5 specifies a different measurement method for pensions and retiree healthcare than the method SFFAS 17 specifies for Social Insurance. It is also true that Social Insurance measurements are more sensitive to assumptions about the most distant years of the projection period. Nevertheless, the Board believes that it is appropriate to report the SOSI as a basic financial statement, essential for fair presentation in conformity with GAAP.

30. Classifying the SOSI as a basic financial statement will mean that auditors will consider a modification of their opinion if this information is materially misstated. A modification would send a clear and appropriate signal to users in such a circumstance. The Board understands that some added audit expense will be incurred as a result of this change in status for Social Insurance information, and added demands may be made on the accounting and actuarial staff of agencies that report Social Insurance information. The Board believes that the benefits in this case outweigh the expense. The SOSI is important to those who would understand the Government's financial

condition and its impact on the financial condition of individual citizens, interesting to the public, and essential to fair presentation.

31. The exposure draft proposed to reclassify all Social Insurance information as an integral part of the basic financial statements. In response to concerns expressed about the cost and feasibility of auditing this information, the Board decided to define only the SOSI as a basic financial statement, and provided additional time for implementation. The impact of the change in audit status for the SOSI should be mitigated by the fact that preparers and users have experience with similar information. Also, much of the actuarial and audit work can be done before the end of the fiscal year, if the preparer and auditor prefer. SFFAS 17 provides for considerable flexibility in selecting the measurement date. Paragraph 26 of SFFAS 17 states:

> All projections and estimates required in these standards should be made as of a date (the valuation date) as close to the end of the fiscal year being reported upon ("current year") as possible and no more than one year prior to the end of the current year. This valuation date should be consistently followed from year to year.

Conclusions Regarding Effective Date

32. The standard eliminates the requirement to present the CSA, and does not change the definition, presentation guidelines, or audit status for Risk Assumed information. (RSSI is currently treated as RSI for audit purposes, pursuant to instructions in OMB's *Audit Bulletin*.) No delay is needed as a result of the changes regarding these two items. Accordingly, these changes are effective immediately.

33. Audit status for the SOSI would change; however, as noted above, the information is not new. Most of the relevant agencies have produced similar information for several years, and analysts and public officials have routinely used this information. Also, the impact of the audit requirement on the auditor and preparer should be reduced by the flexibility SFFAS 17 provides in selecting a measurement date for Social Insurance. The Board consulted with AICPA regarding the time needed to develop appropriate audit guidance. The Board also noted that federal agencies will be confronted with a challenging requirement for accelerated financial reporting in FY 2004. As a result, the Board concluded that the SOSI should be presented as a basic

financial statement for reporting periods that begin after September 30, 2004, with earlier implementation encouraged.

Distinguishing RSI from the Basic Financial Statements and Associated Notes

34. To help readers understand the Board's deliberations, this section provides more details about some practical and conceptual factors that affected the Board's decision whether to designate an item as RSI or as an integral part of the basic financial statements. The basic financial statements include the principal financial statements and associated notes on which the auditor expresses an opinion as to whether the information is presented in conformity with GAAP. The terms "basic financial statements" and "principal financial statements" have been used synonymously in federal accounting.

35. FASB tends to use the term "basic financial statements" or simply "financial statements" consistent with the definition in FASB Concepts Statement 5, *Recognition and Measurement in Financial Statements of Business Enterprises*:

> . . . a financial statement is a formal tabulation of names and amounts of money derived from accounting records that displays either financial position of an entity at a moment in time or one or more kinds of changes in financial position of the entity during a period of time. Items that are recognized in financial statements are financial representations of certain resources (assets) of an entity, claims to those resources (liabilities and owners' equity), and the effects of transactions and other events and circumstances that result in changes in those resources and claims. The financial statements of an entity are a fundamentally related set that articulate with each other and derive from the same underlying data. (SFAC 5, paragraph 5, footnote omitted.)

AICPA tends to use the term "basic financial statements" or simply "financial statements" also to encompass footnotes that are regarded as an integral part of the basic financial statements as defined in SFAC 5. Depending on the context, FASAB may use the term either way. The following discussion focuses on the distinction between information on which the auditor expresses an opinion (whether reported on the face of the basic statements or in the notes to the statements) and supplementary information that is also required by GAAP.

Operational Differences Between the Basic Financial Statements and RSI

36. Figure 1 (on page 1042) identifies some operational differences under current auditing standards. Given these operational differences between basic financial statements and RSI, the Board must determine whether it would be more appropriate for a given item of required

information to be deemed an integral part of the basic financial statements or RSI. The appropriateness depends on the particular benefits (based on various federal financial reporting objectives) and the costs (preparing, auditing, user processing, other) of making it subject to audit (vs. more limited procedures) and varying the potential audit opinion treatment (qualification vs. mere mention in the auditor's report).

Figure 1

Comparison Dimension	Basic Financial Statements	RSI
Is the information required to be in the financial **report**? (That is, it is either an integral part of the basic financial statements or it must accompany them.)	Yes	Usually[a]
Is the information deemed essential if the financial **statements** are to "present fairly" in conformity with GAAP?	Yes	No
What audit fieldwork is required?	Audit	Limited procedures pursuant to AU 558
Auditor's report	Positive assurance regarding "fair presentation"	Silent, no explicit assurance unless engaged to audit the RSI. However, if the RSI is financial information that has been subjected to audit procedures in connection with auditing the basic financial statements, the auditor may express assurance "in relation to the financial statements taken as a whole."
What audit report mention is required if the information is missing or not prepared in conformity with guidelines?	Qualified or adverse opinion	Mention in report; no qualification of opinion on the basic financial statements.

[a]In some cases, RSI need not physically accompany the basic financial statements in the same document; certain GASB standards permit reference to another publicly-available report as an option for specified RSI.

37. It should be noted that the value of information to users and the value added by auditing it are separate, though certainly related, considerations. For example, some information may be valuable to some users, yet auditing it might add little value. On the other hand, some information (e.g., aggregated financial information for a federal agency as a whole) may not be used directly by decision makers as input to a particular "decision model," but auditing it might provide some degree of valuable assurance about other information (e.g., detailed program cost or budgetary expenditure information) or objectives of interest (e.g., internal accounting control and finance-related legal compliance). Auditing financial statements may also deter fraud and unintentional errors of various sorts in other, more timely reports.

Footnote vs. RSI Section

38. Although not required by auditing standards, RSI has customarily been located in a separate section of the financial report, to aid in distinguishing it from audited information.[6] This practice has continued with RSSI, evidently in part because federal preparers thought it was necessary, or at least desirable, to report "stewardship" items together. It is possible that placement of information in different sections of the financial report leads some types of readers to pay more (or less) attention to the information. Although the magnitude of these differences is an open question, research has shown that formatting can matter to individual users.

Audit Aspects of Basic vs. RSI

39. Both footnote disclosures and required supplementary information are viewed as being sufficiently relevant to be required to accompany the basic financial statements in financial reports,[7] though only the notes are regarded as required for fair presentation in conformity with

[6] AU 558.10 states: "Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the FASB, GASB, or FASAB. However, management may choose not to place the required supplementary information outside the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information."

In practice, notes and RSI generally have not been commingled. Indeed, in discussing the location of RSI it requires, FASB said, "Reporting specialized information on oil and gas producing activities in a single location within a financial report is a desired objective of this Statement so as to make the relationship among the different types of information easier to analyze." (FAS 69, par. 117)

In theory, RSI might be integrated with related audited information, provided the unaudited information was suitably labeled. Whether this would be feasible and desirable in practice may be debatable. Concern on the part of independent CPAs about litigation risk has been among the factors that encouraged physical separation of audited information from unaudited information.

Another practical consideration may be introduced by recent guidance from AICPA intended to clarify the auditor's ability to offer some limited assurance "in relation to the financial statements" on certain RSI. This could imply a need to distinguish the RSI for which such assurance is offered from other types of supplementary information, both required and voluntary.

Some comments regarding FASAB's *Preliminary Views on Eliminating the Category "Required Supplementary Stewardship Information"* suggested that some people believe there are conceptual as well as practical reasons to report different kinds of information separately.

GAAP. As discussed previously, one major difference between the two types of information is the extent and nature of the auditor's scrutiny and responsibility for the information; another is the nature of the auditor's report and the kind of "signal" it sends. Thus, the cost and value added by audit are factors to consider. The main question is: for what types of information, users, and objectives would the benefits of making an item an integral part of the basic financial statements instead of RSI exceed the incremental costs of audit, compared with reviewing pursuant to AU 558's limited procedures?

Factors to Consider

40. In deciding whether a given item should be classified as RSI or as an integral part of the basic financial statements, one might consider a variety of factors, such as those listed in figure 2. They are not listed in any particular order, and some "overlap" or convey similar ideas. Different people assign different weight to each factor. Some people may not consider some of the factors at all, and some people may consider factors that are not listed. Likewise, different people may evaluate each item to be reported differently on each dimension. Therefore, figure 2 is not a decision tree, hierarchy, or precise algorithm for classifying items, but a general framework for each individual's judgment.

[7] As noted, certain GASB standards permit reference to another publicly-available report as an option for specified RSI.

Figure 2

-Low (implies RSI) < < < < < < < < < < < < < < > > > > > > > > > > > > > **+High (implies basic**)

<Relevance to fair presentation>

< Connection with elements of financial reporting >

< Use of historical financial data or financial transaction data >

<Preparers' discretion in preparing and presenting the information>

< Strength of signal Board wishes to be sent in the financial report >

< Significance, relevance or importance of the item in light of *Objectives* >

< Strength of the signal the Board wishes to be sent in the auditor's report >

< Relevance to measuring financial position or changes in financial position >

<Extent to which the information interests a wide audience (rather than specialists)>

<Extent to which there are not alternative sources of reliable information>

< Agreement on criteria that permit comparable and consistent reporting >

< Experience among users, preparers, and auditors with the information >

<Extent to which the information is aggregated (lacking in detail)>

< Benefit/cost ratio of using resources to ensure accuracy >

< Connection with basic financial statements >

< Reliability and/or precision possible >

< Reliability and/or precision needed >

-Low (implies RSI) < < < < < < < < < < < < < < > > > > > > > > > > > > > **+High (implies basic**)

41. Different people will assign different importance to each factor. However, a consensus did emerge during the Board's deliberations on the proper classification of Social Insurance information that three related factors are particularly important for that decision: (1) The Board agreed that the SOSI is "essential to fair presentation." A set of financial statements could not be said to "present fairly" when the SOSI is missing or materially misstated. For this reason, it is important (2) that this signal clearly be communicated to the reader of the financial report and (3) to the reader of the auditor's report. Other factors listed also were deemed relevant, and were deemed consistent with "basic" status; for example, a wide audience is interested in this information.

42. The Board ultimately decided to rescind the requirement to present the CSA for reasons discussed on page , but not before it considered the proper classification of the CSA. The amount of discretion available to the preparer was deemed especially important to the decision about how to classify the CSA. If there is very little discretion

in preparing the information, the value of auditing may be modest. An example is SFFAS 8's requirement to reprint information as it was presented in the *President's Budget*, without independent criteria for evaluating it. On the other hand, if there is great discretion, questions may arise about whether the resulting information would be sufficiently reliable, comparable, and consistent without auditing. Another factor, relevant both to the decision initially to classify the information as RSI and to the decision eventually to terminate the requirement, is that there are other, credible sources of similar information. As noted, OMB and CBO routinely publish intermediate and long-term projections that are scrutinized by Congress and by analysts in the private sector.

43. Because SFFAS 5 does not include detailed criteria for defining and measuring Risk Assumed, preparers have considerable discretion in calculating it. This might seem to imply that audit would be desirable. However, auditors may have concerns about expressing positive assurance on information for which specific definitions and measurement criteria have not been defined. In other words, there may not be sufficient agreement on criteria that permit comparable and consistent reporting to permit classifying Risk Assumed as an integral part of the basic financial statements. Another example where this concern has affected classification is information about the condition of stewardship assets and deferred maintenance of property, plant and equipment. Even when auditors do provide assurance, in some cases they may wish to express special qualifications, explanations, or caveats in their report. An example might be an auditor's report on an examination of prospective financial information where there is great inherent uncertainty, or an examination of other assertions by management about matters where management has great discretion.

44. Concerning the "significance" factor: The basic financial statements (including notes that are regarded as an integral part of the financial statements) and RSI are both important enough to be required items in financial reports. With respect to the audit status of the information, it would seem that, by itself, the importance of an item need not automatically imply that the information should be audited. Rather, one would also consider the extent of the information-preparer's discretion as well as the cost of auditing the information item. However, it does seem that the more important the item, the more likely it should be audited, if the information preparer had a significant

degree of discretion. One would be willing to incur more audit costs to avoid misstatement of very important information items that could affect users' decisions. Furthermore, the more important the item, the more likely it would be deemed essential to fair presentation, thus implying a need to qualify the auditor's opinion if the information were missing or misstated.

45. Concerning the "reliability and/or precision" factors: These factors are intertwined, and all affect the extent to which one would prefer audited information to RSI. "Reliability and/or precision *needed*" asks one to evaluate the users' tolerance for imprecise measures of a relevant item. Since auditing is likely to increase precision (either through inducing more precise measures by the preparer or by reducing the variance in the measures by audit procedures), the less tolerance for imprecision that users have concerning an information item, the more likely that the Board would want to make the item a required note disclosure instead of RSI.

46. "Reliability and/or precision *possible*" deals with the very nature of the information item being reported. Precision about measures of past events seems inherently more possible than precision about estimates of future events. To the extent that there is a fundamental minimum amount of imprecision in certain information items, the cost of increasing audit effort might not be justified. For some Board members, this consideration was among the factors (along with others such as cost/benefit) that imply "Risk Assumed" information should properly be classified as RSI at this time. At the same time, however, uncertainty need not preclude classifying information as an integral part of the basic financial statements when other factors indicate this is appropriate, as is the case with the SOSI. Uncertainty should be disclosed and described to the extent feasible.

47. Some other listed factors also relate to the nature of the information. For example, some people may define the domain of accounting and/or financial reporting (or categories within that domain) in terms of the nature of information involved (e.g., as limited to "historical" financial information or to certain defined "elements" of financial reporting, or to certain concepts such as "financial position"). FASB has emphasized the role of "elements of financial reporting" in defining the financial statements and notes. FASB and GASB also emphasize the concept of net assets or financial position in defining financial statements and notes.

48. Other people may define financial reporting, and its component categories, in terms of the comparative advantage unique to reporting based on the information system for processing financial transactions. SFAC 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, says that the "financial statements . . . articulate with each other and derive from the same underlying data (par. 5). Some believe this idea is rooted in the basic "bookkeeping" paradigm of accounting (see SFFAC 1, *Objectives of Federal Financial Reporting*, paragraphs 166-168). Such a definition might be expected to lead to accounting standards that would define the basic financial statements in a narrow or traditional way, with other kinds of information (e.g., performance indicators or management's assertions about internal control) being reported as RSI.

49. Others may define the domain of financial reporting, and categories within that domain, more broadly. A broader definition might, for example, be expressed in terms of the objectives of federal financial reporting, or the comparative advantage of the annual reporting and audit cycle, which assures the production and examination of information that GAAP say is essential to fair presentation, where GAAP reporting is mandated by law, contract, or market forces. This kind of broader definition might be expected to lead to standards that would define more types of information (e.g., performance indicators or management's assertions about internal controls) as a part of the basic financial statements.

50. More generally, the "benefit/cost ratio of using resources to assure accuracy" asks one to assess the costs of producing auditable information and auditing it versus the benefits that could be achieved by merely preparing the information as RSI and applying the procedures specified at AU 558. Other things being equal, one would avoid auditing where the cost of auditing is quite high. Similarly, to the extent that alternative, credible sources of information exist, the cost of auditing the information may exceed its benefits.

Board Approval and Dissent

51. This Statement was adopted by the affirmative votes of seven members of the Board. Mr. Anania dissented. Mr. Kull abstained.

52. Mr. Anania dissents from this Statement because he believes the Board's decision to have the information required by Par. 27(3) and 32(3) of SFFAS l7 presented as a basic financial statement is

premature and is not supported by a change in circumstances or appropriate technical considerations by the Board.

53. The Board issued SFFAS 17 in August 1999 after more than four years of debate and consideration of many major issues including: (1) definition of a federal liability with weight given to the unique circumstances of the Federal Government, including its sovereign powers, (2) nature of Social Insurance laws and practices, (3) significance of Social Insurance programs to individual taxpayers, and (4) long-term sustainability of the programs as currently constructed.

54. In SFFAS 17, Appendix A - Basis for Conclusions - Section 2, the arguments are presented for (Par. 73-79) and against (Par. 65-72) recognition, disclosure or supplementary reporting of Social Insurance programs. The Board's conclusion (Par. 80-83) acknowledges there were two polarized views. These sentences from SFFAS 17 summarize those views and the Board's decisions related to disclosure and measurement of Social Insurance obligations:

> . . . On the one side are those who believe that social insurance programs - especially Social Security and Medicare - constitute a liability of the Federal Government that should be recognized on the consolidated balance sheet and that the closed group is the best measure of it.... At the opposite pole are those who firmly believe that the closed group measure is meaningless or even potentially misleading and should not be disclosed at all in the financial report (Par. 80).
>
> . . . Although both sides make strong arguments, no empirical evidence has been offered that would prove one side right and the other wrong. The Board believes the best approach to resolve this issue is for the closed group data to be reported off the balance sheet as a part of a balanced RSSI package of disclosures about the Social Security and other social insurance programs (Par. 81).
>
> The Board believes that a more complete picture of the financial condition of the government can be provided by a forward-looking assessment of whether it can ‘sustain public service and meet obligations as they come due’ (Par. 85). . . .

55. Mr. Anania believes the key issues debated by the Board prior to the issuance of SFFAS 17 remain significant and unresolved. He believes the Board should reconsider the technical aspects of the Social Insurance programs from an accounting and reporting perspective before making the change that is called for by this Statement. He cites the following issues as some, but not all, of the issues the Board should deliberate while keeping the original SFFAS 17 requirements in place: (1) whether the distinction between exchange and non-exchange transactions in the Board's concepts is relevant to a liability recognition, (2) whether the closed group (current participants) population is the most meaningful focus for either recording a liability or for disclosure, and (3) whether the notions of a constructive liability or an "in substance" plan concept require consideration.

56. Further, he is concerned that not enough consideration and debate in connection with the issuance of this Statement was focused on the uncertainty inherent in the open group population (current and future participants) actuarial present values required by Par. 27 (3) (c), (f) and (g). While he acknowledges that the use of assumptions and estimates is accepted in the recording and/or disclosure of financial information, he has serious reservations as to whether the open group actuarial projections that include estimates for future participants in the plans can meet the reliability test. Those projections include receipts and outlays for people expected to be born or immigrate to the U.S. during the projection period (currently 75 years), as well as individuals under 15 years of age at the time of the projection. He believes it is imperative that this issue be fully considered before the Statement of Social Insurance (SOSI) is reclassified as a basic financial statement.

57. Mr. Anania also points out that audit coverage of the SOSI and other information required by SFFAS 17 has been discussed with members of the American Institute of Certified Public Accountants (AICPA) FASAB Liaison Taskforce and Social Insurance Taskforce. To date, there is no clear indication from the AICPA as to the nature of the audit coverage and audit report that would be forthcoming from the independent accountants engaged to audit the Social Security Administration (SSA) financial statements, including the SOSI information. He believes there is a direct correlation and linkage between the reliability of measurement for recognition purposes and the independent auditor's ability to render a meaningful report on those elements in financial statements. The links include the use of

relevant empirical data, reasonability of and support for assumptions used, and the extent to which the information used can be objectively verified. The reliability of the projection methodology should be further explored before the results of those calculations are made an integral part of the basic financial statements.

58. The open group projection that is used to estimate the future financing shortfall in Social Insurance programs is inherently more sensitive to assumptions about the distant future than is true for the closed group calculations that are used to account for employee pensions and retiree healthcare costs. This is inevitably true, despite the best efforts of actuaries, economists, and other professionals involved in making these projections. This is mainly caused by the fact that a closed group dwindles over time, so that uncertainty about what will happen in the distant future has less impact than is the case for an open group that grows larger during the projection period. Currently, the SOSI is presented in the SSA financial report and in the Consolidated Financial Report of the United States Government (CFR) based on 75-year projections under the intermediate assumptions (sometimes referred to as the "best estimate") of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (generally referred to as Social Security) and corresponding assumptions of the other Social Insurance programs for which the SOSI is required.

59. Mr. Anania observes that FASB Statement of Financial Accounting Concepts No. 7 provides a distinction between estimated cash flows and expected cash flows. The latter refers to the sum of probability-weighted amounts in a range of possible estimated amounts; the estimated mean or average. It is believed by some, including Mr. Anania, that a probability-based approach is a more effective measurement tool in many situations. SSA is currently experimenting with methods that might better incorporate and communicate probabilities and uncertainties, as has been recommended by its technical review panels.[8] Mr. Anania believes that FASAB should study this further in consultation with others, including actuaries from SSA and the Centers for Medicare and Medicaid Services, before elevating the SOSI as currently defined to the status of a basic financial statement. Mr. Anania believes that the open-group projections that are the basis of the SOSI are more sensitive to assumptions about uncertain future events than is true for most, if not all, long-term

liabilities and basic financial statement disclosures in both private and governmental financial reporting today.

60. Mr. Anania believes there is a further, significant issue that requires consideration before the SOSI is reclassified as a basic statement. The concept is articulation of the elements of the required financial statements. Articulation refers to the linkage of an item in one financial statement to an item reported on a different financial statement. Articulation demonstrates the interrelationships of the various financial statements. That linkage is demonstrated in Appendix 1- A thru 1- F of SFFAC 2, *Entity and Display.* The concept of linkage (described therein as "the order and flow of Data in the financial statements") is also very clearly depicted in a chart on page 43 of the 2001 *Consolidated Financial Report of the United States Government* (CFR). Since the other statements outlined in SFFAC 2 are prepared on an accrual basis, there is no linkage (articulation), as traditionally understood, between the basic financial statements described in SFFAC 2 and the SOSI. While that condition may be tolerable in a compromise standard that requires disclosure as Required Supplementary Stewardship Information (RSSI), Mr. Anania

[8] For example, the report of the 1999 Technical Panel includes the following observations (available at http://www.ssab.gov/Rpt99_III.html#pgfId-1005309) under the heading, "Illustrating Uncertainty":

"The current system of presenting low- and high-cost alternatives to the intermediate assumptions is inadequate. The alternatives are useful in demonstrating the sensitivity of the forecast to the underlying parameters (section II.G of the Trustees Report). However, without any model of the probabilities of the underlying parameters taking on the alternative values, there is no way to use the alternatives to form a distribution of possible outcomes. It is inadequate to show any forecast without an indication of the uncertainty that surrounds it. We follow previous panels in strongly recommending efforts toward stochastic modeling or similar techniques that are better able to capture the interrelationship among assumptions. We are not dogmatic in the recommendation, as we recognize that even stochastic modeling requires some set of assumptions about the variance in future outcomes--for example in fertility rates--that are hard to estimate. However, the assumptions are in some way embedded in current methods of projection in any case.

"Some modeling techniques allow for graphical presentations that are better at displaying the range of uncertainty. What we seek is a method of displaying to policy makers and the public just how uncertain is some average cost outcome or date of exhaustion of the Trust Funds, and what are the probabilities that events will be close to or far from that result. That the system might have a very high probability of being out of balance by 2 or more percent of taxable payroll, for instance, may be worth knowing regardless of whether it has attained actuarial balance under some set of intermediate assumptions."

does not believe that condition is technically sound or tolerable in basic financial statements.

61. Finally, Mr. Anania does not believe the users of the SSA and CFR financial reports, particularly citizens and citizen intermediaries, will be better served by the change required by this Statement. He is concerned that the lack of linkage to the other basic statements will not be easily understood by users willing to study the information with reasonable diligence. Elevating the SOSI information to become a basic financial statement without accruing a liability or recognizing an expense based on that information might increase confusion of users of Government reports.

62. Mr. Anania does not dissent to Par. 4 of this statement in which the information about Risk Assumed is reclassified from RSSI to required supplementary information (RSI) or to Par. 5, which rescinds the current requirements for the Current Services Assessment.

63. Mr. Kull will abstain from voting on this statement. He will not dissent, as he believes that social insurance information should be included in the basic financial statements and notes and should be subject to audit. However, he shares Mr. Anania's concerns, and further believes these and other concerns need to be resolved before full implementation takes effect, including the development of appropriate audit standards, and the need for items in the financial statements to be grounded in appropriate definitions of the elements of financial reporting. His abstention from voting is intended as an expression of his assessment that the Board has not completed work on this matter.

Interpretation of Federal Financial Accounting Standards No. 1: Reporting on Indian Trust Funds in General Purpose Financial Reports of the Department of the Interior and in the Consolidated Financial Statements of the United States Government: An Interpretation of SFFAS 7

Status

Issued	March 12, 1997
Effective Date	For fiscal periods beginning after September 30, 1997
Volume I References	SFFAC No. 2, *Entity and Display* SFFAS No. 7, *Accounting for Revenue and Other Financing Sources*
Volume II References	
Interpretations and Technical Releases	
Affects	No other statements.
Affected by	No other statements.

Summary

The assets, liabilities and operating transactions of the Indian trust funds are not part of the Department of Interior and should not be included in the balance sheet, statement of net cost, and statement of changes in financial position of the Department or of the United States Government. However, the Department does have a fiduciary responsibility for these funds and is required to report on them in footnotes.

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Introduction

1. The Department of the Interior requested guidance about how to report information on Indian trust funds in the general purpose financial report of the Department. The Indian trust funds are managed by Interior's Office of Special Trustee, Office of the Secretary. (Prior to FY 1996 the trust funds were managed by the Bureau of Indian Affairs.) Some of the funds belong to individual Indians, others belong to tribes. The funds are managed by the federal government in a trust arrangement. While the Government's responsibility for all of these funds is of a fiduciary nature, some portion of the annual flows for some of the funds have been included in the *Budget of the United States Government*. (Further discussion regarding types of funds involved is provided on page 1069.)

2. According to SFFAC 2, *Entity and Display*, inclusion of a program in the section of the budget currently entitled "Federal Programs by Agency and Account" is conclusive evidence that the program should be part of the reporting entity. The question thus arises whether the assets and activities of the Indian trust funds should be reported in the Department of Interior's general purpose financial statements. Also, SFFAS 7, *Accounting for Revenue and Other Financing Sources*, requires certain disclosures regarding "dedicated collections," including fiduciary funds. During discussion of this issue at the FASAB, questions arose about what type of disclosures should be provided regarding the Indian trust funds.

Interpretation

3. The assets, liabilities and operating transactions of the Indian trust funds are not part of the Department of Interior and should not be included in the balance sheet, statement of net cost, and statement of changes in financial position of the Department or of the United States Government. However, the Department does have a fiduciary responsibility for these funds and is required to report on them in footnotes to the financial statements by SFFAS 7, *Accounting for Revenue and Other Financing Sources*, paragraphs 83-87.

Scope Of Interpretation

4. This Interpretation deals with what information about Indian trust funds should be included in the general purpose financial report of the Department of Interior and of the United State Government. It does not address issues regarding (1) reporting formats for the footnote disclosure required by SFFAS 7, (2) inclusion or exclusion of other

fiduciary funds as components of the federal reporting entity, (3) inclusion or exclusion of any funds or entities in the *Budget of the United States Government*, or (4) reporting on other funds labeled "trust funds" in the federal budget, reporting for trust funds, or reporting on deposit funds generally.[1]

Effective Date

5. The interpretation is effective upon implementation of SFFAS 7, which is effective for reporting periods that begin after September 30, 1997. Earlier application of SFFAS 7 is encouraged.

[1]This restriction on the scope of this interpretation does not imply that this treatment would be inappropriate for other fiduciary funds. Other funds were not included in the research supporting this Interpretation and are therefore excluded.

Appendix: Basis For Conclusions

Entity Criteria

6. In its discussion of the budgetary perspective, SFFAC 2 notes:

> 18. Care must be taken in determining the nature of all trust funds and their relationship to the entity responsible for them. A few trust funds are truly fiduciary in nature. Most trust funds included in the budget are not of a fiduciary nature and are used in federal financing in a way that differs from the common understanding of trust funds outside the federal government. In many ways, these trust funds can be similar to revolving or special funds in that their spending is financed by earmarked collections.
>
> 19. In customary usage, the term "trust fund" refers to money belonging to one party and held "in trust" by another party operating as a fiduciary. The money in a trust must be used in accordance with the trust's terms, which the trustee cannot unilaterally modify, and is maintained separately and not commingled with the trustee's own funds. This is not the case for most federal funds that are included in the budget—the fiduciary relationship usually does not exist. The beneficiaries do not own the funds and the terms in the law that created the trust fund can be unilaterally altered by Congress.

7. Indian trust funds are "true" trust funds in the customary sense, in which there is a legal fiduciary relationship between the Government as trustee and the Indians as trustor. The Government does not own the assets of the funds. In some cases the Government's trustee relationship is with individuals, in other cases with tribes. For many of the funds involved, a tribe or individual can use the funds or dissolve the trust at any time; however, there is a restriction on the use of funds that have been received through legal judgments. Those funds are generally not available until the beneficiaries agree how the funds are to be distributed among them.

8. The budget treats the two types of Indian trust funds differently. Tribal funds are included in the budget. Individuals' funds are not in the budget; they are treated as deposit funds. The Indian tribal trust funds appear to meet *Entity and Display's* conclusive criterion because of their budgetary treatment. The question regarding these funds is whether this implies that these funds should be reported on the face of Interior's financial statements, with the assets, liabilities, revenues and expenses of the Department.

9. Another question arises regarding the Indian trust funds that do not appear to meet the conclusive criterion: would they meet the indicative criteria? The Department of the Interior interprets the indicative criteria in paragraph 44 of SFFAC 2 to mean that the Indian trust funds do not possess any of these characteristics.

10. Some people believe that the sixth indicative criterion does, in fact, apply: ". . . a fiduciary relationship with a reporting entity . . ." However, they believe that meeting any single indicative criterion is not necessarily sufficient to define the Indian trust funds as part of a reporting entity. *Entity and Display* cautioned expressly that "no single indicative criterion is a conclusive criterion."

11. Other people do not believe that even this indicative criterion applies. They believe that, notwithstanding the use of this terminology, the relationship discussed in the sixth indicative criterion concerns factors relating to committing the component entity financially, controlling the collection and disbursement of funds, or having financial interdependence. They believe that this type of financial control and interdependence does not exist between the Indian trust funds and the federal government.

12. While the Indian tribal funds might appear to meet the criteria for inclusion as a component of the federal reporting entity (by virtue of the budgetary criterion if no other), the sovereignty of the Indian tribes as entities outside the federal government, and the fiduciary relationship between the Government and the Indians, indicate that the criteria stated in *Entity and Display* should not be interpreted to suggest that the assets, liabilities, revenues and expenses of these fiduciary funds should be reported on the face of Interior's financial statements.

13. *Entity and Display's* discussion of the budget perspective cautions that, when defining a reporting entity, care must be taken in determining the nature of all trust funds and their relationship to the entity responsible for them (SFFAC 2, para. 18). This provides some common sense advice relevant to the Indian trust funds.

Disclosures For Dedicated Collections

14. As noted, the disclosure requirements for dedicated collections in SFFAS 7, para. 83-87, are applicable to the Indian trust funds. The Department of Interior should include this information in footnotes to

its basic financial statements. In addressing the comments received on the exposure draft leading to Statement 7, the Board specifically noted that:

226.1 The proposed standard did not cover funds administered by a federal entity in a fiduciary relationship with beneficiaries that were not included in the entity's financial statement. In addition, it did not cover other funds which are of the same nature as many trust funds. The standard now requires disclosures for these funds also.

Interpretation of Federal Financial Accounting Standards No. 2: Accounting for Treasury Judgment Fund Transactions: An Interpretation of SFFAS No. 4 and SFFAS No. 5

Status

Issued	March 12, 1997
Effective Date	For fiscal periods beginning after September 30, 1996
Volume I References	SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government* SFFAS No. 5, *Accounting for Liabilities of the Federal Government* SFFAS No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting* SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation: An Amendment of SFFAS No. 5, Accounting for Liabilities of the Federal Government*
Volume II References	Managerial Cost Accounting (M20), Liabilities (L40)
Interpretations and Technical Releases	TR No. 1, *Audit Legal Representation Letter Guidance*
Affects	
Affected by	• SFFAS No. 12 affects Interpretation No. 2 paragraphs 3 and 8 by changing the recognition criteria for recognizing liabilities arising from litigation.

Summary

The Federal entity's management, as advised by the Justice Department, must determine whether it is probable that a legal claim will end in a loss for the Federal entity and the loss is estimable. If the loss is probable and estimable, the entity would recognize an expense and liability for the full amount of the expected loss. The expense and liability would be adjusted periodically, as necessary, based on any changes in the estimated loss. The Federal entity involved in the litigations shall discuss in a footnote to the financial statements the Judgment Fund's role in the payment of a possible loss.

Once the claim is either settled or a court judgment is assessed against the Federal entity and the Judgment Fund is determined to be the appropriate source for the payment of the claim, the liability should be removed from the financial statements of the entity that incurred the liability and an "other financing source" amount (which represents the amount to be paid by the Judgment Fund) would be recognized. If the Judgment Fund is responsible for only a portion of the claim or settlement, the imputed financing source amount would reflect only that amount to be paid by the Judgment Fund on behalf of the Federal entity. Once the claim is either settled or a court judgment is assessed and the Judgment Fund is determined to be the appropriate source for payment of the claim, the Judgment Fund would recognize an expense and an accounts payable or a cash outlay for the full cost of the loss.

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Introduction

1. The Federal Accounting Standards Advisory Board (FASAB) has been asked to clarify Federal accounting standards as they relate to the Treasury Judgment Fund. The Treasury Judgment Fund was established by Congress in the 1950's to pay in whole or in part the court judgments and settlement agreements negotiated by the Justice Department on behalf of agencies, as well as certain types of administrative awards. The Congress established the Judgment Fund as a permanent, indefinite appropriation.

2. The clarification addresses (1) how Federal entities should report the costs and liabilities arising from claims to be paid by the Treasury Judgment Fund and (2) how the Judgment Fund should account for the amounts that it is required to pay on behalf of Federal entities. This interpretation has been prepared on the basis of the following three accounting Standards:

   - Statement of Federal Financial Accounting Standards (SFFAS) Number 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*
   - Statement of Federal Financial Accounting Standards Number 5, *Accounting for Liabilities of the Federal Government*
   - Statement of Federal Financial Accounting Standards Number 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*.

> The provisions of this interpretation need not be applied to immaterial items.

Interpretation

Accounting by the Federal Entity

3. SFFAS No. 5 states that a contingent liability should be recognized when a past event or exchange transaction has occurred; a future outflow or other sacrifice of resources is probable; and the future outflow or sacrifice of resources is measurable. The Federal entity's management, as advised by the Justice Department, must determine whether it is probable that a legal claim will end in a loss for the Federal entity and the loss is estimable. If the loss is probable and estimable, the entity would recognize an expense and liability for the

full amount of the expected loss[1]. The expense and liability would be adjusted periodically, as necessary, based on any changes in the estimated loss. The Federal entity involved in the litigations shall discuss in a footnote to the financial statements the Judgment Fund's role in the payment of a possible loss.

4. Once the claim is either settled or a court judgment is assessed against the Federal entity and the Judgment Fund is determined to be the appropriate source for the payment of the claim, the liability should be removed from the financial statements of the entity that incurred the liability and an "other financing source"[2] amount (which represents the amount to be paid by the Judgment Fund) would be recognized. If the Judgment Fund is responsible for only a portion of the claim or settlement, the imputed financing source amount would reflect only that amount to be paid by the Judgment Fund on behalf of the Federal entity.

Accounting by the Treasury Judgment Fund

5. Once the claim is either settled or a court judgment is assessed and the Judgment Fund is determined to be the appropriate source for payment of the claim, the Judgment Fund would recognize an expense and an accounts payable or a cash outlay for the full cost of the loss. According to SFFAS 4, the imputed financing source amount recognized by the Federal entity and the expense recognized by the Judgment Fund would be eliminated at the Federal consolidated financial report level.

Effective Date

6. This interpretation is effective upon implementation of SFFAS 4 & 5, which become effective for fiscal periods beginning after September 30, 1996.

[1]See paragraph 39 in SFFAS #5 for the complete discussion on "Estimating Contingent Liabilities."

[2]See paragraph 73 in SFFAS #7 for the complete discussion on "Financing Imputed for Cost Subsidies."

Appendix A: Basis For Conclusions

7. This interpretation is primarily based on the principles of SFFAS 5 and SFFAS 4. The following brief discussion explains the basis for the interpretation in terms of those standards which are the foundation for the interpretation.

8. In accordance with the general principles of the liability standard (SFFAS 5), once a legal claim is filed against a Federal entity, the entity's management should determine the likelihood that the Federal entity will incur a loss related to the claim[3], regardless of the fact that the payment may be paid in full or in part by the Judgment Fund. The contingencies[4] section of SFFAS 5 states that if the likelihood of the contingent loss is remote no reporting is necessary; if the likelihood of the loss is reasonably possible and the amount is measurable the estimated loss should be disclosed; and, if the likelihood of loss is probable (more likely than not which is a greater than 50% chance of occurrence) and estimable, the estimated loss must be recognized as a liability. If the probability of the loss is changed at any time prior to payment of the claim, the proper adjustments should be recognized [e.g., from disclosure (reasonably possible) to recognition (probable)]. If at any time the estimated loss amount changes, the liability and expense should be adjusted to reflect the change.[5]

9. In accordance with the principles of SFFAS 4[6], a Federal entity incurring a loss or expense must recognize the full cost of the loss [claim], regardless of who is actually paying the [settlement or judgment] amount. The standard requires the Federal entity incurring a loss or expense to use an estimate of the cost if the actual cost information is not provided. The estimate must be reasonable and should be aimed at determining realistic losses expected.

[3]In most cases this determination involves the U.S. Department of Justice.

[4]A contingency is an existing condition, situation or set of circumstances involving uncertainty as to possible gain or loss to an entity. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm a gain or loss.

[5]See paragraphs 35 - 42 in SFFAS # 5 for the complete discussion on "Contingencies."

[6]See paragraphs 89 - 104 and 105 - 115 in SFFAS #4 for the complete discussion on "Full Cost" and "Inter-entity Costs", respectively.

Appendix B: Illustrative Journal Entries

Based on the above noted accounting standards and the generalized events described below, the conceptual journal entries[7] should be as follows:

Federal entity entries:

The Federal entity's management, through the advisement of the Justice Department, has determined that the probability of the legal claim ending in a loss against the Federal entity is probable and the loss is estimable. The entity would recognize an expense and liability for the full amount of the expected loss. The expense and liability would be adjusted as necessary based on any changes in the estimated loss.

Entry #1:

DR. Expense
CR. Liability—Legal claims

Once the claim is either settled or a court judgment is assessed against the Federal entity and the Judgment Fund is determined to be the appropriate source for payment of the claim, the liability should be removed and an other financing source recognized. If the Judgment Fund is responsible for only a portion of the claim or settlement, the imputed financing source amount would only reflect that amount paid by the Judgment Fund on behalf of the Federal entity.

Entry #2:

DR. Liability—Legal claims
CR. Imputed Financing Source—Expenses Paid by Other Entities*

Treasury Judgment Fund entries:

The claim is either settled or a court judgment is assessed and the Judgment Fund is determined to be the appropriate source for payment.

[7]Actual journal entries are under the authority of the Standard General Ledger.

Entry #3:

DR. Expenses Paid for Other Entities*
CR. Cash or Fund Balance with Treasury

*According to the Cost Accounting Standard, the imputed financing source and expenses paid for other entities amounts would be eliminated at the consolidation level.

Interpretation of Federal Financial Accounting Standards No. 3: Measurement Date for Pension and Retirement Health Care Liabilities

Status

Issued	August 29, 1997
Effective Date	For fiscal periods beginning on or after September 30, 1997
Volume I References	SFFAS No. 5, *Accounting for Liabilities of the Federal Government*
Volume II References	Liabilities (L40), Pension, Other Retirement Benefits and Other Post-Employment Benefits(P20)
Interpretations and Technical Releases	
Affects	
Affected by	

Summary

Pension and retirement health care liabilities in general purpose federal financial reports prepared pursuant to SFFAS 5 shall be measured as of the end of the fiscal year (or other reporting period if applicable). This measurement shall be performed following the end of the period reported, but does not have to be based on a full actuarial valuation as of the end of the reporting period. The measurement shall, however, reflect the best available estimates of the major factors that would be reflected in a full actuarial valuation. This measurement may be based on an actuarial valuation performed as of an earlier date during the fiscal year, including a beginning-of-year actuarial valuation, with suitable adjustments for the effects of changes during the year in major factors such as the pay raise, cost of living adjustment, etc.

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Introduction

1. The Federal Accounting Standards Advisory Board (FASAB) was asked to endorse use of an actuarial valuation as of the beginning of the fiscal year to measure the pension and retirement health care liabilities in general purpose financial reports prepared pursuant to Statement of Federal Financial Accounting Standards Number 5 (SFFAS 5). This has been the practice in some of the special purpose financial reports on pension plans that are prepared pursuant to Public Law 95-595. OMB and GAO issue instructions for preparing the reports required by PL 95-595.

2. The plan reports called for by PL 95-595 receive scrutiny from congressional staff. Based on past experience, some actuaries were concerned that differences between actuarial measurements used in different reports would cause problems and confusion. Some people who support using a beginning-of-year valuation also were concerned about the potential for disagreements between auditors and preparers if projections or estimates were used instead of a full actuarial valuation. Other people, on the other hand, believed that measurements for recognizing liabilities in financial statements prepared pursuant to SFFAS 5 should be as of the end of the reporting period, and that a measurement based on a projection or "roll forward" of a full actuarial valuation would be appropriate if it were not feasible to perform a full actuarial valuation as of year end.

Interpretation

3. Pension and retirement health care liabilities in general purpose federal financial reports prepared pursuant to SFFAS 5 shall be measured as of the end of the fiscal year (or other reporting period if applicable). This measurement shall be performed following the end of the period reported, but does not have to be based on a full actuarial valuation as of the end of the reporting period. The measurement shall, however, reflect the best available estimates of the major factors that would be reflected in a full actuarial valuation, such as the actual pay raise, the actual cost of living adjustment, and material known changes in the number of employees covered (enrollment) that cause a change in the liability.

4. This measurement may be based on an actuarial valuation performed as of an earlier date during the fiscal year, including a beginning-of-year actuarial valuation, with suitable adjustments for the effects of changes during the year in major factors such as the pay raise, cost of

living adjustment, etc. This is sometimes referred to as a measurement based on a "projection" or "roll-forward" of the most recent available actuarial valuation. In evaluating the effect on the liability caused by changes in enrollment for plans that cover employees of more than one reporting entity (e.g., CSRS, FERS), materiality shall be assessed at the plan level. In evaluating the effect on the liability caused by changes in enrollment for plans that cover employees of only one reporting entity (e.g., Coast Guard, Department of State), materiality shall be assessed at the reporting entity level.

Scope of Interpretation

5. This interpretation applies to pension and retirement health care liabilities recognized in accordance with SFFAS 5 in general purpose federal financial reports, such as financial statements prepared pursuant to the Chief Financial Officers Act of 1990, as amended. It does not apply to reports on pension plans pursuant to the requirements of PL 95-595.

Effective Date

6. This interpretation shall be applied for reporting periods that end on or after September 30, 1997. The FASAB has reviewed and agreed with this interpretation. After this interpretation is signed by the FASAB members who represent the Department of the Treasury, the Office of Management and Budget, and the General Accounting Office, it will be published by OMB and will be effective. [Note: see Forward for explanation of new procedures to reflect SAS No. 91 and revised FASAB MOU]

Appendix: Basis For Conclusions

7. SFFAS 5 defines standards for recognition and measurement of pension and retirement health care liabilities, which are reported as of the balance sheet date. Although SFFAS 5 does not explicitly discuss the measurement date, its provisions implicitly call for measurement at year end. "Measurement" implies estimation based on the best available information at the time, but does not necessarily require a full actuarial "valuation" as that term is used by actuaries.

8. To avoid potential confusion, ambiguity, or conflict with auditors, some people would prefer to use a beginning-of-year valuation (which is permitted by private sector standards for plan reporting pursuant to SFAS 35), or at least would prefer to use beginning-of-year enrollment while updating the valuation for other changes during the year (e.g., interest rate assumptions, COLAs, salary increases), which generally are more significant.

9. The Board acknowledges that changes in enrollment during the year will rarely lead to a material change in the liability, and that such changes will therefore not be a factor in some years. Nevertheless, in those years when a material change in the liability does arise because of a change in enrollment during the year, that change should be reflected in the measurement. Conceptually there is no reason to treat enrollment differently from other factors used in the measurement. The Board also acknowledges that precise enrollment data may not be readily available soon after year end, when the measurement is to be performed. The Board does not believe that this should normally present a problem, however, because absolute precision regarding enrollment should not be necessary, given a reasonable definition of materiality.

Interpretation of Federal Financial Accounting Standards No. 4: Accounting for Pension Payments in Excess of Pension Expense

Status

Issued	December 19, 1997
Effective Date	For fiscal periods beginning on or after September 30, 1997
Volume I References	SFFAS No. 5, *Accounting for Liabilities of the Federal Government*
Volume II References	Liabilities (L40), Pension, Other Retirement Benefits and Other Post-Employment Benefits (P20)
Interpretations and Technical Releases	
Affects	
Affected by	

Summary

Changes in normal costs due to re-estimates of demographic and economic assumptions should be accounted for by the administrative entity as a change in accounting estimate. The effect of the change should be recognized in current and future years.

When the employer entity's total payment for FERS and CSRS exceeds the related total pension expense as defined in SFFAS No. 5, the entity should account for the excess payment as a transfer-out. The entity should include the transfer-out when determining results of operations on its statement of changes in net position.

Any FERS-related payment that exceeds the FERS-related pension expense should be offset against any imputed financing resulting from a CSRS-related payment being less than CSRS-related pension expense in calculating the amount of the transfer out. Only when the total pension payment exceeds total pension expense would a transfer-out be recognized.

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Introduction

1. The Federal Accounting Standards Advisory Board (FASAB) was asked for guidance regarding accounting at the agency level for employer agencies' payments to the pension trust fund when they exceed pension expense (based on an allocation of the total service [or "normal"] cost[1] by the Office of Personnel Management). This is a situation that was not contemplated in Statement of Federal Financial Accounting Standards (SFFAS) No. 5, *Accounting for Liabilities of the Federal Government*.

2. The objective of SFFAS No. 5 (paras. 71-78) is to have employer entities recognize the annual cost of their employees' pensions (pension expense) as measured by the annual normal cost for their employees, less any amounts contributed by the employees (para. 74).

3. The employer entity payment rates for the two major civilian pension systems—the Federal Employees Retirement System (FERS) and the Civil Service Retirement System (CSRS)—are provided in law and are not the same. For FERS, the payment rate is the employer entity's normal cost less the amount contributed by its employees; for FERS, the payment rate and the pension expense rate under SFFAS No. 5 theoretically would be the same, since both would be based on the same principle: that pension expense and employer payments to the pension trust fund equal normal cost less the employees' contribution. For most CSRS, employer payments to the pension trust fund are by law set at seven percent of salaries which is substantially less than normal costs and therefore also less than pension expense based on normal cost.

4. SFFAS No. 5 explicitly provides the accounting for a situation in which pension expense is <u>more than</u> employer payments to the pension trust fund. The difference between the pension expense and the payment to the plan is to be accounted for by the employer entity as imputed financing.

5. However, due to (1) planning and operational requirements of budgetary administration and (2) recent legislation, the employer

[1]"Service cost" and/or "normal costs"—the terms are used synonymously in SFFAS No. 5—are defined in SFFAS No. 5 as that portion of the actuarial present value of pension plan benefits and expenses that is allocated to a valuation year by the actuarial cost method.

entity's FERS pension expense may be less than the FERS-related employer payments to the pension trust fund.

6. The pension expense rate used by civilian employer entities to calculate pension expense is supplied by the administrative entity — in the case of FERS and CSRS, the administrative entity is the Office of Personnel Management (OPM). OPM analyzes the demographic and economic assumptions periodically and recalculates normal costs (for both FERS and CSRS).[2] The recalculation was done during FY 1997 and resulted in a lower normal cost for both FERS and CSRS, and OPM has issued a revised FY 1997 pension expense rate based thereon. However, regarding the rate for employer payments to the pension trust fund, OPM allows time for employer entities to adopt the new rate for budgeting purposes during which the prior, higher payment rate will continue to be used by employer entities.

7. In addition, the Balanced Budget Act of 1997 (BBA) increases FERS employees' withholding rate from 1999 through 2001 without correspondingly decreasing the employer entity's payment rate. For example, if FERS normal costs were $10,000 and the employees' contribution were raised from $5,000 (as calculated absent BBA) to $5,500 by the BBA, then the employer's expense according to SFFAS No. 5 should be $4,500 ($10,000 - $5,500). However, the BBA does not allow the employer entity to reduce its payment, and therefore the employer pays what it would have paid without the BBA, $5,000. The $500 difference between the $4,500 SFFAS No. 5 pension expense and the $5,000 payment to the pension trust fund represents a payment in excess of pension expense.

8. For FY 1997, OPM has indicated that employer entities are unlikely to report total payments to the trust fund in excess of total pension expense (based on normal cost) at the entity-wide level, although it is possible, because the amount of the CSRS contribution deficiency is more than the excess FERS payment. However, OPM believes that it is probable that total payments will exceed total pension expense (based on normal cost less employee contributions) in future years.

[2]This is separate from OPM's annual recalculation of the actuarial liability which can result in actuarial gains and losses the accounting for which is provided in SFFAS No. 5.

Interpretation

9. ***Change in Estimate*** - Changes in normal costs due to re-estimates of demographic and economic assumptions should be accounted for by the administrative entity as a change in accounting estimate. The effect of the change should be recognized in current and future years.

10. ***Payments in Excess of Pension Expense*** **-** When the employer entity's total payment for FERS and CSRS exceeds the related total pension expense as defined in SFFAS No. 5, the entity should account for the excess payment as a transfer-out. The entity should include the transfer-out when determining results of operations on its statement of changes in net position.

11. Any FERS-related payment that exceeds the FERS-related pension expense should be offset against any imputed financing resulting from a CSRS-related payment being less than CSRS-related pension expense in calculating the amount of the transfer out. Only when the total pension payment exceeds total pension expense would a transfer-out be recognized.

12. Example #1:

    i. if an employer entity calculates total pension expense as $635,000 reflecting a FERS-related pension expense of $535,000 and a CSRS-related pension expense of $100,000,[3] and

    ii. it makes a total pension payment to the trust fund — excluding its employees' contribution — of $630,000 reflecting $570,000 for its FERS employees and $60,000 for its CSRS employees,

[3]The amounts used for CSRS are from the example in SFFAS No. 5, paragraph No. 78.

iii. then it would off-set the $35,000 FERS-related excess payment ($570,000 - $535,000) against the $40,000 CSRS-related under payment ($100,000 - $60,000) and recognize the net $5,000 underpayment as an imputed financing as follows:

DR. Pension Expense *(FERS $535,000 + CSRS $100,000)*	635,000	
CR. Funds with Treasury *(FERS $570,000 + CSRS $60,000)*		630,000
CR. Imputed Financing *($40,000 - $35,000)*		5,000

13. Example #2: Assuming the same facts as in the paragraph immediately above except that the employer entity makes a payment of $640,000 ($580,000 FERS-related and $60,000 CSRS-related) instead of $630,000, then the entity would recognize a net transfer-out of the amount that the FERS-related excess payment ($580,000 - $535,000 = $45,000) exceeded the CSRS-related under payment ($100,000 - $60,000 = $40,000) as follows:

DR. Pension Expense *(FERS $535,000 + CSRS $100,000)*	635,000	
DR. Transfer-out *($45,000 - $40,000)*	5,000	
CR. Funds with Treasury *(FERS $580,000 + CSRS $60,000)*		640,000

14. **Administrative Entity Intra-governmental Entries** - The administrative entity should account for funds received from employer entities in excess of the normal cost of pension expense as a transfer-in. The administrative entity should include the transfer-in when determining results of operations on its statement of changes in net position.

15. **Adjusting Entries** - Employer entities that recorded total FERS payments as pension expense during FY 1997 will need to adjust their accounts. The following examples use the amounts from paragraphs 12 and 13 above.

a. Example #3 - if the entity had originally recorded the following pension expense based on an earlier provided normal cost rate:

DR. Pension Expense *(FERS $570,000 + CSRS $100,000)*	670,000	
CR. Funds with Treasury *(FERS $570,000 + CSRS $60,000)*		630,000
CR. Imputed Financing (CSRS)		40,000

then, when the revised estimate is provided, the entry would recalculate pension expense as $635,000 (FERS-related $535,000 + CSRS-related $100,000) and adjust the accounts accordingly by means of the following two simultaneous entries:

(1) to reduce pension expense from $670,000 to $635,000 (FERS $535,000 + CSRS $100,000):

DR. Transfer-out	35,000	
CR. Pension Expense		35,000

(2) to off-set the transfer-out against imputed financing:

DR. Imputed Financing	35,000	
CR. Transfer-out		35,000

These entries adjust the accounts to the amounts that would have been entered had the original entry reflected the revised normal cost as shown in paragraph 12 above.

b. Example #4 - Also, if the entity's accounting resulted in a net transfer-out, an adjustment may be necessary. For example, using the illustration in paragraph 13 above, the entity may have

originally recorded pension expense based on an earlier provided normal cost rate as follows.

DR. Pension Expense *(FERS $580,000 + CSRS $100,000)*	680,000	
CR. Imputed Financing *(CSRS)*		40,000
CR. Funds with Treasury *(FERS $580,000 + CSRS $60,000)*		640,000

then the adjustments would be the following two simultaneous entries:

(1) to reduce pension expense from $680,000 to $635,000 (FERS $535,000 + CSRS $100,000):

DR. Transfer-out *(FERS $580,000 - $535,000 = $45,000)*	45,000	
CR. Pension Expense		45,000

(2) to off-set the transfer-out against imputed financing:

DR. Imputed Financing (CSRS)	40,000	
CR. Pension Expense		40,000

These entries adjust the accounts to the amounts that would have been entered had the original entry reflected the revised normal cost as shown in paragraph 13 above.

Scope of Interpretation

16. This interpretation applies to employer entity pension (and, if applicable, to retirement health care) expense, and to administrative entity's receipt of funds from employer entities, accounted for in accordance with SFFAS No. 5.

Effective Date

17. This interpretation should be applied for reporting periods that end on or after September 30, 1997. The FASAB has reviewed and agreed with this interpretation. After this interpretation is signed by the FASAB members who represent the Department of the Treasury, the Office of

Management and Budget, and the General Accounting Office, it will be published by OMB and will be effective.

Basis For Conclusions

18. Regarding changes in normal cost estimates, the prospective treatment called for in this interpretation reflects current practice, including APB Opinion No. 20, *Accounting for Changes in Accounting Estimate*, which provides that a change in accounting estimate should be accounted for in the period of change, if the change affects that period only, or in the period of change and future periods if the change affects both.

19. Regarding employer payments to the pension trust fund in excess of pension expense, such payments are not an employer entity expense or an administrative entity revenue. Such payments do not meet the definition of employer pension expense in SFFAS No. 5,[4] as discussed above, nor do they meet the general definition of expense.[5] The entity receiving the transfer—in this case an employer payment in excess of pension expense --- does not sacrifice anything of value to obtain the payment, and the transferring entity does not acquire anything of value beyond what it would have gotten had it contributed an amount equalling normal cost less the employees' contribution. Thus, such payments meet the description of "transfer-out" provided in SFFAS No. 7.[6]

[4]SFFAS No. 5, para. 74.

[5]See Statements of Federal Financial Accounting Concepts and Standards, Original Statements, "Appendix E: Consolidated Glossary" on page 1273, wherein expenses are defined as:

> outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from providing goods, rendering services, or carrying out other activities related to an entity's programs and missions, the benefits from which do not extend beyond the present operating period.

[6]For a description of transfers-in/out, see paragraphs 74 and 344 of SFFAS No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting.*

Interpretation of Federal Financial Accounting Standards No. 5: Recognition by Recipient Entities of Receivable Nonexchange Revenue: An Interpretation of SFFAS 7

Status

Issued	December 1998
Effective Date	Upon implementation of SFFAS No. 7, *Accounting for Revenue and Other Financing Sources of the Federal Government and Concepts for Reconciling Budgetary and Financial Accounting*
Volume I References	SFFAS No. 7, *Accounting for Revenue and Other Financing Sources of the Federal Government and Concepts for Reconciling Budgetary and Financial Accounting*
Volume II References	Receivable (R10), Revenue (R40)
Interpretations and Technical Releases	
Affects	
Affected by	

Summary

Entities that receive nonexchange revenue collected on their behalf by another entity should recognize the revenue based on the best available evidence at the time the financial report is prepared. This provision of paragraph 60 of SFFAS 7 is intended to require recognition of the excise tax "true up" of the difference between amounts transferred to trust funds based on estimates by Treasury's Office of Tax Analysis and the actual amount subsequently determined by IRS. IRS certifies the third quarter actual amount in December. The intent of paragraph 60 is to recognize this "true up" amount as a receivable or payable. The Board did not intend to impose "push down" accounting that would require entities such as trust funds that receive boxes collected on their behalf to recognize a portion of IRS's net taxes receivable.

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Introduction

1. Paragraph 60 of SFFAS 7, Accounting for Revenue and Other Financing Sources, requires entities that receive nonexchange revenue collected for them by other entities to recognize ". . . the net change in any related inter-entity balances between collecting and receiving entities." The *Internal Revenue Service (IRS)* is the primary collecting entity for the United States Government, although Customs and other entities also collect substantial amounts of nonexchange revenue on behalf of the General Fund and other federal entities. Some of those involved with preparing and auditing IRS's financial statements have asked whether this should be interpreted to require entities such as trust funds that receive taxes collected on their behalf to recognize a portion of IRS's net taxes receivable. This is sometimes described as "push down" accounting. The Board did not intend to impose "push down" accounting, as is further explained by this interpretation.

Interpretation

2. Entities that receive nonexchange revenue collected on their behalf by another entity should recognize the revenue based on the best available evidence at the time the financial report is prepared. This provision of paragraph 60 of SFFAS 7 is intended to require recognition of the excise tax "true up" of the difference between amounts transferred to trust funds based on estimates by Treasury's Office of Tax Analysis and the actual amount subsequently determined by IRS. IRS certifies the third quarter actual amount in December. The intent of paragraph 60 is to recognize this "true up" amount as a receivable or payable.[1]

Effective Date

3. The interpretation is effective upon implementation of SFFAS 7.

[1]Certification of the actual amount for the fourth quarter is not currently available from IRS until the end of March, which is too late to be included in the financial statements for the prior fiscal year.

Appendix: Basis For Conclusions

4. The Board understood, when it recommended the standards contained in SFFAS 7, that the information available to IRS and its information systems do not presently permit "push down" accounting as described above. It was not the Board's intent to establish a standard in this regard that recipient entities could not comply with because of factors outside their control. The recognition, measurement, and disclosure standards in SFFAS 7 for collecting entities such as IRS were designed to provide for accountability and useful information regarding tax revenues from the collecting entities. Therefore, as noted above, this provision of SFFAS 7 is intended only to require recognition of the most recent available "true up" of the difference between amounts of nonexchange revenue transferred to recipient entities based on estimates by Treasury's Office of Tax Analysis and the actual amount subsequently determined by IRS.

5. One Board member notes that it is not possible to accrue something that is not measurable. He believes that, if the fourth quarter is not measurable, no accrual can be made, and no interpretation is needed. If any entity can "true up" a given tax revenue number, that should be done. That is, it should report the best available information. From this perspective, the standard does not call for more than the best estimate that is possible for a given revenue. This member believes that if someone needs clarification, it should be provided, but the clarification need not be elevated to an interpretation.

6. The Board concluded that, because there is confusion, and because this issue could affect more than one entity, an interpretation would be appropriate to assure that the guidance is readily available to all who need it.

Interpretation Number 6, Accounting for Imputed Intra-departmental Costs: An Interpretation of SFFAS No. 4

Status

Issued	April 18, 2003
Effective Date	for periods beginning after September 30, 2004
Volume I References	SFFAS 4, *Managerial Cost Accounting Standards and Concepts*
Volume II References	Managerial Cost Accounting (M20)
Interpretations and Technical Releases	None.
Affects	SFFAS 4, *Managerial Cost Accounting Standards and Concepts*
Affected by	None.

Summary

Par. 110 of SFFAS No. 4, states "Implementation of this standard on inter-entity costing should be accomplished in a practical and consistent manner by the various federal entities. Therefore, the Office of Management and Budget (OMB), with assistance from the FASAB staff, should identify the specific inter-entity costs for entities to begin recognizing. OMB should then issue guidance identifying these costs…"

Some of those involved with preparing and auditing financial statements for part of a department or larger reporting entity have asked whether par. 110 of SFFAS No. 4, when considered in conjunction with section 4.3 of OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*, limits the recognition of imputed intra-departmental costs, i.e. costs between reporting entities that are part of the same department or larger reporting entity (other than the U.S. government as a whole).

This interpretation clarifies that par. 110 of SFFAS No. 4 does not limit the recognition of imputed intra-departmental costs. This interpretation further explains that reporting entities should account for imputed intra-departmental costs in accordance with the full cost provisions of SFFAS No. 4. To account for the full cost of a program and its output(s), reporting entities should recognize imputed intra-departmental costs.

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Introduction

1. Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Standards and Concepts*, specifies that "each entity's full cost should incorporate the full cost of goods and services that it receives from other entities." (SFFAS No. 4, text box immediately preceding par. 105) SFFAS No. 4 refers broadly to the costs of goods and services provided between entities as "inter-entity costs."

2. SFFAS No. 4 explains that for some inter-entity costs, the provider will be reimbursed by the recipient for the full cost. Therefore, the full cost of these inter-entity goods and services will be recognized in the recipient entity's accounts through the normal recording of transactions. SFFAS No. 4 also specifies that inter-entity costs not fully reimbursed by the receiving entity should be recognized at full cost. To accomplish this recognition, the receiving entity should recognize an imputed financing source (SFFAS No. 4, par. 109 and SFFAS No. 7, par. 73) for the difference between the actual payment (if any) and the full cost. To facilitate discussion of the issue addressed in this interpretation, we will refer to costs that are not fully reimbursed as "imputed costs" whether or not recognized by the recipient.[1]

3. Statement of Federal Financial Accounting Concepts (SFFAC) No. 2, *Entity and Display*, and SFFAS No. 4 use the term "inter-entity"; they do not use the terms "intra-departmental" and "inter-departmental." To facilitate the understanding of the inter-departmental definition and relationship, this interpretation uses "department" to refer to any department, agency, administration or other financial reporting entity[2] that is not a part of a larger financial reporting entity other than the Government as a whole. Thus "department" in this context includes entities such as the General Services Administration, the National Science Foundation, and the Environmental Protection Agency, as well as executive branch departments such as Defense, Agriculture, Treasury, et al.

[1] Recognition of imputed costs is determined by accounting standards (see par. 14 and 30 of this interpretation for additional explanation.) General criteria to help in determining imputed costs that should be recognized are detailed in par. 112-113 and 239-243 of SFFAS No.4.

[2] Reporting entity as used in this interpretation refers to any entity that issues general purpose financial statements as discussed in par. 29 of *SFFAC No. 2*, *Entity and Display.*

4. Activities between reporting entities that are not part of the same department or larger reporting entity other than the U.S. government as a whole are considered inter-departmental. Activities between reporting entities that are part of the same department or larger reporting entity (such as bureaus, components or responsibility segments within a department) are considered intra-departmental. Appendix B provides an illustration of inter-departmental and intra-departmental relationships.

Summary of Issue

5. Par. 110 of SFFAS No. 4, states "Implementation of this standard on inter-entity costing should be accomplished in a practical and consistent manner by the various federal entities. Therefore, the Office of Management and Budget (OMB), with assistance from the FASAB staff, should identify the specific inter-entity costs for entities to begin recognizing. OMB should then issue guidance identifying these costs…"

6. OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*, Section 4.3, second par. states "Reporting entities are required to recognize the following costs…To ensure consistency, agencies should not recognize costs other than those listed until OMB provides further guidance."

7. Some of those involved with preparing and auditing financial statements for part of a department or larger reporting entity have asked whether par. 110 of SFFAS No. 4, when considered in conjunction with section 4.3 of OMB Bulletin 01-09, limits the recognition of imputed intra-departmental costs, i.e. costs between reporting entities that are part of the same department or larger reporting entity (other than the U.S. government as a whole).

8. This interpretation clarifies that par. 110 of SFFAS No. 4 does not limit the recognition of imputed intra-departmental costs. This interpretation further explains that reporting entities should account for imputed intra-departmental costs in accordance with the full cost provisions of SFFAS No. 4. To account for the full cost of a program and its output(s), reporting entities should recognize imputed intra-departmental costs.

Interpretation

9. Although par. 110 of SFFAS No. 4, when considered in conjunction with section 4.3 of OMB Bulletin 01-09, does limit the recognition of inter-entity costs to those costs that OMB has identified for recognition, this limitation applies solely to imputed inter-departmental costs. Par. 110 of SFFAS No. 4 does not limit the recognition of imputed intra-departmental costs.

10. **Imputed inter-departmental costs** are the unreimbursed (i.e. non-reimbursed and under-reimbursed) portion of the full costs of goods and services received by the entity from a providing entity that is not part of the same department or larger reporting entity other than the U.S. government as a whole.

11. **Imputed intra-departmental costs** are the unreimbursed portion of the full costs of goods and services received by the entity from a providing entity that is part of the same department or larger reporting entity (i.e. other bureaus, components or responsibility segments within the department or larger reporting entity).

12. Appendix B provides an illustration of inter-departmental and intra-departmental relationships.

13. Reporting entities should account for and recognize imputed intra-departmental costs in accordance with the full cost provisions of SFFAS No. 4. To account for the full cost of a program and its output(s), reporting entities should recognize imputed intra-departmental costs.

14. The recognition criteria in par. 112-113 of SFFAS No. 4 (which provides general criteria to determine which costs should be recognized) apply to both imputed intra-departmental and inter-departmental costs. Accounting and reporting for imputed intra-departmental and inter-departmental costs that are recognized should be consistent and in accordance with par. 108-109 and 114-115 of SFFAS No. 4, which provide specific accounting examples.

15. Reporting entities should disclose on the face of the financials or in the notes to the financial statements, which are an integral part of the basic financial statements, both imputed intra-departmental and inter-departmental financing sources that are recognized.

Scope of Interpretation

16. This interpretation applies to imputed inter-entity costs accounted for in accordance with SFFAS No. 4. Specifically, this interpretation clarifies that par. 110 of SFFAS No. 4 does not limit the recognition of imputed intra-departmental costs.

Effective Date

17. This interpretation is effective for periods beginning after September 30, 2004. Earlier implementation is encouraged.

The provisions of this Interpretation need not be applied to immaterial items.

Appendix A: Basis for Conclusions

This appendix summarizes some of the considerations deemed significant by the Board in reaching the conclusions in this Interpretation. It includes the reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.

Summary of Issue

18. Par. 110 of SFFAS No. 4 states "Implementation of this standard on inter-entity costing should be accomplished in a practical and consistent manner by the various federal entities. Therefore, the Office of Management and Budget (OMB), with assistance from the FASAB staff, should identify the specific inter-entity costs for entities to begin recognizing. OMB should then issue guidance identifying these costs…"

19. OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*, section 4.3, second par. states "Reporting entities are required to recognize the following costs…To ensure consistency, agencies should not recognize costs other than those listed until OMB provides further guidance."

20. Some of those involved with preparing and auditing financial statements for part of a department or larger reporting entity have interpreted par. 110 of SFFAS No.4, when considered in conjunction with section 4.3 of OMB Bulletin 01-09, as limiting departmental management's ability to recognize imputed costs among reporting entities within the department. This is not the Board's intent.

Interpretation and Explanation, Including Definition of Terms

21. Although par. 110 of SFFAS No. 4, when considered in conjunction with section 4.3 of OMB Bulletin 01-09, does limit the recognition of inter-entity costs to those costs that OMB has identified for

recognition[3], this limitation applies solely to imputed inter-departmental costs. Par. 110 of SFFAS No. 4 does not limit the recognition of imputed intra-departmental costs.

22. The limitation is necessary with respect to imputed inter-departmental costs, because government-wide guidance is necessary to assure that imputed inter-departmental costs are accounted for and recognized in a practical and consistent manner. This limitation is not necessary with respect to the recognition of imputed intra-departmental costs. Department management can define responsibility segments for a department, and it can determine and implement comparable and consistent cost accounting policy in accordance with SFFAS No. 4 within the department. It does not need external guidance to set policy or external authority to enforce it.

23. Imputed intra-departmental costs are the unreimbursed portion of the full costs of goods and services received by the entity from a providing entity that is part of the same department or larger reporting entity (ie. other bureaus, components or responsibility segments within the same department or larger reporting entity.) An example of an imputed intra-departmental cost would be within the Department of Justice, the Drug Enforcement Agency (DEA) may perform drug processing (lab testing, results, etc.) for the Federal Bureau of Investigation without reimbursement.

24. Imputed inter-departmental costs are the unreimbursed portion of the full costs of goods and services received by the entity from a providing entity that is not part of the same department or larger reporting entity other than the government as a whole. An example of an imputed inter-departmental cost would be for drug processing provided by

[3] With respect to the limitations on recognition of imputed inter-departmental costs, par. 110 of SFFAS No. 4 indicates that OMB will provide guidance. Specifically, OMB Bulletin No. 01-09 provides such guidance and states the following costs should be recognized: (1) employees' pension, post-retirement health and life insurance benefits, (2) other post-employment benefits for retired, terminated, and inactive employees which includes unemployment and workers compensation under the Federal Employees' Compensation Act, and (3) losses in litigation proceedings. Currently, a task force of the Accounting and Auditing Policy Committee is identifying other potential inter-departmental costs for recognition and related guidance that should lead to consistency among departments recognizing inter-entity costs.

DEA to the U.S. Customs Service (which is not a part of the Department of Justice) without reimbursement.[4]

25. Appendix B provides an illustration of intra-departmental and inter-departmental relationships.

26. SFFAS No. 4 requires reporting entities to measure and report the full costs of their outputs (products and services) in general purpose financial reports. SFFAS No. 4 further defines the full cost of an output produced by a responsibility segment as the sum of (1) the costs of resources consumed by the segment that directly or indirectly contribute to the output, regardless of funding sources and (2) the costs of identifiable supporting services provided by other responsibility segments within the reporting entity, and by other reporting entities.

27. SFFAS No. 4 par. 108 reads:

> If an entity provides goods or services to another entity, regardless of whether full reimbursement is received, the providing entity should continue to recognize in its accounting records the full cost of those goods or services. The full costs of the goods or services provided should also be reported to the receiving entity by the providing entity.

28. Further support of the Board's intent is found in SFFAS No. 4's basis for conclusions. Specifically, par. 224-249, indicate that the Board considered the inter-entity issue as involving inter-departmental costs. In particular, footnote 50 in SFFAS No. 4, reads:

> Full cost, as discussed in the full cost standard, contemplates both intra-entity costs and inter-entity costs applicable to a responsibility segment. This standard elaborates on inter-entity costs. Intra-entity costing is accomplished through the costing methodology selected for use within the reporting entity since these costs are passed among responsibility segments.

[4]Although the example is an imputed inter-departmental cost, current OMB guidance does not include this particular cost as one to be recognized. See footnote 3 for additional detail regarding the current OMB guidance and the project to identify other costs for recognition.

29. This indicates that the Board intended intra-departmental costs to be assigned, allocated, or imputed as determined by department management in accordance with the full cost standard. Reporting entities should account for intra-departmental costs in accordance with the full cost provisions of SFFAS No. 4. To account for the full cost of a program and its output(s), reporting entities should recognize imputed intra-departmental costs.

Accounting and Implementation

30. The recognition criteria in par. 112-113 of SFFAS No. 4 apply to both imputed intra-departmental and inter-departmental costs. The standard explains that the determination of whether the cost of non-reimbursed or under-reimbursed goods and services should be recognized requires the use of judgment. Ultimately, the decision should be "based on the specific facts and circumstances of each case, with consideration of the degree to which inclusion or exclusion would change or influence the actions and decisions of reasonable persons relying on the information." (SFFAS No. 4, par. 113)

31. Accounting and reporting for imputed intra-departmental and inter-departmental costs that are recognized should be consistent and in accordance with par. 108-109 and par.114-115 of SFFAS No. 4 which provide specific accounting examples. The standard requires that the receiving entity recognize the full cost of the goods or services that it receives. To the extent that reimbursement is less than full cost, the receiving entity should recognize the difference as a financing source.

32. Reporting entities should disclose both imputed intra-departmental and inter-departmental financing sources that are recognized. This will allow the readers of the financial statements to understand how much a reporting entity is subsidized by other reporting entities within the department or larger reporting entity, versus those outside of the department. Additionally, it would be of particular importance when the reporting entity is producing stand-alone financial statements, as the intra-departmental costs and financing sources would not be eliminated. However, intra-departmental costs and financing sources would be eliminated for any consolidated financial statement covering both reporting entities, which is consistent with par. 109 of SFFAS No. 4, but disclosure of such financing sources should be included in the notes to the financial statements. Par. 244-246 of SFFAS No. 4 provides additional discussion of consolidated financial reports that include both the providing entity and the receiving entity.

Results of Questionnaire to Executive Agencies

33. Prior to the Board's deliberation on the issue, staff obtained information regarding current practices related to the accounting for imputed intra-departmental costs by distributing a questionnaire to the Chief Financial Officers and Inspector Generals of the Executive Departments. The responses to the questionnaire indicated that most Departments do not recognize imputed intra-departmental costs. Also, respondents indicated that there may be a need for guidance on various issues within SFFAS No. 4, such as materiality and acceptable methodologies.

34. The Board did consider the issues identified by respondents, but believed the issues were much broader than the scope of the interpretation. Additionally, the Board noted that there is existing guidance available related to cost accounting. Specifically, the CFO Council's Cost Accounting Implementation Guide and the Joint Financial Management Improvement Program's System Requirements for Managerial Cost Accounting, among others, are good sources of information on cost accounting.

Responses to the Exposure Draft (ED)

35. The Board issued the Exposure Draft *"Accounting for Imputed Intra-departmental Costs: An Interpretation of SFFAS No. 4"* in November 2002. The Board received twelve responses on the exposure draft from the following sources:

	Federal (internal)	Nonfederal (external)
Users, academics, others		2
Auditors	2	2
Preparers and financial managers	6	

All but two of the respondents supported the interpretation. One respondent commented that the proposed action goes beyond an interpretation of an existing standard. Many respondents (eight) did not agree with the Board's proposed effective date.

36. It is important to note that the Board did not rely on the number in favor of or opposed to a given position. Information about the majority view is provided only as a means of summarizing the comments. The Board considered the arguments in each response and

weighed the merits of the points raised. The respondents' comments are summarized below.

Respondents Supporting the ED

37. All but two of the respondents supported the interpretation and agreed that reporting entities should recognize imputed intra-departmental costs. One respondent stated that entities should be able to determine intra-departmental costs and apply consistent internal cost methodologies in accordance with SFFAS No. 4. Another respondent elaborated that including these costs will inform readers of the financial statements of significant costs and ensure full and complete information for decision makers.

38. Although the majority of respondents supported the interpretation, most did not agree with the proposed effective date in the ED--for reporting periods beginning after September 30, 2002 (FY 2003.) Since most departments do not currently recognize imputed intra-departmental costs and the interpretation will not be finalized until the middle of FY 2003, the respondents indicated that it would be difficult to implement during FY 2003. The Board recognizes that implementation may require reviews and studies of intra-departmental activities. Therefore, the Board believes allowing more time for implementation is appropriate. The Board agrees and the effective date of this interpretation has been changed to periods beginning after September 30, 2004, with earlier implementation encouraged.

39. Respondents supporting the ED did offer some additional comments for the Board's consideration. In particular, one respondent suggested that the proposed interpretation goes beyond what is required in SFFAS No. 4, and therefore should be covered in an amendment rather than an interpretation. The Board believes that the interpretation is a clarification of par. 110 of SFFAS No. 4 and does not impose any new requirements.

Respondents Opposing the ED

40. Two respondents did not agree that agencies should be required to recognize imputed intra-departmental costs. Specifically, both respondents believed that it would be inconsistent to require recognition of imputed costs at the intra-departmental level but not at the inter-departmental level. It is important to note that the Board believes that recognition of imputed inter-departmental costs is also required. However, when par. 110 of SFFAS No. 4 is considered in

conjunction with section 4.3 of OMB Bulletin 01-09, recognition of imputed inter-departmental costs is presently limited to those identified by OMB. A gradual approach to the implementation of inter-departmental full costing was provided by SFFAS No. 4 because the Board acknowledged a need for Government-wide guidance on the recognition of imputed inter-departmental costs.

41. The Board recognizes that costs of the same goods or services may be provided to both intra-department and inter-department recipients without full cost reimbursement. As such, certain imputed costs would be recognized by entities within a department (intra-departmental), but would not be recognized by entities that are not part of that department (inter-departmental). Although respondents note inconsistency, the Board believes it is appropriate to recognize the imputed intra-departmental costs in accordance with the standard.

42. The Board does not believe that this action will increase inconsistency. Rather, the Board believes that this interpretation is a necessary step toward consistent full cost information for the following reasons:

    a. Current treatment of imputed costs results in receiving entities recognizing less than the full cost of the goods or services that it receives, which results in reporting understated costs. Applying this interpretation eliminates the intra-departmental misstatement.

    b. Currently, some goods and services acquired by entities are recognized at full costs and other goods and services are not.[5] This interpretation reduces the pool of goods and services that are not recognized at full cost.

    c. Development of intra-departmental cost information will facilitate implementation of inter-departmental full costing. The Board believes that department management will develop cost accounting methodologies for imputed intra-departmental costs and ensure they are consistently identified and implemented

[5] In 1998, the CFO Council published the CFO Council Cost Accounting Implementation Guide that urged agencies to enter into reimburseable agreements and thus, reduce the pool of goods and services provided at less than full cost. Therefore, implementation of the guidance should have resulted in a decline in unrecognized inter-departmental costs.

within a department. The experience gained through the intra-departmental efforts may lead to (1) full cost inter-departmental fees based on the improved cost information and (2) the availability of information and methodologies needed for imputed inter-departmental costs.

43. A task force of the Accounting and Auditing Policy Committee (AAPC) is currently identifying inter-departmental costs for recognition and guidance that will assist departments and improve consistency. The Board believes addressing the implementation issues and identifying these types of imputed intra-departmental costs for recognition within the department will ultimately assist with the obstacles in the recognition of imputed inter-departmental costs.

44. One respondent requested that the interpretation clarify how the 'broad, general support' criteria within par. 112 of SFFAS No. 4 would be applied to imputed intra-departmental costs. Par. 112 of SFFAS No. 4 (which provides general criteria to determine which costs should be recognized) discusses the criteria of broad and general support and recognizes that some entities provide support to all or most other federal entities, generally as a matter of their mission. The costs of such broad services should not be recognized as an expense (or asset) by the receiving entities when there is no reimbursement of costs. However, the standard discusses if the service is an integral and necessary part of the receiving entity's operations and outputs, those costs should be recognized.

45. The standard offers the example of check writing services by the Department of Treasury that may be considered a broad and general service to most federal entities, but may be considered an integral part of operations to entities such as the Internal Revenue Service and the Social Security Administration. Utilizing this example and applying the broad and general support criteria to imputed intra-departmental costs, the Internal Revenue Service may be required to recognize these imputed costs if they are determined to be an integral part of their operations and meet the standard for recognition, but the U.S. Customs Service (which is also a part of Treasury) may not recognize these costs as they may not be considered an integral part of their operations.

46. When appropriate, reporting entities should also consider the costing methodology standard of SFFAS No. 4 that addresses cost

accumulation and cost assignment. Specifically par. 122 of SFFAS No. 4, provides:

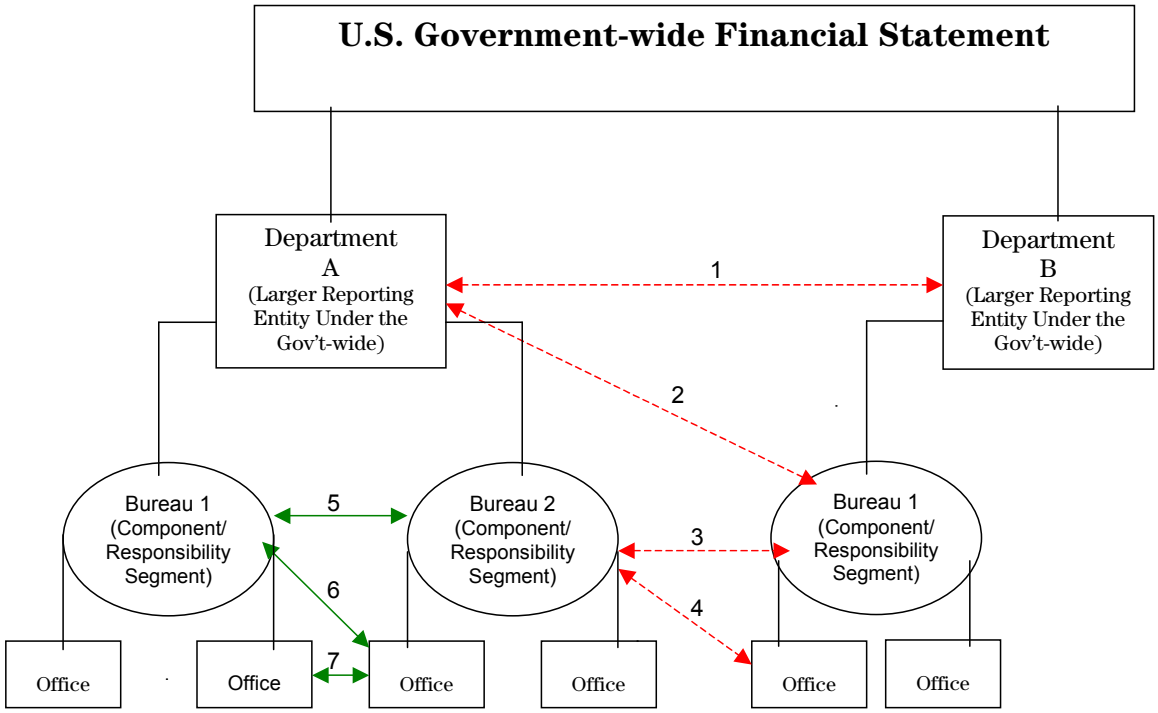
> Some responsibility segments of an entity may provide supporting services or deliver intermediate products to other segments within the same entity. The costs of the supporting services and intermediate products should be assigned to the segments that receive the services and products. This is referred to as the intra-entity cost assignments. Also, in accordance with the inter-entity cost standard discussed in the preceding section, an entity should recognize inter-entity costs for goods and services received from other federal entities. The inter-entity costs should also be assigned to the responsibility segments that use the inter-entity services and products.

Board Approval

47. This interpretation was approved for issuance by all members of the Board.

Appendix B Illustration of Inter-entity Relationships

The following chart provides an illustration of the inter-departmental and intra-departmental relationships.



The lines labeled 1-7 represent goods and services provided between reporting entities.

Inter-departmental--The dashed lines (labeled 1-4) represent activities between reporting entities that are not part of the same department or larger reporting entity and are considered inter-departmental. The provision of goods or services result in inter-departmental costs and if the providing entity is not fully reimbursed, paragraph 110 of SFFAS No. 4 applies and when considered in conjunction with section 4.3 of OMB Bulletin 01-09, recognition of imputed inter-departmental costs is limited to those specifically identified by OMB.

Intra-departmental--The solid lines (labeled 5-7) represent activities between reporting entities that are part of the same department or larger reporting entity (such as bureaus, components or responsibility segments within a department) and are considered intra-departmental. The provision of goods or services result in intra-departmental costs and if the providing entity is not fully reimbursed, recognition of imputed intra-departmental costs is required to achieve full cost recognition, in accordance with SFFAS No. 4.

Technical Bulletin 2000-1: Purpose and Scope of Techincal Bullentins and Procedures for Issuance

Status

Issued	June 2000
Effective Date	June 2000
Volume I References	None.
Volume II References	None.
Interpretations and Technical Releases	None.
Affects	N/A
Affected by	N/A

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Federal Accounting Standards Advisory Board

1. On October 19, 1999, the Council of the American Institute of Certified Public Accountants (AICPA) adopted an amendment to Rule 203 of the AICPA's Code of Professional Ethics. This amendment recognized accounting standards published by the Federal Accounting Standards Advisory Board as generally accepted accounting principles (GAAP) for federal financial reporting entities. The amendment recognized FASAB as the source of GAAP for federal entities. Consequently, the Federal Accounting Standards Advisory Board has authorized its staff to prepare FASAB Technical Bulletins to provide timely guidance on certain financial accounting and reporting problems of federal financial reporting entities. This Bulletin describes the purpose and scope of FASAB Technical Bulletins, the procedures for issuing them, and related background information.

2. The FASAB anticipates that it will communicate primarily through the issuance of Statements and Interpretations. Such pronouncements may require extensive due process, including appointing task forces and holding public hearings. The FASAB also recognizes the need for providing timely guidance to financial statement preparers and attestors for both currently emerging and existing problems.

3. To provide timely guidance within the context of the standard FASAB procedures, Technical Bulletin procedures provide for both due process (more limited in scope and within a tighter minimum time frame than provided for Statements and Interpretations) and review by FASAB members.

4. FASAB Technical Bulletins provide guidance for applying FASAB Statements and Interpretations and resolving accounting issues not directly addressed by them. The following kinds of guidance may be provided in a Technical Bulletin:

    a. Guidance to clarify, explain, or elaborate on an underlying Statement or Interpretation,
    b. Guidance to address areas not directly covered by existing Statements or Interpretations,
    c. Interim guidance on problems in applying an existing Statement or Interpretation currently under study by the FASAB, or
    d. If applicable, guidance for applying FASB or GASB standards to federal activities.

The FASAB staff analyzes an accounting or reporting problem that comes to the FASAB's attention to determine whether the problem may be resolved by issuing a FASAB Technical Bulletin. Generally, a Technical Bulletin can provide guidance if the problem can be resolved within the following guidelines:

a. The guidance is not expected to cause a major change in accounting practice.
b. The administrative cost involved in implementing the guidance is not expected to be significant to most affected entities.

The guidance does not conflict with a broad fundamental principle or create a novel accounting practice.

5. Generally, a FASAB Statement or Interpretation is more appropriate than a Technical Bulletin if any of these guidelines is not met.

6. FASAB members will be provided with copies of all draft Technical Bulletins before their release for comment by interested parties. Within 15 days of sending the draft TB to FASAB members, the Executive Director will review any member comments and consult with members on any issues identified. Based on the comments and consultation, the Executive Director will determine if a majority of members do not object to the proposed Technical Bulletin.

7. If a majority of the FASAB members do not object, the Executive Director will release the proposed Technical Bulletin to selected knowledgeable persons for comment. Those persons include members of the CFO Council, the President's Council on Integrity and Efficiency, the Joint Financial Management Improvement Program, CPA firms, and others the Executive Director and members of FASAB believe should be consulted. Proposed Bulletins will be publicized by electronic communication with interested parties and by posting to FASAB's World Wide Web site during an exposure period of at least 15 days.[1] The FASAB will maintain a public record of proposed Bulletins and all written comments received. The public record will be available for inspection at the FASAB's offices.

[1]Determination of the length of the exposure period will depend on the nature and urgency of the issue. The Board generally prefers that exposure periods be longer than the minimum required and expects that normally exposure periods will be for at least 30 days.

8. All comments received on draft Technical Bulletins will be given to the Board for its consideration at a public meeting before final issuance. A Bulletin will not be issued if a majority of the FASAB members object either to the guidance in it or to communicating that guidance in a Technical Bulletin.

9. The FASAB may support use of a Technical Bulletin because the nature of the accounting issue addressed and the guidance provided do not, in its judgment, warrant more extensive due process. If the appropriateness of issuing a Technical Bulletin is in doubt, the FASAB may choose instead to issue a Statement or Interpretation or take other action as it deems appropriate.

10. Each Technical Bulletin will specify an effective date and transition provisions for initial application. While the FASAB expects that most Technical Bulletins will be applied prospectively, Technical Bulletins may require retroactive application if appropriate in the circumstances.

11. The FASAB monitors the procedures for issuing FASAB Technical Bulletins and may modify these procedures from time to time. Any modification will be announced publicly.

12. FASAB Technical Bulletins are generally in question-and-answer format and are published with this legend:

    The Federal Accounting Standards Advisory Board has authorized its staff to prepare FASAB Technical Bulletins to provide timely guidance on certain financial accounting and reporting problems, in accordance with section III. I. 5 of the Board's rules of procedure, as amended and restated through October 1, 1999 and the procedures described in FASAB Technical Bulletin 2000-1, Purpose and Scope of FASAB Technical Bulletins and Procedures for Issuance. The provisions of Technical Bulletins need not be applied to immaterial items.

    The FASAB has reviewed this Technical Bulletin and a majority of its members do not object to its issuance.

Technical Bulletin 2002-1: Assigning to Component Entities Costs and Liabilities that Result from Legal Claims Against the Federal Government

Status

Issued	July 24, 2002
Effective Date	for periods ending after September 30, 2001
Volume I References	SFFAS 4, Managerial Cost Accounting Concepts and Standards for the Federal Government SFFAS 5, *Accounting for Liabilities of the Federal Government*
Volume II References	Liabilities (L40)
Interpretations and Technical Releases	Interpretation 2 Accounting for Treasury Judgment Fund Transactions
Affects	None.
Affected by	None.

Summary

This technical bulletin is intended to clarify the required reporting of costs and liabilities resulting from legal claims (i.e., judgments and settlements) against the Federal government. Standards issued by FASAB have precedence over other authoritative guidance for Federal entities. This technical bulletin supplements any relevant Federal standards, but is not a substitute for and does not take precedence over the standard.

This technical bulletin requires that all liabilities and costs related to legal claims (i.e., judgments and settlements) must be attributed to the component entities responsible for the programs or activities that contributed to the claims, or to their successor component entities. This attribution follows the general principle that all transactions or events reported on the consolidated statements should be attributed to some Federal component entity.

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Introduction

1. Some Federal entities have requested guidance on assigning costs and liabilities resulting from legal claims (i.e., judgments and settlements) against the Federal government when one or more Federal entities are involved in the litigation. General guidance for the accounting and reporting of costs and liabilities resulting from legal claims against the Federal government is provided in Statement of Federal Financial Accounting Standards (SFFAS) Number 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government* (SFFAS 4) and Statement of Federal Financial Accounting Standards Number 5, *Accounting for Liabilities of the Federal Government* (SFFAS 5).

2. This issue is based primarily on the provisions required in the following Federal standards: SFFAS Number 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government* and SFFAS Number 5, *Accounting for Liabilities of the Federal Government.*

3. SFFAS 4 provides a full cost standard that states: "Reporting entities should report the full costs of outputs in general purpose financial reports. The full cost of an output produced by a responsibility segment is the sum of (1) the costs of resources consumed by the segment that directly or indirectly contribute to the output, and (2) the costs of identifiable supporting services provided by other responsibility segments within the reporting entity and by other reporting entities." SFFAS 4 also provides a costing methodology standard which states in part, "The full costs of resources that directly or indirectly contribute to the production of outputs should be assigned to outputs through costing methodologies or cost finding techniques that are most appropriate to the segment's operating environment and should be followed consistently." In discussing cost assignment, SFFAS 4 provided the following principles in the order of preference:

   a. Directly tracing costs wherever economically feasible;

   b. Assigning costs on a cause-and-effect basis; and

   c. Allocating costs on a reasonable and consistent basis.

4. SFFAS 5 requires that entities recognize a liability for a past event or exchange transaction that has occurred when a future outflow or other sacrifice of resources is probable and the future outflow or sacrifice of resources is measurable. "Probable" refers to that which can reasonably be expected or is believed to be more likely than not on the basis of available evidence or logic, with the exception of pending or threatened litigation and unasserted claims. For pending or threatened litigation and unasserted claims, "probable" implies that the future confirming event or events are likely to occur. [As amended by paragraphs 10 and 11 of SFFAS 12, *Recognition of Contingent Liabilities arising from Litigation: An Amendment of SFFAS 5, Accounting for Liabilities of the Federal Government]*. SFFAS 5 also requires that contingent liabilities be recognized when probable and measurable.

Effective Date

5. This technical bulletin is effective for reporting periods beginning after September 30, 2001.

Technical Guidance

Issue

6. What reasonable cost assignment principles should be applied when it is not clear where the liability and cost related to legal claims (i.e., judgments and settlements) should be reported because (a) the actions of Federal component entities[1] contribute to a legal claim having been filed against the Federal government or (b) a Federal component entity disputes that its actions contributed to the legal claim having been filed against the Federal government?

[1] The term "component entity" is used to distinguish between the U. S. Federal government and its components. The U. S. Federal government is composed of organizations that manage resources and are responsible for operations, i.e., delivering services. These include major departments and independent agencies, which are generally divided into sub organizations, i.e., smaller organizational units with a wide variety of titles, including bureaus, administrations, agencies, and corporations. (SFFAC No. 2, *Entity and Display*, paragraphs 11-12) Use of "component entity" in this technical bulletin is only intended to distinguish between the U.S. Federal government's consolidated financial statements and financial statements of its components.

General Principles

7. All liabilities and costs must be attributed to the component entities responsible for the programs or activities that contributed to the claims or to their successor component entities. This attribution follows the general principle that all transactions or events reported on the consolidated statements should be attributed to some Federal component entity.

Implementation

8. The following hierarchy of cost assignment principles should be applied when the actions of one or more Federal component entities contribute to a legal claim having been filed against the Federal government or when a Federal component entity disputes that its actions contributed to the legal claim having been filed against the Federal government and it is not clear where the liability and cost should be reported.

   a. The component entities should apply the cost methodology principles provided in SFFAS 4 in the following order of preference:

      ii. Directly tracing costs wherever economically feasible;

      iii. Assigning costs on a cause-and-effect basis; and

      iv. Allocating costs on a reasonable and consistent basis.

      The component entities should seek advice from the appropriate legal counsel (Office of the General Counsel, Department of Justice, etc.) about pertinent legal matters and other factors that could be relevant to assigning costs. The management of the component entities involved should work together to resolve the issues before moving on to step (b.) below.

   b. If a reasonable cost assignment or allocation cannot be determined, as outlined in step (a.) above, the component entities should seek guidance from OMB's Office of Federal Financial Management (or its successor division) and recognize costs and liabilities as directed by OMB. In addition, all component entities involved should disclose the information concerning the nature

of the costs and/or liability[2], the problems of assigning the costs to the component entities involved, and the estimated total liability among all the component entities involved.

The provisions of this bulletin need not be applied to immaterial items.

[2] See specific disclosure requirements in Interpretation 2 paragraph 3 and SFFAS 5 paragraphs 40-42.

Appendix A: Basis For Conclusions

9. This appendix summarizes some of the considerations deemed significant in reaching the conclusions in this technical bulletin. It includes the reasons for accepting certain approaches and rejecting others. Some factors had greater weight than other factors.

10. The issue raised in this technical bulletin is:
What reasonable cost assignment principles should be applied when it is not clear where the liability and cost related to legal claims (i.e., judgments and settlements) should be reported because (i) the actions Federal component entities contribute to a legal claim having been filed against the Federal government or (ii) a Federal component entity disputes that its actions contributed to the legal claim having been filed against the Federal government?

11. The Accounting and Auditing Policy Committee (AAPC) of FASAB originally proposed that in those rare instances, when allocating to one or more specific entities does not appear to be appropriate, OMB could allocate the costs directly to the consolidated financial statements of the U.S. government. However, a majority of the Board did not agree with the AAPC proposal and concluded that all costs and liabilities must be reported at the component level before flowing into the consolidated statements. Thus, the AAPC's proposed guidance was not issued as a technical release.

12. This Technical Bulletin exposure draft was issued in March 2002. During the 30-day comment period 12 comment letters were received. Eight of the respondents either said they agreed with or had no comment on the proposed guidance. Three other respondents commented on specific sections of the guidance and one additional respondent disagreed with the proposed guidance. The respondents' comments are summarized below. The Board does not simply rely on the number of respondents in favor of or opposed to a given position. The Board considers the arguments in each response and weighs the merits of the points raised. Information about respondent's views is provided only as a means of summarizing the comments.

	Federal	Non-federal
Users, academics, and others	2	1
Auditors	6	
Preparers and financial managers	3	

Respondents made the following individual comments:

a. the initial assessment of the probability of a legal liability should be made by the respective legal counsel but legal counsel should not make accounting decisions;

b. the attribution of liabilities to existing agencies for the activities of long-defunct federal instrumentalities, like the WWII entities, will overstate the apparent cost associated with that agency or its programs.

Based on the respondent's comment letters the Board reiterated the following conclusions.

With regard to the concern that legal counsel would not be in the position of offering accounting advice to agencies with respect to appropriate cost accounting methodology, the TB directs the component entities only to consult with legal counsel on information that may be relevant to determining the cost assignment.

With regard to legal costs of long-defunct Federal entities, the TB specifically states that component entities be responsible for their own claims as well as those of their successor component entities and that in those cases where the entities no longer exist, footnote disclosures are available for further explanations.

13. The Board's position is that all costs and liabilities must be attributed to component entities; that is, entities other than the U. S. Federal government as a whole. In general, the Board believes that the consolidated financial statements of the U. S. Federal government are a summation of component entity financial statements with appropriate intragovernmental eliminations.

14. Staff reviewed with the Board the possibility of reporting those unassigned costs and liabilities on the Treasury Judgment Fund (TJF)[3]

[3] In 1956, Congress enacted a permanent, indefinite appropriation ("the Judgment Fund") for the payment of final judgments that were "not otherwise provided for" (i.e. which cannot legally be paid from any existing appropriation or fund). Payments from the judgment appropriations may be made only upon certification by Financial Management Service, Department of the Treasury. Treasury's role is to "oversee" the use of this appropriation.

financial statements. Staff and the Board believe TJF should not bear the responsibility of recording all unassigned legal costs, as each component entity should accumulate and report the costs of its own activities. In addition, the TJF is merely the funding mechanism for many of the legal settlements and judgments against the Federal government.

15. Therefore, staff concluded that entities should first apply the cost methodology principles provided in SFFAS 4 and that all legal costs must be allocated to a component entity, whether those costs are paid by the entity or by the Treasury Judgment Fund. This principal is consistent with those outlined in the Interpretation 2, *Accounting for Treasury Judgment Fund Transactions*. However, in instances when it is impossible for component entities to agree on a reasonable cost assignment or allocation basis, the entities should recognize costs and liabilities as directed by OMB. In addition, the Federal entities involved will be required to fully disclose all pertinent information related to the legal costs.

Technical Bulletin 2002-2: Disclosures Required by Paragraph 79(g) of SFFAS 7 Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting

Status

Issued	September 19, 2002
Effective Date	Immediate
Volume I References	Paragraph 79(g) of SFFAS 7 *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*
Volume II References	Revenue (R40)
Interpretations and Technical Releases	None
Affects	Paragraph 79(g) of SFFAS 7 *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*
Affected by	None

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References

SFFAS 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, paragraphs 77-79.

Question

1. Paragraph 77 of SFFAS 7 calls for presentation of certain material budgetary information by federal financial reporting entities "whose financing comes wholly or partially from the budget:

   a. total budgetary resources available to the reporting entity during the period;

   b. the status of those resources (including 'obligations incurred');

   c. outlays."

2. Paragraph 79(g) of SFFAS 7 calls for disclosure of "explanations of any material differences between the information required by paragraph 77 and the amounts described as 'actual' in the *Budget of the United States Government*" (also known as the "President's Budget").

3. If a federal financial reporting entity issues financial statements for a given fiscal year before the President's Budget with actual numbers for the same fiscal year is published, what disclosure, if any, should the reporting entity make pursuant to paragraph 79(g) of SFFAS 7?

Response

4. The reporting entity should disclose that the President's Budget with actual numbers for the fiscal year has not yet been published, explain when it is expected to be published, and indicate where it will be available. The information called for by paragraph 79(g) for the prior fiscal year should be included in the current financial report (unless it was included the entity's prior report, as will be the case in the first year in which the financial report is published before the President's Budget).

5. For example, a department that issued its financial report for FY 2001 in March of 2002 would have included the information called for by paragraph 79(g) in that report, because the President's Budget with that information had been published before the department's financial

report was published. If the department publishes its financial report for FY 2002 in December 2002, the department would disclose that the President's Budget with actual numbers for the fiscal year had not yet been published, explain when it is expected to be published, and indicate where it will be available. There would be no need to disclose the information called for by paragraph 79(g) with respect to FY 2001, because that information had already been reported in the FY 2001 report. If the department then publishes its financial report for FY 2003 in December 2003, that report would include the information called for by paragraph 79(g) with respect to FY 2002.

Effective Date and Transition

6. The provisions of this Technical Bulletin are effective immediately.

The Federal Accounting Standards Advisory Board has authorized its staff to prepare FASAB Technical Bulletins to provide guidance on certain financial accounting and reporting problems on a timely basis, pursuant to the procedures described in FASAB Technical Bulletin 2000-1 *Purpose and Scope of FASAB Technical Bulletins and Procedures for Issuance*. The provisions of Technical Bulletins need not be applied to immaterial items.

Appendix: Background Information and Consideration of Comments Received

7. When SFFAS 7 was published in 1996, federal entities that published financial reports typically did so well after the *Budget of the United States Government* (also known as "the President's Budget") was published. Since 1996, several federal entities have improved their financial accounting and reporting practices to the point where they can publish financial reports before the President's Budget is available. Most, if not all federal reporting entities are expected to do this in future years.

8. The disclosure called for by paragraph 79(g) is informative and addresses the objective of budgetary integrity, but it would be inappropriate to delay publication of the entire financial report until the President's Budget with actual numbers for the fiscal year is published. In such circumstances, the intent of paragraph 79(g) can best be accomplished as described in paragraph 4.

9. Pursuant to FASAB's procedures for exposing a technical bulletin (TB), the proposed TB was distributed by e-mail to federal Chief Financial Officers and Inspectors General. The proposed TB was also posted on FASAB's World Wide Web site (www.fasab.gov), and notices were sent to everyone on FASAB's e-mail list. FASAB received 18 responses. Most supported the proposed TB or expressed no comment. Four suggested clarifying language or expressed concerns that implied a need for clarification. Accordingly, paragraph 5 was added to illustrate the effect of applying the Technical Bulletin.

10. The Board reviewed the proposed TB and the comments at its meeting on August 8, 2002. The TB was revised as discussed in paragraph 9 and distributed to the Board. FASAB's Executive Director determined that a majority of the FASAB did not object to the TB as revised, and accordingly posted the TB to www.fasab.gov.

Technical Bulletin 2003-1: Certain Questions and Answers Related to the Homeland Security Act of 2002

Status

Issued	June 13, 2003
Effective Date	for periods ending after September 30, 2002
Volume I References	SFFAS 6, Accounting for Property, Plant, and Equipment SFFAS 7, *Accounting for Revenue and Other Financing Sources* (for guidance on transfers)
Volume II References	None.
Interpretations and Technical Releases	None.
Affects	None.
Affected by	None.

Summary

I. This technical bulletin answers certain questions arising from the creation of the Department of Homeland Security and other transfers of operations between federal entities directed by the Homeland Security Act of 2002. Standards issued by the Federal Accounting Standards Advisory Board (FASAB) have precedence over other sources of generally accepted accounting principles for Federal entities. This technical bulletin supplements any relevant Federal standards, but is not a substitute for and does not take precedence over standards and interpretations issued by FASAB.

II. The primary effects of this technical bulletin are that:

a. Legacy entities will segregate the net costs of continuing and transferred operations, and recognize a transfer-out for assets and liabilities transferred. Segregation of the net cost is required for both current and prior period net cost.

b. Transferred entities will segregate the net costs of continuing and transferred operations for components of the transferred entity that (1) were not transferred from the legacy entity or (2) subsequent to the creation of the Department of Homeland Security were no longer included in the transferred entity's operations. Transferred entities will recognize a transfer-out for assets and liabilities transferred. Segregation of the net cost is required for both current and prior period net cost.

c. Department of Homeland Security and other receiving entities will recognize assets and liabilities received at book value[1] and recognize a "transfer-in." Financial statements based on the transfers and actual operations subsequent to the transfer will be presented.

III. Guidance on segregating the net costs of continuing and transferred operations is consistent with Financial Accounting Standard 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Guidance on transfers of assets and liabilities is consistent with Statement of Federal Financial Accounting Standards 7, *Accounting for Revenue and Other Financing Sources*.

[1] "Book value" is the net amount at which an asset or liability is carried on the books of account (also referred to as carrying value or amount). It equals the gross or nominal amount of any asset or liability minus any allowance or valuation amount.

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Introduction

1. The Homeland Security Act of 2002 impacts many federal entities in varying ways. The purpose of this Technical Bulletin is to provide accounting and reporting guidance for legacy, transferred and receiving entities. The guidance is based largely on Financial Accounting Standard (FAS) 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, modified to fit the circumstances of federal entities. The objective is to provide comparable information for entities affected by the HS Act to the extent feasible.

Effective Date

2. This technical bulletin is effective for reporting periods beginning after September 30, 2002.

Technical Guidance

Scope

3. What entities' accounting practices are addressed in this Technical Bulletin?

4. This guidance is limited to transfers of functions[1], personnel, assets, and liabilities resulting from the Homeland Security Act of 2002 (HS Act[2]). The following types of entities affected by the HS Act are addressed:

   a. "Receiving entity" refers to an entity to which functions are transferred.

   b. "Legacy entity" refers to an entity from which a smaller entity or specific function is being transferred.

[1] The HS Act provides for the transfer of functions, personnel, assets, and liabilities. The term "functions" includes authorities, powers, rights, privileges, immunities, programs, projects, activities, duties, and responsibilities. The term "operations" is more commonly used in accounting literature and is sometimes used as a substitute for "functions" in this document.

[2] Public Law 107-296, 116 Stat. 2135, November 25, 2002.

c. "Transferred entity" refers to an entity preparing stand-alone financial statements consolidated with a legacy entity's financial statements prior to transfer and with a receiving entity's financial statements after transfer.[3]

APB 20 Is Not Applicable

5. **Should receiving, legacy, and/or transferred entities apply Accounting Principles Bulletin (APB) 20 (par. 12 and 35) guidance for a change in entity? (See Appendix B, page 21, for the relevant text of APB 20)**

6. No. APB 20 should not be applied to any of the changes resulting from transfers of functions among federal entities due to the HS Act.

FAS 144 is Applicable

Accounting by Legacy Entities

7. **Should legacy entities apply Financial Accounting Standard (FAS) 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*,[4] in accounting for and reporting on components of the entity[5] transferred to receiving entities? (See Appendix C, page 1150, for the relevant text of FAS 144)**

8. Yes. FAS 144 par. 41 to 44 and 47(a)[6] should be applied by legacy entities with the exception of par. 43 guidance requiring recognition of

[3] Guidance is provided for transferred entities because it is possible that functions would be transferred back to the legacy entity. The Office of Management and Budget (OMB) plan for Department of Homeland Security (DHS) specifically provides that "any functions of those entities that are not directly related to securing the homeland will continue to be allocated to the agencies and subdivisions in which they are currently incorporated."

[4] This Technical Bulletin addresses questions related to applying FAS 144 to a federal reporting entity. While this Technical Bulletin discusses many aspects of applying FAS 144, it does not provide a comprehensive illustration.

[5] FAS 144, par. 41 states that "a component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity."

[6] Paragraph 47(a) requires the following disclosure: A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group.

a gain or loss on disposal (see par. What amount should legacy entities report for the transfer of assets and liabilities? through This SFFAS 7 guidance precludes application of FAS 144's requirement that gains and losses be included in the results of operations of discontinued or transferred operations (FAS 144, par. 37 and 43). below). While FAS 144 uses the term "discontinued operations", legacy entities should use the term "Transferred Operations" as appropri[7]ate.

9. In reporting the "results of operations of the component" for current and prior periods as required by par. 43 of FAS 144 (see page 1150), what information should the legacy entities report?

10. For all periods presented, legacy entities should report material amounts of gross cost, exchange revenue, and net cost for transferred or discontinued components of the entity (as defined by par. 41 of FAS 144 - see page 1150). In some cases, functions may be discontinued or transferred but may not be "components of the entity" as defined in par. 41 of FAS 144. If functions are not "components of the entity" there is no requirement to separately report the function's results of operations under FAS 144.

11. The Statement of Net Cost should present a sub-total for "Net Cost of Continuing Operations" immediately before the presentation of amounts related to transferred and/or discontinued operations. All elements related to transferred and/or discontinued operations should be appropriately labeled. For example, for transferred operations:

Net Cost of Continuing Operations		$XX
Transferred Operations:		
Cost of Transferred Operations	$ XX	
Exchange Revenue from Transferred Operations	XX	
Net Cost of Transferred Operations		XX
Net Cost		$XX

[7] All affected entities are components of the Federal Government as a whole. Thus, all statements should clearly distinguish between operations that are transferred versus truly "discontinued." While the operations may be discontinued at one entity – they may be continued at another entity. Thus, the term "transferred" may be more appropriate.

12. **What amount should legacy entities report for the transfer of assets and liabilities?**

13. SFFAS 7, par. 74, provides that transfers between entities without reimbursement should be recognized as "transfers-in[8] or out" on the Statement of Changes in Net Position. The amount transferred is equivalent to the book value[9] of all assets and liabilities transferred.

14. This SFFAS 7 guidance precludes application of FAS 144's requirement that gains and losses be included in the results of operations of discontinued or transferred operations (FAS 144, par. 37 and 43).

15. **Does FAS 144 require legacy entities to segregate the Statements of Budgetary Resources and Financing between continuing and transferred and/or discontinued operations?**

16. No. There are no FAS 144 requirements that would apply to the Statements of Budgetary Resources and Financing.[10]

Accounting by Transferred Entities

17. **Should a transferred entity preparing its own financial statements apply FAS 144 par. 41 through 44 and 47(a) to reporting on discontinued or transferred components of the entity?**

18. Yes. If a transferred entity had material components (as defined by FAS 144 par. 41) that were not also transferred with the rest of the entity, the transferred entity should apply FAS 144, par. 41 through 44 and 47(a) and par.For all periods presented, legacy entities should report material amounts of gross cost, exchange revenue, and net cost for transferred or discontinued components of the entity (as defined by par. 41 of FAS 144 - see page 1150). In some cases, functions may be

[8]It is possible to have a negative transfer-out at the legacy entity because liabilities transferred may exceed assets transferred.

[9]"Book value" is the net amount at which an asset or liability is carried on the books of account (also referred to as carrying value or amount). It equals the gross or nominal amount of any asset or liability minus any allowance or valuation amount.

[10] While these statements may be affected by transactions related to the HS Act, this Technical Bulletin provides guidance on application of FAS 144 in light of existing federal guidance. FAS 144 requirements relate primarily to exchange transactions as well as events associated with operations. Thus, FAS 144 requirements do not extend to these statements.

discontinued or transferred but may not be "components of the entity" as defined in par. 41 of FAS 144. If functions are not "components of the entity" there is no requirement to separately report the function's results of operations under FAS 144. and The Statement of Net Cost should present a sub-total for "Net Cost of Continuing Operations" immediately before the presentation of amounts related to transferred and/or discontinued operations. All elements related to transferred and/or discontinued operations should be appropriately labeled. For example, for transferred operations: above and report separately the results of continuing and transferred operati[11]ons.

19. What additional disclosures should a transferred entity preparing free-standing entity-level financial statements provide?

20. Transferred entities should disclose:

a. a description of the facts and circumstances leading to the transfer,

b. the timing of the transfer,

c. significant changes in its operations as a result of the transfer, and

d. the net cost attributable to the transferred entity's pre-transfer operations (this amount is equal to the amount the legacy entity would report as "net cost of discontinued or transferred operations" per par.For all periods presented, legacy entities should report material amounts of gross cost, exchange revenue, and net cost for transferred or discontinued components of the entity (as defined by par. 41 of FAS 144 - see page 1150). In some cases, functions may be discontinued or transferred but may not

[11] For example, an entity may transfer to DHS "except for" certain functions that remain with the legacy entity. If these un-transferred functions are carried out by a component of the entity as defined in FAS 144 par. 41 and the associated amounts are material, the related revenues and costs would be reported under "transferred operations" per par. The Statement of Net Cost should present a sub-total for "Net Cost of Continuing Operations" immediately before the presentation of amounts related to transferred and/or discontinued operations. All elements related to transferred and/or discontinued operations should be appropriately labeled. For example, for transferred operations:.

be "components of the entity" as defined in par. 41 of FAS 144. If functions are not "components of the entity" there is no requirement to separately report the function's results of operations under FAS 144. above).

Accounting by Receiving Entities

21. How will receiving entity financial statements report on the transfer of components and functions from legacy entities?

22. Receiving entities will recognize assets and liabilities based on the legacy entities' book values at the time of transfer. SFFAS 7, par. 74 provides guidance for transfers-in and requires that transferred assets be recognized by the receiving entity at the legacy entity's book value.[12]

23. The net effect of the assets and liabilities received will be recognized as a "transfer-in" on the receiving entity's Statement of Changes in Net Position. Note that it is possible to have a negative transfer-in at the receiving entity because liabilities transferred may exceed assets transferred.

24. Receiving entities will prepare financial statements based on the transfers and actual operations subsequent to the transfer..

The provisions of this bulletin need not be applied to immaterial items.

[12] The net amount at which an asset or liability is carried on the books of account (also referred to as carrying value or amount). It equals the gross or nominal amount of any asset or liability minus any allowance or valuation amount.

Appendix A: Basis For Conclusions

25. The Federal Accounting Standards Advisory Board has authorized its staff to prepare FASAB Technical Bulletins to provide timely guidance on certain financial accounting and reporting problems, in accordance with section III. I. 5 of the Board's rules of procedure, as amended and restated through October 1, 1999 and the procedures described in FASAB Technical Bulletin 2000-1, Purpose and Scope of FASAB Technical Bulletins and Procedures for Issuance. The provisions of Technical Bulletins need not be applied to immaterial items.

26. An exposure draft was issued March 21, 2003 and the Board considered responses to the exposure draft at its April 24, 2003 public meeting. The FASAB has reviewed this Technical Bulletin and a majority of its members do not object to its issuance.

27. This appendix discusses some factors considered significant by staff in reaching the conclusions in this Technical Bulletin. It includes the reasons for accepting certain approaches and rejecting others. Some factors were given greater weight than other factors. The guidance enunciated in the technical guidance section---not the material in this appendix---should govern the accounting for specific transactions, events or conditions

APB 20 Is Not Applicable

28. APB 20 defines a "change in entity" as:

    This type [of accounting change] is limited mainly to (a) presenting consolidated or combined statements in place of statements of individual companies, (b) changing specific subsidiaries comprising the group of companies for which consolidated financial statements are presented, and (c) changing the companies included in combined financial statements. A different group of companies comprise the reporting entity after each change. (Financial Accounting Standards Board, Original Pronouncements, Change in Reporting Entity (par. 12))

29. APB 20 requires restatement when a "change in entity" occurs. Restatement means the "recasting of a previously determined (and published) balance sheet or operating statement, and its republication where there has been a substantial change in accounting principles or

policies." (Kohler's Dictionary for Accountants) For private-sector entities a complete set of comparable financial statements for an individual reporting entity is critical to lending and investing decisions.[13] The current and prior period financial statements assist in discerning the earning power and credit-worthiness of entities thus trends in assets, liabilities and results of operations are essential.

30. Federal financial reporting objectives do not focus on the earning power or credit worthiness of the component entities of the government. Instead, federal financial reporting objectives focus on:

    a. Compliance with laws and regulations governing the use of resources (budgetary integrity);

    b. Evaluating the service efforts and accomplishments of a reporting entity (operating performance) as well as the entity's management of assets and liabilities;

    c. Assessing the government's financial position and changes in its financial position (stewardship); and

    d. Assuring that systems and controls support compliance with laws and regulations (systems and controls).

[13] FASB Concepts Statement 1: Objectives of Financial Reporting by Business Enterprises states that:

—Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.

—Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investors' and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.

—Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change its resources and claims to those resources.

31. Restatement may obscure information about the changes directed by the HS Act since restatement would portray financial information as if the event occurred prior to its enactment and effective date. Portraying the actual results of operations including actual transfers of assets and liabilities for which an entity is legally accountable is most consistent with federal reporting objectives. Thus, staff does not believe restatement aids in meeting federal financial reporting objectives.

32. Further, staff does not believe that comparable financial statements for all affected entities could result from the restatement envisioned by APB 20. Staff does not believe that the changes required by the HS Act are "changes in entity" as defined in APB 20. APB 20 describes a change in entity as "changing specific subsidiaries for which consolidated financial statements are presented." The APB 20 description does not fit all of the changes required by the HS Act. The HS Act requires concurrent changes within entities that are transferred as well as realignment of entities and operations that are part of a single larger entity both before and after the change.

33. Respondents to the March 21, 2003 exposure draft supported the staff's assertion that APB 20 is not applicable. Some respondents suggested that the scope of the Technical Bulletin be expanded so that APB 20 would not be applied to any future changes at the federal level. Staff has not incorporated this suggestion but has recommended that the Board consider it when an opportunity to address new issues arises in the future.

Applicability of FAS 144

34. FAS 144 addresses discontinued operations and provides for separate reporting of the results of operations associated with discontinued operations. The standard provides a definition of "component of an entity" (FAS 144, par. 41, see page 1150) as well as criteria for determining if the activity of the component has been discontinued (FAS 144, par. 42, see page 1150).

35. Under the HS Act, functions may be discontinued at the legacy entity, but not discontinued by the government-as-a-whole. Therefore, the term "transferred" operations should be substituted for "discontinued" operations when appropriate. This will ensure that the reader does not conclude that the government has stopped performing certain functions.[14]

36. FAS 144 provides guidance that – in the private sector – results in segregation of critical information directly linked to operations that are either continuing or discontinued. Application of FAS 144 to entities affected by the Homeland Security Act of 2002 will result in:

    a. Legacy and transferred entities providing comparable financial information for continuing operations by separately identifying the net cost of continuing and transferred operations on the face of the Statement of Net Cost for all periods presented; and

    b. Receiving entities preparing Statements of Net Cost based on the actual operations subsequent to the transfer.

37. This will result in the most useful presentation since it produces a consistent and understandable result across all entities.

38. Respondents to the March 21, 2003 exposure draft supported the staff's assertion that FAS 144 is applicable. Some respondents suggested that the scope of the Technical Bulletin be expanded so that FAS 144 would be applied to any future changes at the federal level. Staff has not incorporated this suggestion but has recommended that the Board consider it when an opportunity to address new issues arises in the future.

Respondents' Request for Guidance on General PP&E Transfers

39. Some respondents asked for specific guidance on the transfer of general property, plant, and equipment (PP&E). The questions posed were:

    a. Should a capitalization threshold be applied to the book value upon transfer?

    b. Should the acquisition date be adjusted to the transfer date?

    c. Should the gross book and associated accumulated depreciation be recorded or should the PP&E be booked at "net"?

40. Staff has not incorporated guidance on these questions in this Technical Bulletin. The questions posed are procedural in nature. Staff

[14] "Discontinued operations" may be appropriate in the event that material functions are discontinued.

believes management may determine the most effective procedures to accomplish the initial recognition of the book value of general PP&E and its depreciation during the operating period.

Respondents' Request for Guidance on the Statements of Custodial Activity and Changes in Net Position

41. Some respondents asked whether collections for which the collecting function was transferred should be separately disclosed on the face of or in notes to the Statement of Custodial Activity. Staff has not included in this Technical Bulletin this requirement or expressed a preference for the suggested display. However, staff notes that there is nothing precluding the suggested treatment. Staff did not believe the issue was controversial enough to suggest a proposed resolution.

42. Some respondents suggested that the Statement of Changes in Net Position also should present separate amounts for continuing and transferred (or discontinued) operations. While this proposal may be explored at a future time, staff does not believe it would be appropriate to impose this requirement through a Technical Bulletin. Technical Bulletins receive minimal due process. Thus, limitations are placed on the types of requirements that may be imposed in a Technical Bulletin.

43. Technical Bulletin 2000-1 provides that staff may pursue an issue through a Technical Bulletin if:

    a. the guidance is not expected to cause a major change in accounting practice. (TB 2000-1, par. 5a)

    b. the administrative cost involved in implementing the guidance is not expected to be significant to most affected entities. (TB 2000-1, par. 5b)

    c. the guidance does not conflict with a broad fundamental principle or create a novel accounting practice. (TB 2000-1, par. 5c)

44. In this case, staff elected to rely on practices developed through full due process in other domains by searching GAAP for non-governmental entities for relevant requirements. FAS 144 was found to be the best fit for this circumstance. In relating the FAS 144 guidance to the federal reporting model, staff was mindful that FAS 144 provisions are applicable to revenues, expenses, gains and losses resulting from exchange transactions and related events. Staff found

that the elements for which FAS 144 requires segregation aligned with the elements presented on the Statement of Net Cost.

45. Staff does not believe that FAS 144 requirements extend logically to financing sources presented on the Statement of Changes in Net Position. Thus, FAS 144 would not support a requirement that federal entities segregate continuing and transferred/discontinued financing sources.

46. In addition, the federal reporting model requires entities to report net cost by program while reporting financing sources for the entity as a whole. Staff believes that requiring the Statement of Changes in Net Position to present information for a transferred/discontinued "component of an entity" is arguably a major change in practice from aggregated to disaggregated financing information.

47. Therefore, staff believes segregation of the Statement of Changes in Net Position warrants greater due process than that provided through a Technical Bulletin and has not incorporated the respondents' suggestions in this Technical Bulletin.

Statement of Budgetary Resources

48. As mentioned in par. , FAS 144 does not require segregation of information beyond the results of continued and discontinued operations. Since the Statement of Budgetary Resources does not report the results of operations, FAS 144 would not support a requirement that federal entities segregate elements of the Statement of Budgetary Resources between continuing and transferred/discontinued budgetary and reconciling elements. For reasons similar to those provided in paragraphs through , staff does not believe this Technical Bulletin should require segregation of the elements of this statement.

49. Staff also notes that the Statement of Budgetary Resources presents information intended to support the "budgetary integrity" reporting objective. This reporting objective provides that "Federal financial reporting should assist in fulfilling the government's duty to be publicly accountable for monies raised through taxes and other means and for their expenditure in accordance with the appropriations laws that establish the government's budget for a particular fiscal year and related laws and regulations."(SFFAC 1, par. 112)

50. Thus, the information presented on the Statement of Budgetary Resources relates to compliance with budgetary provisions including reporting on transfers of budgetary resources associated with the HS Act. It also relates to the current availability of budgetary resources. It is less clear that the Statement of Budgetary Resources is intended to provide information needed to determine whether financing sources will be "continuing." In addition, SFFAS 7, par. 79 currently requires extensive disclosures relating to legislative actions affecting resources provided to entities. Thus, staff does not believe that immediate changes to the Statement of Budgetary Resources are needed to ensure that federal financial reporting objectives are met.

51. Generally, staff believes that existing guidance in accounting standards, guidance from the Office of Management and Budget regarding the Statement of Budgetary Resources (e.g., OMB Circular A-11 which is referenced by SFFAS 7, par. 78), and other operational guidance will assist in resolving some of the other issues raised by respondents.

Statement of Financing

52. SFFAS 7 indicates that the purpose of the Statement of Financing is:

> .. to explain how budgetary resources obligated during the period relate to the net cost of operations for that reporting entity. This information should be presented in a way that clarifies the relationship between the obligation basis of budgetary accounting and the accrual basis of financial (i.e., proprietary) accounting. By explaining this relationship through a reconciliation, the statement provides information necessary to understand how the budgetary (and some nonbudgetary) resources finance the cost of operations and affect the assets and liabilities of the reporting entity. (SFFAS 7, par. 95)

53. Staff does not believe that SFFAS 7 envisioned explanations of these relationships in greater detail than the "reporting entity" level. To impose a greater disaggregation would, in staff's opinion, require greater due process than afforded for a Technical Bulletin.

Unique Federal Guidance Sought by Some Respondents

54. Some respondents agreed that the result of applying FAS 144 was desirable but asserted that standards tailored to the unique federal environment and reporting model should be developed. Staff believes this Technical Bulletin provides important guidance in response to an immediate need. Given the limited due process associated with Technical Bulletins, staff believes that – in this case – it was

appropriate to rely on non-federal accounting standards to support a solution that fits the circumstances and meets federal reporting objectives.

Effective Date

55. The effective date of this Technical Bulletin -- for reporting periods beginning after September 30, 2002 – is necessary due to the timing of the HS Act. Staff does not routinely issue pronouncements that are effective in the period issued but must do so in this case to provide timely guidance.

Appendix B: Accounting Principles Board Opinion 20

Excerpt From FASB's Original Pronouncements

Changes in Accounting Principles
Change in Reporting Entity

APB20, Par. 12

12. One special type of change in accounting principle results in financial statements which, in effect, are those of a different reporting entity. This type is limited mainly to (a) presenting consolidated or combined statements in place of statements of individual companies, (b) changing specific subsidiaries comprising the group of companies for which consolidated financial statements are presented, and (c) changing the companies included in combined financial statements. A different group of companies comprise the reporting entity after each change.

35. Disclosure. The financial statements of the period of a change in the reporting entity should describe the nature of the change and the reason for it. In addition, the effect of the change on income before extraordinary items, net income, and related per share amounts should be disclosed for all periods presented. Financial statements of subsequent periods need not repeat the disclosures. (Paragraphs 56 to 65 and 93 to 96 of APB Opinion No. 16, Business Combinations, describe the manner of reporting and the disclosures required for a change in reporting entity that occurs because of a business combination.)

Appendix C: Excerpt From Financial Accounting Standard 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*

FAS144, Par. 41

41. For purposes of this Statement, a component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment (as those terms are defined in paragraph 10 of Statement 131), a reporting unit (as that term is defined in Statement 142), a subsidiary, or an asset group (as that term is defined in paragraph 4).

42. The results of operations of a component of an entity that either has been disposed of or is classified as held for sale shall be reported in discontinued operations in accordance with paragraph 43 if both of the following conditions are met: (a) the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction and (b) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction. (Examples 12-15 of Appendix A illustrate disposal activities that do or do not qualify for reporting as discontinued operations.)

43. In a period in which a component of an entity either has been disposed of or is classified as held for sale, the income statement of a business enterprise (or statement of activities of a not-for-profit organization) for current and prior periods shall report the results of operations of the component, **including any gain or loss recognized in accordance with paragraph 37** [emphasis added], in discontinued operations. The results of operations of a component classified as held for sale shall be reported in discontinued operations in the period(s) in which they occur. The results of discontinued operations, less applicable income taxes (benefit), shall be reported as a separate component of income before extraordinary items and the cumulative effect of accounting changes (if applicable). For example, the results of discontinued operations may be reported in the income statement of a business enterprise as follows:

Income from continuing operations before income taxes		$XXXX
Income taxes		XXX
Income from continuing operations[a]		$XXXX
Discontinued operations (Note X)		
Loss from operations of discontinued Component X (including loss on disposal of $XXX)	XXXX	
Income tax benefit	XXXX	
Loss on discontinued operations	XXXX	
Net income		$XXXX

[a] This caption shall be modified appropriately when an entity reports an extraordinary item or the cumulative effect of a change in accounting principle or both in accordance with Opinion 20. If applicable, the presentation of per-share data will need similar modification.

A gain or loss recognized on the disposal shall be disclosed either on the face of the income statement or in the notes to the financial statements (paragraph 47(b)).

44. Adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of an entity in a prior period shall be classified separately in the current period in discontinued operations. The nature and amount of such adjustments shall be disclosed. Examples of circumstances in which those types of adjustments may arise include the following:

    a. The resolution of contingencies that arise pursuant to the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser

    b. The resolution of contingencies that arise from and that are directly related to the operations of the component prior to its disposal, such as environmental and product warranty obligations retained by the seller

c. The settlement of employee benefit plan obligations (pension, postemployment benefits other than pensions, and other postemployment benefits), provided that the settlement is directly related to the disposal transaction.[15]

Reporting Disposal Gains or Losses in Continuing Operations

45. A gain or loss recognized for a long-lived asset (disposal group) classified as held for sale that is not a component of an entity shall be included in income from continuing operations before income taxes in the income statement of a business enterprise and in income from continuing operations in the statement of activities of a not-for-profit organization. If a subtotal such as "income from operations" is presented, it shall include the amounts of those gains or losses.

Reporting a Long-Lived Asset or Disposal Group Classified as Held for Sale

46. A long-lived asset classified as held for sale shall be presented separately in the statement of financial position. The assets and liabilities of a disposal group classified as held for sale shall be presented separately in the asset and liability sections, respectively, of the statement of financial position. Those assets and liabilities shall not be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale shall be separately disclosed either on the face of the statement of financial position or in the notes to financial statements (paragraph 47(a)).

Disclosure

47. The following information shall be disclosed in the notes to the financial statements that cover the period in which a long-lived asset (disposal group) either has been sold or is classified as held for sale:

    a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group

[15] Paragraph 3 of FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, defines *settlement* as "a transaction that (a) is an irrevocable action, (b) relieves the employer (or the plan) of primary responsibility for a pension benefit obligation, and (c) eliminates significant risks related to the obligations and the assets used to effect the settlement." A settlement is directly related to the disposal transaction if there is a demonstrated direct cause and effect relationship and the settlement occurs no later than one year following the disposal transaction, unless it is delayed by events or circumstances beyond an entity's control (refer to paragraph 31).

b. The gain or loss recognized in accordance with paragraph 37 and if not separately presented on the face of the income statement, the caption in the income statement or the statement of activities that includes that gain or loss

c. If applicable, amounts of revenue and pretax profit or loss reported in discontinued operations

d. If applicable, the segment in which the long-lived asset (disposal group) is reported under Statement 131.

48. If either paragraph 38 or paragraph 40 applies, a description of the facts and circumstances leading to the decision to change the plan to sell the long-lived asset (disposal group) and its effect on the results of operations for the period and any prior periods presented shall be disclosed in the notes to financial statements that include the period of that decision.

Examples 12–15—Reporting Discontinued Operations

A24. The results of operations of a component of an entity that either has been disposed of or is classified as held for sale shall be reported in discontinued operations if (a) the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction and (b) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction (paragraph 42). Examples 12–15 illustrate disposal activities that do or do not qualify for reporting as discontinued operations.

Example 12

A25. An entity that manufactures and sells consumer products has several product groups, each with different product lines and brands. For that entity, a product group is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each product group is a component of the entity.

A26. The entity has experienced losses associated with certain brands in its beauty care products group.

a. The entity decides to exit the beauty care business and commits to a plan to sell the product group with its operations. The

product group is classified as held for sale at that date. The operations and cash flows of the product group will be eliminated from the ongoing operations of the entity as a result of the sale transaction, and the entity will not have any continuing involvement in the operations of the product group after it is sold. In that situation, the conditions in paragraph 42 for reporting in discontinued operations the operations of the product group while it is classified as held for sale would be met.

b. The entity decides to remain in the beauty care business but will discontinue the brands with which the losses are associated. Because the brands are part of a larger cash-flow-generating product group and, in the aggregate, do not represent a group that on its own is a component of the entity, the conditions in paragraph 42 for reporting in discontinued operations the losses associated with the brands that are discontinued would not be met.

Example 13

A27. An entity that is a franchiser in the quick-service restaurant business also operates company-owned restaurants. For that entity, an individual company-owned restaurant is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each company-owned restaurant is a component of the entity.

a. The entity has experienced losses on its company-owned restaurants in one region. The entity decides to exit the quick-service restaurant business in that region and commits to a plan to sell the restaurants in that region. The restaurants are classified as held for sale at that date. The operations and cash flows of the restaurants in that region will be eliminated from the ongoing operations of the entity as a result of the sale transaction, and the entity will not have any continuing involvement in the operations of the restaurants after they are sold. In that situation, the conditions in paragraph 42 for reporting in discontinued operations the operations of the restaurants while they are classified as held for sale would be met.

b. Based on its evaluation of the ownership mix of its system-wide restaurants in certain markets, the entity commits to a plan to sell its company-owned restaurants in one region to an existing franchisee. The restaurants are classified as held for sale at that date. Although each company-owned restaurant, on its own, is a component of the entity, through the franchise agreement, the entity will (1) receive franchise fees determined, in part, based on the future revenues of the restaurants and (2) have significant continuing involvement in the operations of the restaurants after they are sold. In that situation, the conditions in paragraph 42 for reporting in discontinued operations the operations of the restaurants would not be met.

Example 14

A28. An entity that manufactures sporting goods has a bicycle division that designs, manufactures, markets, and distributes bicycles. For that entity, the bicycle division is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the bicycle division is a component of the entity.

A29. The entity has experienced losses in its bicycle division resulting from an increase in manufacturing costs (principally labor costs).

a. The entity decides to exit the bicycle business and commits to a plan to sell the division with its operations. The bicycle division is classified as held for sale at that date. The operations and cash flows of the division will be eliminated from the ongoing operations of the entity as a result of the sale transaction, and the entity will not have any continuing involvement in the operations of the division after it is sold. In that situation, the conditions in paragraph 42 for reporting in discontinued operations the operations of the division while it is classified as held for sale would be met.

b. The entity decides to remain in the bicycle business but will outsource the manufacturing operations and commits to a plan to sell the related manufacturing facility. The facility is classified as held for sale at that date. Because the manufacturing facility is part of a larger cash-flow-generating group (the bicycle division), and on its own is not a component of the entity, the conditions in

paragraph 42 for reporting in discontinued operations the operations (losses) of the manufacturing facility would not be met. (Those conditions also would not be met if the manufacturing facility on its own was a component of the entity because the decision to outsource the manufacturing operations of the division will not eliminate the operations and cash flows of the division [and its bicycle business] from the ongoing operations of the entity.)

Example 15

A30. An entity owns and operates retail stores that sell household goods. For that entity, each store is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each store is a component of the entity.

A31. To expand its retail store operations in one region, the entity decides to close two of its retail stores and open a new "superstore" in that region. The new superstore will continue to sell the household goods previously sold through the two retail stores as well as other related products not previously sold. Although each retail store on its own is a component of the entity, the operations and cash flows from the sale of household goods previously sold through the two retail stores in that region will not be eliminated from the ongoing operations of the entity. In that situation, the conditions in paragraph 42 for reporting in discontinued operations the operations of the stores would not be met.

Federal Financial Accounting and Auditing Technical Release No. 1: Audit Legal Representation Letter Guidance

Status

Issued	March 1, 1998
Effective Date	For fiscal periods beginning after September 30, 1997
Volume I References	SFFAS No. 5, *Accounting for Liabilities of the Federal Government* SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation: An Amendment of SFFAS No. 5, Accounting for Liabilities of the Federal Government*
Volume II References	Liabilities (L40)
Interpretations and Technical Releases	Interpretation No. 2, *Accounting for Treasury Judgment Fund Transactions: An Interpretation of SFFAS No. 4 and SFFAS No. 5*
Affects	
Affected by	

Summary

Management of the Federal reporting entity is responsible for adopting policies and procedures to identify, evaluate and account for litigation, claims and assessments as a basis for the preparation of financial statements, including those handled by outside legal counsel. Management is responsible for reporting loss contingencies in accordance with the requirements of Statement of Federal Financial Accounting Standards No.5. This may require consultation by management and its legal department with DOJ, as well as other outside legal counsel.

The auditor should request that management send a letter of audit inquiry to legal counsel with whom management has consulted concerning litigation, claims and assessments. Management of the Federal reporting entity and its legal department are responsible for providing the auditor with a legal representation letter.

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Issue:

Who should be the source of audit legal representation letters in cases where Department of Justice attorneys are handling legal matters on behalf of other Federal reporting entities?

Background:

This issue was raised by the Department of Justice (DOJ) in relation to Interpretation No. 2, Accounting for Treasury Judgment Fund Transactions, issued by the Federal Accounting Standards Advisory Board (FASAB), however it is applicable to any situation where outside legal counsel is handling legal matters on behalf of a Federal reporting entity.

FASAB Interpretation No. 2 states that "the Federal entity's management, as advised by the Justice Department, must determine whether it is probable that a legal claim will end in a loss for the Federal entity and the loss is estimable." DOJ is concerned that the language in the Interpretation will lead agencies to conclude that DOJ is the sole source of audit legal representation letters in cases where DOJ attorneys are handling legal matters on behalf of other Federal reporting entities.

Recommended Implementation Guidance

Management of the Federal reporting entity is responsible for adopting policies and procedures to identify, evaluate and account for litigation, claims and assessments as a basis for the preparation of financial statements in accordance with the requirements of the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. These include litigation, claims and assessments handled by legal counsel outside of the Federal reporting entity's legal department.

Management of the Federal reporting entity is responsible for ensuring that loss contingencies, including those arising from litigation, claims and assessments, are presented in the financial statements in accordance with the requirements of Statement of Federal Financial Accounting Standards No.5, *Accounting for Liabilities of the Federal Government*. This may require consultation by management and its legal department with DOJ, as well as other outside legal counsel, to ensure the accuracy and completeness of the presentation of matters related to litigation, claims and assessments in the Federal reporting entity's financial statements. Such

consultation may include requesting a list of pending litigation, claims and assessments from DOJ or other outside legal counsel.

A representation letter from legal counsel to the auditor, in response to a letter of audit inquiry from management to legal counsel, is the auditor's primary means of corroborating the information furnished by management concerning the accuracy and completeness of litigation, claims and assessments. The auditor should request that management send a letter of audit inquiry to legal counsel with whom management has consulted concerning litigation, claims and assessments. A materiality limit for the legal representation letter is generally established in the letter of audit inquiry, based on an understanding between management and the auditor.

Management of the Federal reporting entity and its legal department are responsible for providing the auditor with a legal representation letter. The legal representation letter should cover all litigation, claims and assessments pertaining to the Federal reporting entity, including matters handled by DOJ or other outside legal counsel on behalf of the Federal reporting entity.

The legal representation letter provided to the auditor by the Federal reporting entity's legal department, or "inside counsel", may provide sufficient evidential matter for the auditor. In certain circumstances the auditor may also need supporting legal representation from outside counsel. Section AUI 337.26 of the AICPA Codification of Statements on Auditing Standards provides the following guidance for situations where inside counsel is handling litigation, claims and assessments either exclusive of or in conjunction with outside counsel:

> Audit inquiry letters should be sent to those lawyers, which may be either inside or outside lawyers, who have the primary responsibility for, and knowledge about, particular litigation, claims and assessments. If inside counsel is handling litigation, claims and assessments exclusively, their evaluation and response ordinarily would be considered adequate. Similarly, if both inside and outside lawyers have been involved in the matters, but inside counsel has assumed primary responsibility for the matters, inside counsel's evaluation may well be considered adequate. However, there may be circumstances where litigation, claims and assessments involving substantial overall participation by outside lawyers are of such significance to the financial statements that the auditor should consider obtaining the outside lawyers' response that they have not

formulated a substantive conclusion that differs in any material respect from inside counsel's evaluation, even though inside counsel may have primary responsibility.

In those circumstances where the auditor determines that a legal representation letter is needed from DOJ, or other outside legal counsel, to support the Federal reporting entity's legal representation letter, the Federal reporting entity's management, in conjunction with its legal department, would request such representation in a letter of audit inquiry. The Federal reporting entity would provide DOJ with its description and evaluation of the possible outcome of the case in question, and request that the DOJ lawyer respond directly to the auditor. If the Federal reporting entity is not sufficiently knowledgeable of the case to provide a description and evaluation, the DOJ lawyer would be requested to provide a description and evaluation directly to the auditor. Such requests to DOJ should be case specific and directed to the lead DOJ lawyer handling the case. To meet the reporting deadlines for audited financial statements, there should be early coordination between the auditor and the Federal reporting entity's management and legal department to determine whether supporting legal representations will be needed from DOJ.

The legal representation letter provided to the auditor by the legal department of the Federal reporting entity requires an assertion as to the completeness of the list of litigation, claims and assessments, including matters handled by DOJ or other outside legal counsel on behalf of the Federal reporting entity. The auditor's consideration of this completeness assertion is based primarily on the assessed effectiveness of the Federal reporting entity's internal control structure for identifying, evaluating and accounting for litigation, claims and assessments. The auditor also may need to request additional information from the Federal reporting entity, or DOJ or other outside legal counsel, to obtain evidence about the completeness assertion. Such requests to DOJ or other outside legal counsel should be made through management of the Federal reporting entity. Further, the auditor should consider whether the audit scope is limited by the inability to obtain sufficient competent evidential matter regarding the completeness assertion for litigation, claims and assessments.

References

Interpretation of Federal Financial Accounting Standards No. 2, *Accounting for Treasury Judgment Fund Transactions*

Statement of Federal Financial Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government*

AICPA Codification of Statements on Auditing Standards, AU Section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments*; and Auditing Interpretations of AU Section 337

Federal Financial Accounting And Auditing Technical Release No. 2: Determining Probable and Reasonably Estimable for Environmental Liabilities in the Federal Government

Status

Issued	March 15, 1998
Effective Date	For fiscal periods beginning after September 30, 1997
Volume I References	SFFAS No. 5, *Accounting for Liabilities of the Federal Government* SFFAS No. 6, *Accounting for Property, Plant, and Equipment* SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation: An Amendment of SFFAS No. 5, Accounting for Liabilities of the Federal Government*
Volume II References	Cleanup Costs (C40), Liabilities (L40)
Interpretations and Technical Releases	None.
Affects	
Affected by	SFFAS No. 12: definitional change for “probability”.

Summary

Agencies that must deal with environmental contamination should first refer to the hierarchy of accounting standards contained in the current Office of Management and Budget (OMB) Bulletin on “Form and Content of Agency Financial Statements” for guidance. Standards issued by General Accounting Office (GAO) and OMB have precedence over other authoritative guidance for federal entities. This technical release supplements the relevant federal standards, but is not a substitute for and does not take precedence over the standards.

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Introduction

Federal agencies are required to recognize a liability when a future outflow or other sacrifice of resources as a result of past transactions or events is "probable" and "reasonably estimable." This technical release is intended to assist federal agencies in determining probable and reasonably estimable liabilities related to their environmental cleanup responsibilities.

Agencies that must deal with environmental contamination should first refer to the hierarchy of accounting standards contained in the current Office of Management and Budget (OMB) Bulletin on "Form and Content of Agency Financial Statements" for guidance. Standards issued by General Accounting Office (GAO) and OMB have precedence over other authoritative guidance for federal entities. This technical release supplements the relevant federal standards, but is not a substitute for and does not take precedence over the standards.

This technical release includes two sections and an appendix. Section 1 will help an agency determine whether its environmental contamination meets the definition of probable (i.e., a future outflow of resources will be required to clean up the contamination). Section 2 offers guidance in quantifying an agency's liability for cleanup. Appendix I lists key laws and regulations relating to environmental contamination.

Scope

This technical release offers guidance based on *Statements of Federal Financial Accounting Standards* (SFFAS), and draws on information from other literature. The applicable federal standards are:

SFFAS No. 6, *Accounting for Property, Plant, and Equipment*
SFFAS No. 5, *Accounting for Liabilities of the Federal Government*

SFFAS No. 6[1] addresses cleanup costs from federal operations known to result in hazardous waste. SFFAS No. 6 provides guidance when cleanup occurs at the end of the useful life of the property, plant, and equipment (PP&E) or at regular intervals (scheduled phase cleanup) during that life.

[1]The recognition and measurement provided in SFFAS #6 are subject to the criteria for recognition of liabilities included in SFFAS #5. That is, liabilities shall be recognized when the following conditions are met:
-- a past transaction or event has occurred,
-- a future outflow or other sacrifice of resources is probable, and
-- the future outflow or sacrifice of resources is measurable.

SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, applies to all environmental liabilities not specifically covered in SFFAS # 6, including cleanup resulting from accidents or where cleanup is an ongoing part of operations[2].

Section 1: Determining "Probable" Environmental Liabilities

Description of Issue

An agency is required to recognize a liability for environmental cleanup costs as a result of past transactions or events when a future outflow or other sacrifice of resources is probable and reasonably estimable.[3] Concerns have been raised about when costs associated with environmental damage meet the probable and reasonably estimable criteria. Probable is related to whether a future outflow will be required.[4] This section addresses only the "probable" part of this requirement; reasonably estimable will be addressed in Section 2.

[2]In the case of cleanup as an ongoing part of operations [i.e., the operation or activity generates hazardous waste that is cleaned up as it is created (e.g., hospitals regularly dispose of hazardous materials)], a liability may not need to be recognized if the need to cleanup and the full cleanup occur in the same reporting period. However, the total cost of cleanup should be recognized in the period the cleanup need arises. Refer to footnote 15 for further information.

[3]This Release generally discusses "sites" or "contamination" when referring to environmental contamination. However, property, plant and equipment that requires cleanup (because of damaging the environment when being used or at time of disposal) is included in the scope . A further discussion of issues related to PP&E, including recognizing a liability for PP&E already in service, is included in Section 2 under the heading "Guidance for Active Sites."

[4]This Release uses SFFAS No. 5's definition of "probable," which is "more-likely-than-not" (see par. 33 of SFFAS No. 5). This Release applies the contingent liability criteria (i.e., probable, reasonably possible, and remote) from SFFAS No. 5 to all environmental liability estimates, whether or not they meet the criteria (see par. 36 of SFFAS No. 5).

Key Determinants and Positions

Various key factors (tests) must be considered in determining whether a future outflow of resources from a federal agency for environmental cleanup is probable. The factors are:

1. Likely Contamination,

2. Government Related and Legally Liable,

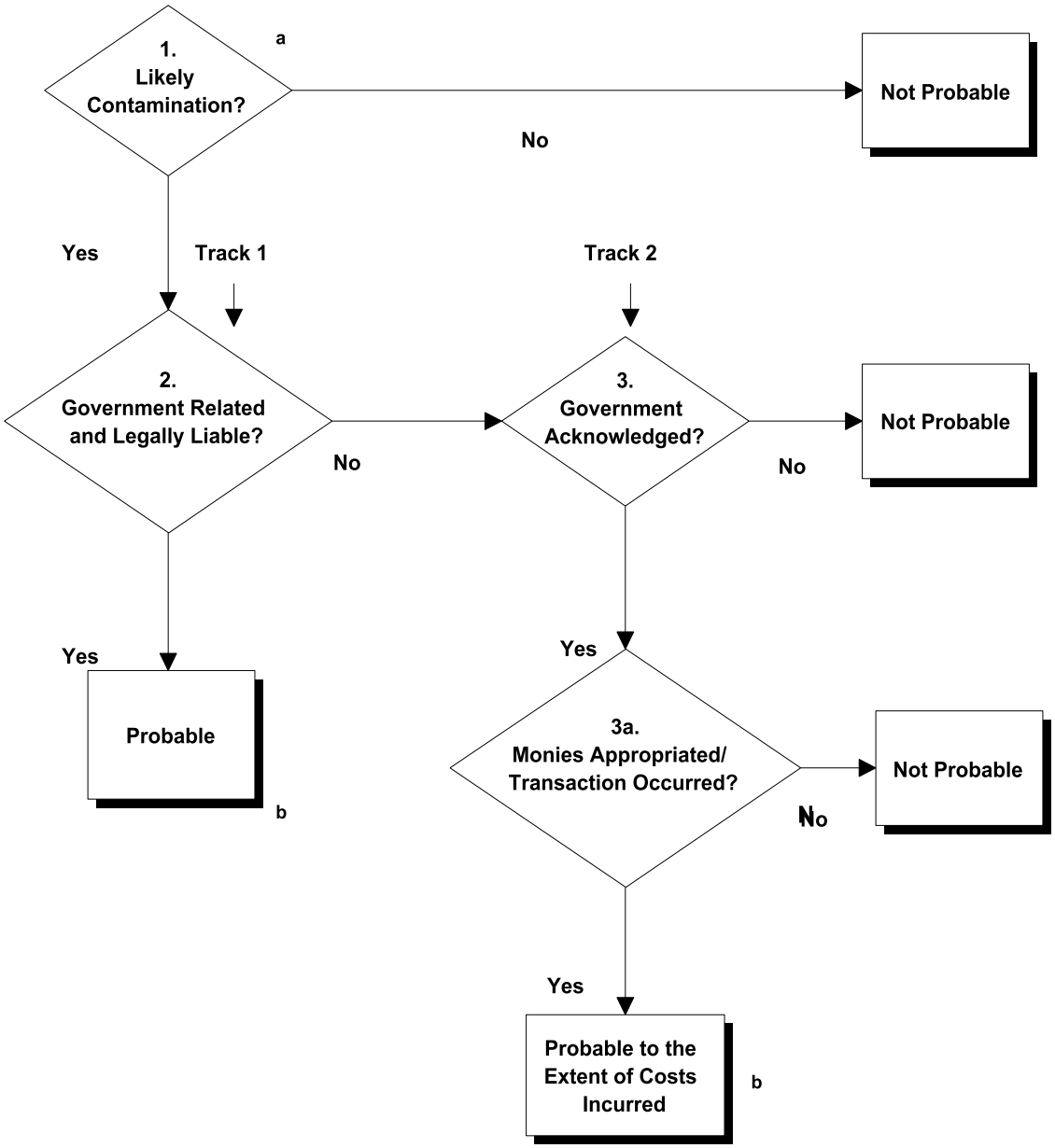
3. Government Acknowledged Financial Responsibility,

   3a. Monies Appropriated/Transaction Occurred, and

4. No Known Remediation Technology Exists.

Diagram 1.1 illustrates the above tests. These tests for probability assume that a past transaction or event has occurred (i.e., past or present operation, contribution and/or transportation of waste), and apply to both active and closed sites. A narrative discussion of each of these tests for probability follows on Diagram 1.1.

Diagram 1.1: Determination of Probable Environmental Liabilities



[a] See discussion on “due care”.

[b] If *no known technology exists*, then it would be probable to the extent of any required study costs, costs associated with containment, or any other monies obligated or spent. However, given that the actual remediation is not feasible, the actual remediation costs would not meet the probable criteria.

Diagram 1.1 shows that there are two primary tracks for determining whether a federal agency's environmental responsibilities meet the probable criterion. The first track is when contamination is known, is related to federal government operations, and represents a legal liability. The second track is when the federal government knows of contamination, and although the contamination is not government related and the government is not legally liable, the government acknowledges financial responsibility for cleanup. For both tracks, if no known technology exists, then the probability criterion is met only to the extent of likely expenditures (e.g., for study costs and containment). A more detailed discussion of the various components of Diagram 1.1 follows.

1. **Likely Contamination**: If the agency has exercised due care in determining the presence of contamination and as a result, believes it is unlikely that contamination (for which it is responsible) exists, then the probability criterion is not met. However, if the relevant agency is aware of contamination, having used the due care criteria (see below), then the agency must determine whether the contamination is government related and the federal government (i.e., the agency) is legally liable.

   Due care refers to a reasonable effort to identify the presence or likely presence of contamination. Due care is considered to be exercised if an agency has effective policies and procedures in place to routinely attempt to identify contamination and forward that information to the responsible agency official. Procedures that are evidence of the exercise of due care may include, but are not limited to, the following:

   - review of recorded chain-of-title documents (including restrictions, covenants and any possible liens) and good faith inquiry and investigation into prior uses of the property;
   - investigation of aerial photographs *that are available through government agencies* that may reflect prior uses;
   - analyses to estimate the existence of uninvestigated sites based on information from known sites;
   - inquiry into records *that are available* from federal, state, and/or local jurisdictions that show whether there has been a release or potential release of hazardous substances on the property (and adjacent property, if suspected contaminators exist);
   - visual site inspection of any portions of the property where environmental contamination is likely or suspected, and

- investigation of complaints regarding abnormal health conditions.

2. **Government Related and Legally Liable[5]:** As it relates to environmental damage/contamination, government related events are those where a governmental entity either *caused* contamination (i.e., contribution of waste) or is otherwise related to it in such a way that it is legally liable to clean up the contamination. If the agency believes it is more likely than not that it will be legally liable, then the probability criterion is met.[6]

3. **Government Acknowledged Financial Responsibility:** If environmental contamination is not government related, then the agency, under its statutory programmatic authority, must determine whether it is authorized to formally accept financial responsibility for cleanup.[7] If the government does not accept financial responsibility, then the probability criterion is not met.

   3a. **Monies Appropriated/Transaction Occurred:** If an agency accepts financial responsibility under No. 3 above,[8] then the agency determines the extent of probability based on appropriation or authorization legislation and whether a transaction has occurred causing another party to expect

[5]Legally liable is defined, generally, as any duty, obligation or responsibility established by a statute, regulation, or court decision, or where the agency has agreed, in an interagency agreement, settlement agreement, or similar legally binding document, to assume responsibility for cleanup costs. Legal liability should be determined in consultation with the entity's legal counsel. [See American Bar Association's (ABA) Statement of Policy Regarding Lawyers Responses to Auditors' Request for Information (December 1975). Also see American Institute of Certified Public Accountants (AICPA) Professional Standards, Auditing Standards (AU) Section 337C -- source SAS No. 12.]

[6]Federal entities should consider the Environmental Protection Agency's (EPA) National Priorities List [which identifies "potentially responsible parties" (PRP)] when determining probability.

[7]"The Federal government has broad responsibility to provide for the public's general welfare. The Federal government has established programs to fulfill many of the general needs of the public and often assumes responsibilities for which it has no prior legal obligation." Statement of Federal Financial Accounting Standards No. 5, ¶ 30.

[8]This Release does not propose a position regarding environmental contamination caused by natural disasters which may become the responsibility of the Federal Emergency Management Agency's (FEMA).

payment (e.g., contractor has performed cleanup of a site). For example, if the federal government has acknowledged responsibility for cleaning up a site, the cost of which is at $10 million, and $2 million has been appropriated but only $1 million in services have been rendered, probable is only met to the extent of $1 million. In the case of government acknowledged events, both conditions (i.e., appropriations or authorization and transaction executed) must exist for the probability criterion to be met.

4. **No Known Remediation Technology Exists:** In the case of a government related event, where there is no known technology to clean up a particular site, then known costs, for which the entity is responsible, such as a remedial investigation/feasibility study (RI/FS) and/or costs to contain the contamination, meet the probability test. With no known remediation technology, actual remediation is not feasible and therefore the outflow of resources for remediation is not probable.

Section 2: Determining "Reasonably Estimable" Environmental Liabilities

Description of Issue

An agency is required to recognize a liability for environmental cleanup costs resulting from past transactions or events when a future outflow or other sacrifice of resources is probable and reasonably estimable. Concerns have been raised about *when* costs associated with environmental damage meets the probable and reasonably estimable criteria. Reasonably estimable relates to the ability to reliably quantify in monetary terms the outflow of resources that will be required. This section addresses only the

"reasonably estimable" part of this requirement; probable was addressed in Section 1.[9]

Key Determinants and Positions

Various key factors (tests) should be considered in determining whether future outflows of resources can be reasonably estimated. The factors are:

1. Completion of a Remedial Investigation/Feasibility Study (RI/FS)[10] or other Study,

2. Experience with Similar Site and/or Conditions, and

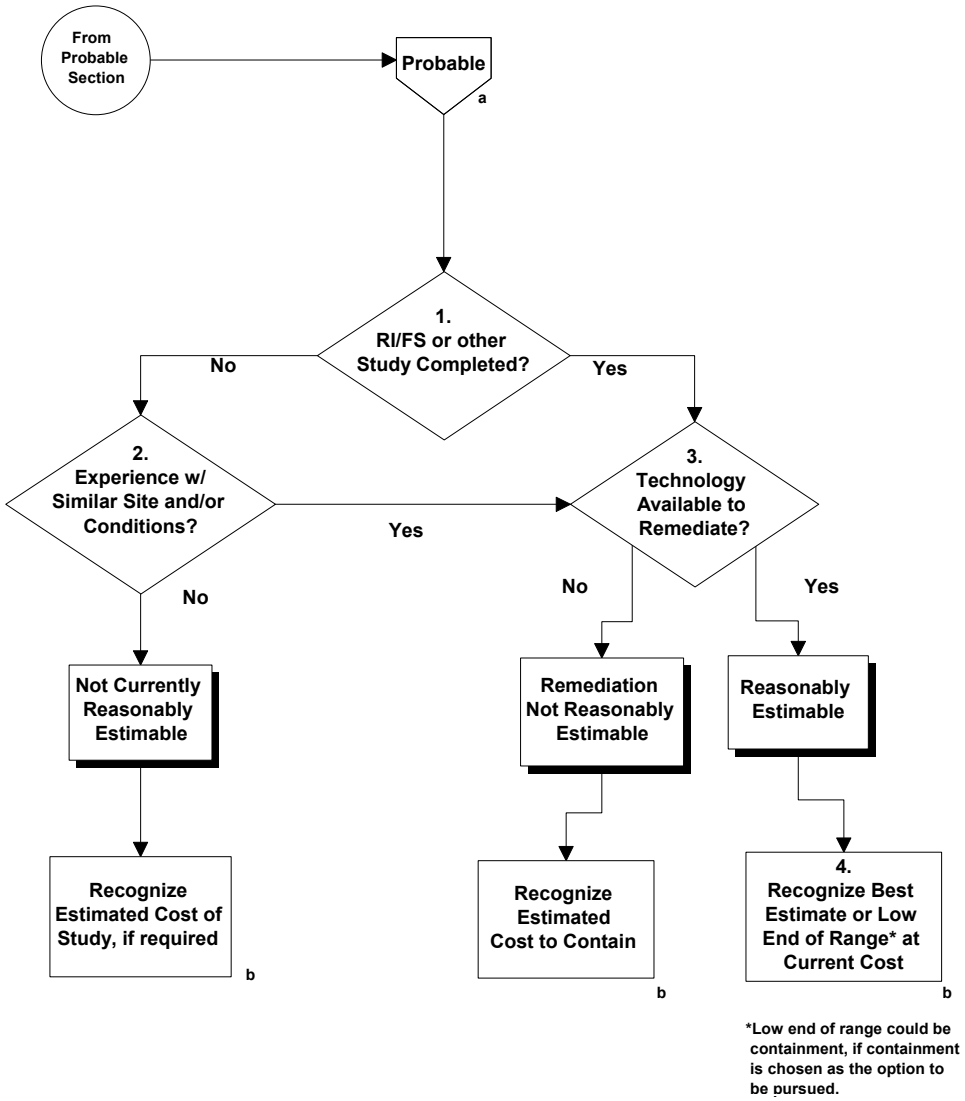
3. Availability of Remediation Technology.

These tests for reasonably estimable are applied after a transaction or event has occurred that meets the definition of "probable" as discussed in Section 1; tests apply to both active and closed sites. The analysis should consider all significant sites, with the information rolled up into an entitywide estimate. Cost estimates should be based on current technology. Diagram 2.1 on page 1173 illustrates the application of these tests. A discussion of each of the three tests follows Diagram 2.1. The discussion concludes with issues related to quantification of the estimate and guidance for active sites. Overall, it must be emphasized that every effort should be made to develop an estimate.

[9]Disclosure requirements when the criteria for reasonably estimable are not met are as follows:
- the nature of the environmental damage and
- an estimate of the possible liability, an estimate of the range of the possible liability, or a statement that such an estimate cannot be made.

[10]A remedial investigation/feasibility study (RI/FS) is a comprehensive environmental data collection and site characterization study (RI) that evaluates alternative cleanup actions and recommends one (FS).

Diagram 2.1: Determination and Quantification of Reasonably Estimable Environmental Liabilities



[a] Probable refers to track 1 (government related) which is found in Section 1. Track 2 (government acknowledged) is not applicable.

[b] With all tracks, see SFFAS #6 PAR. 107-111 and SFFAS #5 par. 40-42 for disclosure requirements.

Diagram 2.1 begins with the assumption that costs associated with environmental damage has already met the test for probable. This is a direct continuation of the left-side track of Diagram 1.1 on the definition of

probable (i.e., the agency has met probable under government related and is legally liable; see Section 1). As it relates to the "probable" second track (i.e., government acknowledged), probable is only met to the extent that monies have been appropriated or authorized (through authorization legislation) and costs have been incurred (e.g., services rendered). In these situations, a definitive dollar figure has already been determined and an estimate is not required. Therefore, the following discussion refers to determining whether something is "reasonably estimable" only as it relates to government related and legally liable.

1. **Completion of RI/FS or other Study**: The first test in determining whether costs are reasonably estimable is to ascertain whether there is a completed study upon which to base an estimate. For example, if a remedial investigation/ feasibility study (RI/FS) has been completed for a particular site, the RI/FS would form the basis upon which to begin estimating the liability.

   The fact that an agency does not have a *departmentwide* comprehensive study completed does not exempt an agency from making its best effort to estimate a liability for financial statement purposes, or for recognizing a liability for that portion of its obligation that can be estimated.

   If the results of the study indicate that no contamination exists, then probability is not met and the decision process of Diagram 2.1 should be considered complete.

2. **Experience With Similar Site and/or Conditions**: If no study has been completed, the next test is to determine whether a site appears to be similar to any other site or condition where experience has been gained through either a completed study or actual remediation. Similar sites or conditions could be related to other federal entities or private sector corporations. A "site" is defined as a physical place where contamination has occurred. A "location" can be composed of many sites; a site can contain many "conditions." It may be practical for an agency to combine similar conditions or sites into one large site or location.

   If there is a similar site or condition with experience gained (through actual cleanup and/or a completed study to compare), the estimate for recognizing a liability for a site could be based on the similar experience or conditions. In addition, the estimated cost of a future

study (if required) should be recognized. Future studies could result in improved estimates.

If there is no comparable site and/or condition, remediation costs for a site would not be considered reasonably estimable at that time, but the agency would recognize the anticipated cost of conducting a future study, if required, plus any other identifiable costs.

3. **Availability of Remediation Technology**: Assuming a study has been completed, or an agency or other entity has experience with a similar site and/or condition as noted above, the next test is whether there is technology available to remediate a site. If no remediation technology exists, then remediation costs would not be reasonably estimable, but the agency would be required to recognize the costs to contain the contamination and any other relevant costs, such as costs of future studies.

   If technology is available, then remediation costs are reasonably estimable, and the agency would recognize the best estimate at current cost. If no amount within a range of estimates is a better estimate than any other amount, the minimum amount in the range would be recognized. If the estimate is based on similar site criteria, the agency would also recognize the anticipated cost of its own RI/FS or other study, if required.

   In certain instances, the RI/FS or other study may conclude that even though technology *does* exist to remediate, containment should be considered as one of the options by the agency. If the agency has yet to make a decision and they may in fact choose containment rather than remediation, and assuming containment is not precluded by other involved parties (i.e., by EPA, individual states and/or local jurisdictions), the agency would consider the estimated cost of containment when calculating the estimated costs to be recognized or disclosed. The agency would calculate an amount to be recognized based on the type and length of containment required.[11]

   If management has not determined what remedial action should be taken for a contaminated *active* site, the cost of containment at the end of the facility's useful life, plus the cost of a study, if not yet done, should be considered as the low end of the range of future estimated cleanup costs.

4. **Quantification of the Estimate**: According to paragraph 39 of the SFFAS No. 5 on contingent liabilities, the estimated liability may be a specific amount or a range of amounts.[12] If some amount within the range is a better estimate than any other amount within the range, that amount is recognized. If no amount within the range is a better estimate than any other amount, the minimum amount in the range is recognized. According to SFFAS No. 6, ¶ 95, estimated costs should be based on the cleanup plan, assuming current technology and current cost.

   Changes in environmental liability estimates related to PP&E should be accounted for in accordance with SFFAS No. 6. For general PP&E, SFFAS No. 6 requires that the portion of the re-estimate related to current and prior periods be recognized as an expense in the period of the change. For stewardship PP&E, SFFAS No. 6 requires that the change in estimate be expensed for the incremental costs identified in the reestimate and the liability adjusted in the period of the change.

   Where an agency is one of several potentially responsible parties (PRP's) under CERCLA and management has determined that more likely than not the agency is legally liable, the agency should include an estimated liability for its:

   (1) allocable share of the liability for a specific site, and

[11]RCRA (Resource Conservation and Recovery Act) regulations require owners of hazardous waste disposal facilities to implement post-closure maintenance and monitoring activities for a minimum of 30 years. When developing estimates of these operation and maintenance (O&M) costs, EPA generally assumes that O&M activities will be required for 30 years. In most instances, containment costs should be determined on the basis of a minimum of 30 years. It would be expected that in the case of nuclear contamination, different tri-party agreements, technical problems, or other circumstances may lead to the use of a substantially longer time frame than for typical RCRA or CERCLA (Comprehensive Environmental Response Compensation and Liability Act of 1980) sites.

[12]This Release uses SFFAS No. 5's definition of "probable," which is "more likely than not" (see par. 33 of SFFAS No. 5). This Release applies the contingent liability criteria (i.e., probable, reasonably possible, and remote) from SFFAS No. 5 to all environmental liability estimates, whether or not they meet the criteria (see par. 36 of SFFAS No. 5).

(2) share of amounts related to the site that will not be paid by other PRP's.[13]

If an agency shares responsibility with nongovernmental PRP's for a government related event, the agency should recognize the share that management believes it is more likely than not the agency is legally liable for.[14] Where the federal government shares responsibility with nongovernmental PRP's and agency management has decided to accept the nongovernmental PRP's share of the responsibility for the damage (i.e., a government acknowledged event), the agency would *also* recognize a liability for the PRP's share once the criteria of appropriation or authorization legislation and a transaction have occurred, causing another party to expect payment (e.g., contractor has performed site cleanup).

Guidance for Active Sites

Thus far, this technical release has dealt with costs for *past* environmental contamination of property, plant, and equipment (PP&E) related to active and closed sites. In addition, SFFAS No. 6 outlines accounting treatment for *future* environmental contamination of PP&E at active sites. The following shows how environmental cleanup costs[15] for active sites should be recognized for general and stewardship PP&E under SFFAS No. 6.

General PP&E

There are two implementation methods for general PP&E in service at the effective date of the standard. Under the first method, the agency would estimate the total cleanup costs (based on current cost to perform the

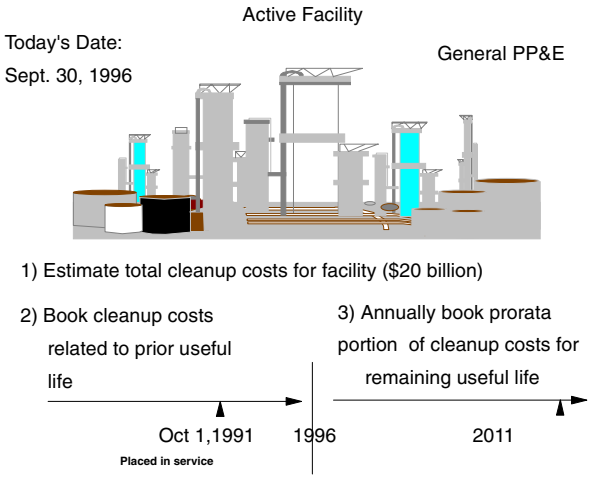
[13]AICPA Statement of Position (SOP) 96-1, *Environmental Remediation Liabilities*, page 43 par. 6.2.

[14]If management determines that an agency should assume responsibility for a portion of another PRP's share of the liability, the agency may recognize a receivable from the other PRP when the federal entity establishes a claim to cash or other assets against the other PRP based on the related legal provisions (i.e., a legal instrument, such as a settlement agreement, or other objective, verifiable information). Losses on receivables should be recognized when it is more likely than not that the receivables will not be collected in total.

[15]Costs referred to in this section are for decontamination and decommissioning (D&D) only, not operating costs. D&D costs are those incurred after plants or equipment become inactive and require cleanup. Operating costs are period costs that flow through the *Statement of Operations and Changes in Net Position*. A liability is not recognized for operating costs.

cleanup[16]) that will be required at the end of the PP&E's useful life. The agency would recognize the estimated cost as a prior period adjustment for the portion of the total estimated cleanup costs related to that portion of the *PP&E's useful life that has already expired*.

To illustrate, assume implementation of SFFAS No. 6 on October 1, 1996. Using the illustration below, and assuming a facility was placed in service at the beginning of fiscal year 1992 with a 20-year useful life, the agency would first estimate the total costs (based on current cost) required to clean up the contaminated facility at the presumed plant closure at the end of fiscal year 2011 ($20 billion). From that estimate (as of October 1, 1996), the amount that relates to that portion of the PP&E's useful life that has already expired (4/20 of $20 billion, or $4 billion) would be charged to net position and the fiscal year 1996 prorata portion would be charged to expense.



Beginning with fiscal year 1997, the agency would annually recognize a prorata portion of the estimated total cleanup costs based on the remaining useful life of the subject PP&E. In our example, for fiscal year 1997, for this plant (with an estimated remaining useful life of 15 years), the agency would recognize 1/15 of the total estimated remaining cleanup cost of $15 billion, or $1 billion. The probable criterion was met under Diagram 1.1 once the PP&E was placed in service. The reasonably estimable criterion

[16]Current cost should be based on existing laws, technology and management plans (SFFAS No. 6, paragraph 188).

was met with the agency's development of an overall estimate of total cleanup costs using the process indicated in Diagram 2.1. Consequently, each years' allocation of cleanup costs is both probable and reasonably estimable, thus requiring the agency to recognize a liability. The allocation method used for cleanup costs, as described above, is similar to depreciation of general PP&E.

Changes in estimates of cleanup costs should be accounted for in accordance with the SFFAS No. 6, which requires that the cumulative effect of changes in total estimated cleanup costs related to current and past operations be recognized as expense, and the liability adjusted in the period of the change in estimate.

SFFAS No. 6 allows a second method for recognizing cleanup cost related to general PP&E in service at the effective date of the standard. The alternative method provides that "if costs are not intended to be recovered primarily through user charges, management may elect to recognize the estimated total [ultimate] cleanup cost as a liability upon implementation of the standard."[17]

For general PP&E placed in service after the effective date of the standard, the agency should estimate the total cleanup costs[18] related to the PP&E and recognize annually a prorata portion of the costs over the life of the asset. Expense recognition shall begin on the date that the PP&E is placed into service.

Because contaminate land does not have a useful life and is not depreciated, it should be treated the same as the facility that is located on the land. For land contaminated in the past, a liability should be recognized for the total estimated cleanup costs. For land expected to be contaminated in the future due to ongoing operations, a portion of estimated total cleanup costs shall be recognized as expense during each period that the associated general PP&E is in operation. If no facility is associated with the land, the

[17]SFFAS No. 6 paragraph 104

[18]According to SFFAS #6 paragraph 95 the estimate shall contemplate:
-- the cleanup plan, including
-- level of restoration to be performed,
-- current legal or regulatory requirements, and
-- current technology; and
-- current cost which is the amount that would be paid if all equipment, facilities, and services included in the estimate were acquired during the current period.

land should be treated as stewardship PP&E. SFFAS No. 6 provides guidance for stewardship PP&E (see the following paragraph for a brief summary of stewardship PP&E).

Stewardship PP&E

Stewardship PP&E includes federal mission PP&E[19], heritage assets, and stewardship land. For stewardship PP&E *already in service*, according to SFFAS No. 6, on the day the standard is adopted or upon early implementation, the agency would charge net position through a prior period adjustment and recognize a liability for the full amount of the estimated ultimate cleanup costs. For new stewardship PP&E, the agency would recognize an expense and a liability for the total amount of estimated ultimate cleanup costs when the PP&E is placed in service. As with general PP&E, the probable criteria would be determined under Diagram 1.1 at the time the standard is adopted or new PP&E is placed in service. Likewise, the reasonably estimable criteria for the total ultimate cleanup costs would be determined based on Diagram 2.1. However, unlike general PP&E, stewardship PP&E is fully expensed once acquisition costs are incurred. SFFAS No. 6 calls for the entire ultimate cleanup costs to be expensed when the PP&E is placed in service.

[19]The FASAB is currently developing an exposure draft that proposes to change the term "federal mission PP&E" to "national defense PP&E" and to alter the definition. [SFFAS No. 11]

Appendix I - Relevant Laws

This appendix lists some of the laws that relate to environmental cleanup. It is not intended to be a comprehensive list of all pertinent laws. Federal agencies should check with their Office of General Counsel to determine which laws are applicable to their agency.

I. Principal Environmental Laws to Which Federal Facilities Are Subject

A. Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA, or Superfund), and subsequent amendments

1. Administered by EPA
2. Established a program to identify sites (National Priorities List)
   a. Typically abandoned or inactive sites
   b. Can be applied to sites still in operation
3. Set up trust fund to cover costs (with attempts to recover)
4. Detailed standards for remediation and settlement provisions and authorized criminal sanctions
5. Entities may have "joint and several" liability for cleanup

B. Resource Conservation and Recovery Act (RCRA)
1. Permits issued by EPA for facilities used or being used to manage hazardous waste (includes generating, treatment, storage, and disposal)
2. Covers both closed and active facilities

C. Clean Air Act
D. Clean Water Act

II. Other Environmental Laws
A. Safe Drinking Water Act
B. Toxic Substances Control Act
C. Federal Insecticide, Fungicide, and Rodenticide Act
D. Pollution Prevention Act 1990
E. Federal Facilities Compliance Act
F. Nuclear Regulatory Act and its amendments
G. Emergency Planning and Community Right-to-Know Act

IV. State laws
A. For federal cleanup activities, state standards can apply, which are at least as stringent as federal laws

V. Foreign Laws

Federal Financial Accounting And Auditing Technical Release No. 3: Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act

Status

Issued	July 31, 1999
Effective Date	For fiscal periods beginning after September 30, 1998
Volume I References	SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees*
Volume II References	Loans and Loan Guarantees (L60)
Interpretations and Technical Releases	
Affects	
Affected by	

Summary

Federal agencies are required to account for direct loans and loan guarantees in accordance with Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees* (SFFAS No. 2). In developing the financial accounting standards in SFFAS No. 2, the Board recognized "the value of having financial accounting support the budget" and that "accounting standards for credit reform be consistent with budgeting under credit reform." Further, the Board stated that "as more experience is gained, some modifications may be made in budgetary requirements. It is the intention of the Board that so long as the modifications made do not materially affect the basic recognition and measurement principles embodied in the accounting standards, accounting practices for direct loans and loan guarantees should change as needed in order to be consistent with the budget." This technical release provides guidance on acceptable accounting practice in light of current budgetary requirements. In addition, it provides audit guidance.

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I. Introduction

The purpose of this technical release is to provide implementation guidance for agencies and auditors to prepare, utilize, report, and audit credit subsidy estimates. Readers of this technical release should first refer to the hierarchy of accounting standards in the current Office of Management and Budget (OMB) Bulletin on "Form and Content of Agency Financial Statements" for guidance. Standards issued by the General Accounting Office (GAO) and OMB have precedence over other authoritative guidance for federal entities. This technical release supplements the relevant accounting and auditing standards, but is not a substitute for and does not take precedence over the standards.

Federal agencies are required to account for direct loans and loan guarantees in accordance with Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees* (SFFAS No. 2). In developing the financial accounting standards in SFFAS No. 2, the Board recognized "the value of having financial accounting support the budget" and that "accounting standards for credit reform be consistent with budgeting under credit reform." Further, the Board stated that "as more experience is gained, some modifications may be made in budgetary requirements. It is the intention of the Board that so long as the modifications made do not materially affect the basic recognition and measurement principles embodied in the accounting standards, accounting practices for direct loans and loan guarantees should change as needed in order to be consistent with the budget."[1] This technical release provides guidance on acceptable accounting practice in light of current budgetary requirements. In addition, it provides audit guidance.

This technical release includes sections on:

- Financial Statement Presentation
- Preparing Direct Loan and Loan Guarantee Subsidy Estimates
- Audit Tests for Direct Loan and Loan Guarantee Subsidy Estimates

It also presents three appendices on:

- Acceptable Sources of Documentation for Subsidy Estimates and Reestimates
- Technical Glossary

[1]SFFAS No. 2, paragraph 17.

- Summary of Reestimate Requirements

II. Background

Since the Credit Reform Act of 1990 was passed, agencies and auditors alike have struggled with the numerous challenges in implementing the various provisions of the act--especially formulating and auditing credit subsidy estimates. This technical release is designed to provide guidance on the preparation and audit of credit subsidy estimates. In addition, a goal of this technical release is to provide implementation guidance that will ensure greater financial statement consistency with the accounting standards set forth in Statement of Federal Financial Accounting Standards (SFFAS) no. 2, *Accounting for Direct Loans and Loan Guarantees*,[2] and compliance with applicable OMB guidance including Circulars A-11 and A-34 and Bulletin 97-01.

The technical release begins with a discussion of the level at which the credit subsidies are reported. It continues by addressing procedures for preparing estimates and reestimates--including acceptable interim alternatives in the absence of the ideal data store and estimation methods. The technical release also discusses audit methods, both internal control and substantive procedures, that may be used to audit credit subsidy estimates and reestimates. As complex and varied as credit subsidies are within government, auditor judgement is essential to implementing this guidance. Finally, the technical release provides guidance on acceptable sources of documentation for subsidy estimates and reestimates.

Definitions:

Case level - each individual loan or guarantee within a cohort.

Cohort - all direct loans or loan guarantees of a program for which a subsidy appropriation is provided for a given fiscal year, even if disbursements occur in subsequent years. For direct loans and loan guarantees for which a subsidy appropriation is provided for 1 fiscal year, the cohort will be defined by that fiscal year. For direct loans and loan guarantees for which multiyear or no-year appropriations are provided,

[2]Authoritative guidance for the recognition of many transactions under credit reform is also included in SFFAS No. 7, Accounting for Revenue and Other Financing Sources, Appendix B, "Guidance for the Classification of Transactions," paragraphs 362-365 and 368 - 369.

however, the cohort may be defined by the year of appropriation or the year of obligation.

Fund - an aggregation of programs into a common grouping consistent with how the Congress provides appropriations - i.e., the program and financing accounts together and, if needed, the negative subsidy accounts.[3]

Program - an aggregation of cohorts which are linked by common terms, conditions, regulations, and/or mission goals; often a sub-division of a fund or the budgetary financing account.

Risk category - subdivisions of a cohort of direct loans or loan guarantees into groups of loans that are relatively homogeneous in cost, given the facts known at the time of obligation or commitment. Risk categories will group all loans obligated or committed for a program during the fiscal year that share characteristics predictive of defaults or other costs. All cohort level guidance in this technical release also applies to risk categories when they are used.

Service or line of business - an aggregation of funds into a common grouping: for example, grouping funds into single family or multifamily designations.

The following example is provided to illustrate the relationship the above terms have to each other and show how they may be aggregated for financial statement purposes. Agencies should consult applicable OMB

[3]Financial statements consolidate the activity of the program and financing accounts and, if needed, the negative subsidy accounts. Thus, it may be difficult to establish a direct link between these accounts and the financial statement presentation.

guidance to determine what level of aggregation is most appropriate and acceptable.

Business line or service: Farm Service Agency

Fund:
A. CCC Export Guarantees
B. Agricultural Credit Insurance Fund

Program:
B1. Farm Ownership Loans
B2. Farm Operating Loans, subsidized
B3. Farm Operating Loans, unsubsidized

Cohort:
B3a. FY 1992 Farm Operating Loans, unsubsidized
B3b. FY 1993 Farm Operating Loans, unsubsidized
B3c. FY 1994 Farm Operating Loans, unsubsidized
B3d. FY 1995 Farm Operating Loans, unsubsidized
B3e. FY 1996 Farm Operating Loans, unsubsidized

Risk category:
B3e1.FY 1996 Farm Operating Loans, unsubsidized, Southwest Region
B3e2.FY 1996 Farm Operating Loans, unsubsidized, Northeast Region

Case:
B3ai Fiscal year 1992 unsubsidized loan to farmer A
B3aiiFiscal year 1992 unsubsidized loan to farmer B

Additional definitions related to credit reform modeling are presented in appendix II.

III. Financial Statement Presentation

Twenty-four of the largest departments and agencies are required by the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994 to prepare and issue audited annual financial statements. The objective of auditing financial statements is to provide assurance that the agency fairly presented, in all material respects, its financial condition and the net cost of operations in the agency's principal financial statements. For some agencies, credit accounts represent an important part of their overall financial picture.

The level of detail at which the audit will take place is driven primarily by the level of detail presented in the financial statements and related footnotes. With regard to credit reform, guidance issued by OMB Bulletin 97-01 and the Treasury Case Studies requires agencies to disclose information concerning credit programs in the footnotes at the fund level or program level, depending on the loan program. This level typically aggregates more detailed information maintained in the agency's system, i.e., the cohort and case level. The following tables summarize the credit related information that should be included in the balance sheet, statement of net cost, and the related footnotes to comply with SFFAS no. 2 and OMB Bulletin 97-01. Although additional financial reporting requirements exist in the other principal financial statements,[4] this technical release will focus only on the preparation and audit requirement for these two financial statements and the footnotes. Finally, additional disclosure requirements exist for direct loans obligated prior to fiscal year 1992 and defaulted guaranteed loans from pre-1992 guarantees.

Principal Statements	Credit Reform Information Presented
Balance Sheet	Credit program receivables and related foreclosed property, net of related subsidy allowance
	Liabilities for loan guarantees
Statement of Net Costs	Subsidy expense will be included as part of the gross program costs (fees will be included as an offset in calculating subsidy expense rather than recorded as revenue)
	Interest revenue and interest expense

[4]Non-authoritative illustrations and explanations of requirements for the other principal financial statements are included in FASAB, *Implementation Guide to SFFAS no. 7, Accounting for Revenue and Other Financing Sources*, chapters 2, 4, and 5.

Footnotes	Credit Reform Information Presented
Direct Loans (and Defaulted Guaranteed Loans) by Program or Fund	By program or fund for direct loans obligated after fiscal year 1991 (and for defaulted guaranteed loans from post-1991 loan guarantees): • loans receivable gross, • interest receivable, • foreclosed property, • allowance for subsidy cost (present value), and • net value of assets related to direct loan programs (and loan guarantee programs)
Guaranteed Loans by Program or Fund	By program or fund: • Present value of post-1991 liabilities for loan guarantees • Face value of guaranteed loans outstanding, • Amount of outstanding principal guaranteed
Statement of Net Cost Items By Program or Fund	By program or fund: • Subsidy expense for current year direct loans or loan guarantees • Subsidy expense for modifications and reestimates • Total direct loan or loan guarantee subsidy expense • Components of current year subsidy expense (interest differential or supplement, defaults, fees, other)* • Nature of the modification of direct loans or loan guarantees, discount rate used to calculate the modification expense, and basis for recognizing a gain or loss relating to the modification

*A proposal has been developed to revise the financial statement disclosure requirements for credit subsidy component information. This technical release will be revised accordingly once the proposal has been finalized.

IV. Preparing Direct Loan And Loan Guarantee Subsidy Estimates

Preparing accurate and timely direct loan and loan guarantee subsidy estimates must be a joint effort between the budget office and the CFO office at each agency. These offices should work together to ensure that the procedures and internal controls[5] outlined in this section are implemented and operating as designed. However, some agencies may not be able to effectively implement all of these procedures, since they have not yet developed the ideal data stores or methods of estimation necessary. Therefore, until the required information on all cash disbursements and collections related to direct or guaranteed loans can be collected at the case level and summarized, by cohort and program, the acceptable alternatives identified in this technical release will need to be utilized to provide the necessary information for developing subsidy estimates.

Agencies must accumulate sufficient relevant and reliable data on which to base cash flow projections. It is important to note that agencies should prepare all estimates and reestimates based upon the best available data at the time the estimates are made. Guidance on the types of supporting documentation that is acceptable is found in appendix I of this technical release. The auditor typically will not audit these budget estimates until 3 years later. For example, the credit subsidy estimate for fiscal year 1997, which was developed during fiscal years 1995 and 1996, will not be audited until fiscal year 1998. In addition, the auditor should be mindful of changes that may have occurred, which could affect the subsidy rate calculations, when assessing the reasonableness of the estimates. Agencies should have reestimated the credit subsidies, in accordance with OMB Circular A-11 and SFFAS no. 2, to reflect the most recent data available as discussed in the reestimate section of this technical release.

In certain limited instances, informed opinion may be used to support cash flow projections in the absence of historical data. Informed opinion refers to the judgement of agency staff or others who make subsidy estimates based on their programmatic knowledge and/or experience without using a fully satisfactory information store and, in some cases, without using an econometric or other statistical model. Informed opinion may be used only as a last resort when relevant historical data and/or modeling capabilities

[5]Internal controls are a process to provide reasonable assurance regarding the achievement of reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Internal controls consist of the control environment, control activities, information and communication, risk assessment, and monitoring. See the section on testing internal controls for further information.

are not available. This could occur when a new program has been established or when the Congress has changed an existing program in ways that cannot be represented by historical data. Informed opinion should therefore be used as an interim method only, and the agency should develop an action plan to establish an information store, appropriate models, and supporting documentation.

Certain conditions must be met before informed opinion will be considered an appropriate source of information. First, the expert's qualifications, such as professional or academic certification or length and kind of experience, must be assessed. Then, the basis of the stated opinion must be articulated in detail. For example, a statistician may be best qualified to determine the appropriate kind of model for estimated cash flows using limited or imperfect data. Most importantly, the expert must explain why that particular projection is appropriate for that particular program.

A. Overall CFO/Budget Procedures and Internal Controls

1. Document the procedures and flow of information used in developing the agency's subsidy estimates at a high level, e.g., flow chart with supporting narrative. These documents should be used to establish consistent procedures for developing the subsidy estimates across funds/programs/cohorts. These documents should also include a discussion of who is responsible for each step of the estimate as well as the review and approval process followed. Documented procedures are necessary to communicate information on the subsidy estimation and reestimation process to employees as well as other interested parties, such as auditors and OMB examiners. Also, when employee turnover is experienced, these documented procedures will provide vital information for new employees on how to complete reliable, well supported estimates of the costs of credit programs.

2. Document the agency's cash flow model(s) used, the rationale for selecting the specific methodologies, and the degree of calibration[6] within the model(s). Also, document the sources of information, the logic flow, and the mechanics of the model(s) including the formulas and other mathematical functions. In addition, document the controls

[6]Calibration is the degree of precision within the model, i.e., the model's ability to accurately predict the cash flows of a given credit program. The degree of calibration within the model can be documented by charts or graphs showing projected cash flows versus the actual cash flows by year and cohort. This document would analyze the variance between projected cash flows and actual cash flows over time.

over the model(s) used by the agency in preparing cash flow worksheets. Further, document that the cash flow model(s) reflect the terms of the loan contracts and, in a loan guarantee program, the loan guarantee contracts. Additional details regarding internal controls are discussed in the specific fund/program procedures and controls section of the technical release.

3. For agencies that have not yet implemented the ideal data store or implemented the estimation methods described in the Model Credit Program Methods and Documentation for Estimating Subsidy Rates and The Model Information Store (issue paper 96-CR-7), document management's strategic plans towards improving the agency's information store and estimation methods. This strategic plan should include who is responsible for various aspects of the plan and milestone dates for significant plan segments. Finally, it should document the progress at achieving the plan goals.

4. Ensure that general data and assumptions applicable to more than one cohort are used consistently for current year estimates and reestimates. For example, the overall economic conditions should be consistent for all cohorts within a program for a given fiscal year or management should document the reasons for the deviations, e.g., different economic assumptions could appropriately vary for specific geographic regions.

5. Ensure that estimates and all key assumptions used in preparing the budget and financial statements have been coordinated with both the program and accounting offices.

6. Management should assess the impact of changes in laws or regulations on the reliability of estimates and should ensure that the cash flow model reflects these changes. For example, a legislative program change may include provisions about maturity or type of borrowers that are outside the scope of past agency experience or may include program changes that shift the composition of new lending toward more or less risky borrowers.

7. The budget and accounting offices should work together to ensure that cash flow models are updated to reflect the actual cash flows and terms of the loan program recorded in the accounting records. Where material differences exist between the initial budgetary estimate and the actual cash flows, the differences should be investigated and

reestimates and/or adjustments to the model should be made as required.[7] Actual obligations, disbursements, recoveries, and receipts should be recorded on a case by case basis. The detail of these transactions should be reflected in the accounting records. However, when this level of detailed information is not available, it may be necessary for the agency to record transactions on another basis. For example, agencies may only receive information in summary from entities that actually make the loans that the Government guarantees. As a result, the agency may need to estimate cash flows based on a detailed analysis of the loan portfolio as a whole and allocate program level cash receipts and disbursements to individual cohorts on an appropriate basis. The basis for this allocation should be clearly documented. Transactions may also be recorded based on estimates derived from representative samples of loans, and/or related transactions, e.g., sampling of loan receipts to allocate cash receipts to cohorts.

8. Interest expense and income should be calculated in accordance with guidance from Treasury/OMB. Discount rates used should be based on the authorized rates from Treasury or OMB.

9. The agency should have an audit trail from individual transactions to the subsidiary ledgers to the general ledger. This will ensure that cash transactions can be identified by type so that they may be identified by subsidy expense component. SFFAS no. 2 currently states: "For the fiscal year during which new direct or guaranteed loans are disbursed, the components of the subsidy expense of those new direct loans and loan guarantees are recognized separately among interest subsidy costs, default costs, fees and other collections, and other subsidy costs." The subgroup has developed a recommendation to revise this disclosure requirement.

10. When a direct loan or loan guarantee is modified as defined by SFFAS no. 2 and OMB Circular A-11, the nature of the modification, the estimated effect on cash flows, and key assumptions should be documented in the same way as the original subsidy estimate.

[7]Reestimates and adjustment to the financial statements may not be required in all cases where material differences exist between the initial budgetary estimate and the actual cash flows. For example, if offsetting differences exist in cash flows, such as positive difference in default recoveries and a negative difference in fees, a reestimate may not be necessary.

Modifications do not include routine administrative workouts of troubled individual loans or actions that are permitted within the existing contract terms.[8]

11. Ensure that the financial statements consolidate the activity of the program accounts, the financing accounts, and, if needed, the negative subsidy accounts. Negative subsidy accounts are established for programs that have negative subsidies or downward subsidy reestimates (except certain programs classified in the budget as mandatory).

12. Ensure that the cash flow spreadsheets are prepared on a disbursement year (all loans from a given cohort that are disbursed in a given fiscal year) or cohort basis, as appropriate. For example, when all loan disbursements occur during a single fiscal year, the disbursement year includes the entire cohort. When loan programs disburse over more than one year, the disbursement year includes just part of the cohort. For such programs, the cash flows for each disbursement year of a given cohort are necessary to precisely calculate subsidies. However, when agencies are unable to provide this level of detail, combinations of 2 or more disbursement years may be used as an approximation.

13. Establish security over access to the OMB Credit Subsidy Model to adequately protect it from unauthorized use and corruption. For example, agency management should establish procedures to ensure that the desktop workstations where the OMB Credit Subsidy Model resides are password protected.

[8]Neither the Federal Credit Reform Act as enacted in 1990 nor its amendments in the Balanced Budget Act of 1997 explicitly states that modifications do not include routine administrative workouts. However, the definition of modification in the 1990 Act was interpreted as excluding routine administrative workouts, and the definition in the 1997 amendments is interpreted in the same way. This interpretation is consistent with paragraph 44 of SFFAS No. 2. Further, the Joint Explanatory Statement of the Committee of Conference on H.R. 2015, the Balanced Budget Act of 1997, states that “workouts are not assumed to be included in the definition of modifications. The conference agreement does not change the treatment of workouts as implemented under the Federal Credit Reform Act of 1990."

B. Specific Fund/Program Procedures and Controls

1. Procedures in place should ensure that cash flow estimates for budgetary and financial statement reporting purposes are based on actual cash flows in previous years to the extent it is appropriate. Agencies should compare budgeted to actual cash flows to ensure that the cash flow models reflect the actual cash flows from the accounting records. Where material differences exist between the initial budgetary estimate and the actual cash flows, the differences should be investigated and reestimates and/or adjustments should be made as required.[9] Changes in key factors and assumptions used as a baseline (e.g., disbursement rates, default rates, recovery rates, time periods, etc.) must be explained, supported, and documented. For example, recoveries have averaged a given percentage for the past 4 years and this recovery rate had been consistently used in preparing cash flow worksheets. However, during the past year, events have occurred which have increased the recovery rate and these events are expected to continue in the future. As a result, the agency may decide to use a recovery rate above the historical average.

2. Sensitivity analysis (or other testing of the agency cash flow models used in developing the subsidy estimates) should be performed to identify which **cash flow** assumptions have the greatest impact on the credit subsidy rate. To perform sensitivity analysis, management must first identify the root of each cash flow assumption[10] to ensure that all subsequently related formulas and assumptions are adjusted appropriately. Generally, each root assumption should be individually adjusted by a fixed proportion (e.g., plus and minus 10%), and the revised cash flows run through the OMB Credit Subsidy Model to determine the assumption's effect on the subsidy rate. Timing assumptions for defaults, recoveries, prepayments, etc. should also be adjusted by a fixed amount (e.g., plus and minus 1 year). The recovery assumption should be adjusted along with the timing of recovery assumption to ensure that a realistic relationship between these two assumptions continues to exist, i.e., to test the sensitivity of

[9]Reestimates may not be required in all cases where material differences exist between the initial budgetary estimates of cash flows components and the actual cash flows of these components. For example, if offsetting differences exist in cash flows such as positive differences in default recoveries and a negative difference in fees, a reestimate may not be necessary.

[10]The root of the cash flow assumption is the starting point for the assumption, i.e., there are no preceding formulas or related inputs that would affect the assumption.

recoveries, the default timing assumption must also be adjusted to ensure that the recovery occurs after the default. Those assumptions that caused the largest change in the subsidy rate are determined to be the key cash flow assumptions.

3. Key assumptions, identified by the sensitivity analysis that is utilized in the process of developing estimates, should be documented including the rationale, justification, and source of supporting documentation.

4. The accounting office should maintain detailed subsidiary accounting records by program, cohort, and case.

5. The cash flow estimation process, including all underlying assumptions, should be reviewed and approved at the appropriate level including revisions and updates to the original model. Cash flow models should be tested for reliability as part of the approval process by comparing estimated cash flows to actual cash flows and assessing the model's ability to replicate a credit program's performance. Additional information on how the auditor will test the model can be found in the control activities and testing sampled cohorts sections of this technical release.

6. The agency should do trend analysis of the credit subsidy expense components, i.e., interest, defaults, fees, and other. When unusual fluctuations are identified, they should be investigated and explained.

7. The agency must document the options used in the OMB Credit Subsidy Model and the reasons those options were selected.[11]

8. The agency should determine whether the proper scale for the cash flow spreadsheets was used. Some program subsidy rates, particularly those for programs disbursing over several years, may be influenced slightly with the scale of the program. Therefore, management should

[11]GAO contracted with an independent public accounting firm to review the OMB Credit Subsidy Model's compliance with the Credit Reform Act and SFFAS no. 2, the reliability of the model's calculations, and the extent of internal controls over the model. GAO's report Credit Reform: Review of OMB's Credit Subsidy Model (GAO/AIMD-97-145, August 29, 1997) provides guidance to agencies and auditors, which has been incorporated into this technical release in summary form, on the types of controls that should be established when using the model.

determine whether rounding to three decimal places has no significant effect on the cash flow spreadsheet values and the subsidy rate.

9. The agency should determine whether the OMB Credit Subsidy Model options selected properly reflect specific characteristics of the applicable credit program. For example, the OMB Credit Subsidy Model option for the timing of principal and interest payments for direct loan program and the percent of loan guaranteed should agree with the program's credit terms.

10. The agency should review the OMB Credit Subsidy Model output to determine whether any warning messages are listed and determine why the situation causing the warning message was not resolved and whether not eliminating the error could have any impact on the subsidy rate calculation. Also, if applicable, the agency should determine whether the suppression of any error messages was appropriate by checking the agency's cash flow spreadsheet to determine whether the "suppress warnings" command was used and assess the impact these suppressed error messages could have on the cash flows.

C. Reestimates

OMB Circular A-11 has established criteria for when agencies should calculate credit subsidy reestimates for the budget. It states that "interest rate reestimates of the subsidy cost of a cohort of direct loans or loan guarantees must be made when a cohort is substantially disbursed (i.e., when 90 percent of the direct loans or guaranteed loans have been disbursed.) The computation should be made at the beginning of the fiscal year after this criterion is met unless a later time within that same fiscal year is approved by the OMB representative with primary budget responsibility for the credit account"; and that "technical/default reestimates of the subsidy cost of a cohort of direct loans or loan guarantees must be made at the beginning of every year as long as the loans are outstanding, unless a different plan is approved by the OMB representative with primary budget responsibility for the credit account. The different plan might be with regard to the time when reestimates are made within the year or the frequency of reestimates." If the plan allows technical/default reestimates to be made less often than every year, it

should require technical/default reestimates in any year when any one of four conditions is met.[12]

SFFAS no. 2 states that "the subsidy cost allowance for direct loans and the liability for loan guarantees are reestimated each year as of the date of the financial statements. Since the allowance or the liability represents the present value of the net cash outflows of the underlying direct loans or loan guarantees, the reestimation takes into account all factors that may have affected the estimate of each component of the cash flows, including prepayments, defaults, delinquencies and recoveries. Any increase or decrease in the subsidy cost allowance or the loan guarantee liability resulting from the reestimates is recognized as a subsidy expense (or a reduction in subsidy expense). Reporting the subsidy cost allowance of direct loans (or the liability of loan guarantees) and reestimates by component is not required." Appendix III summarizes the reestimate requirements that are described below.

1. An interest rate reestimate of the subsidy cost of a cohort of direct loans or loan guarantees is made for the difference between the estimated interest rate at the time of obligation and the actual annual interest rates prevailing during the years of disbursement. An interest rate reestimate should be made whenever the change in the interest rate materially affects the financial statements or, if no material change occurs prior to the cohort being 90% disbursed, at least one time when the cohort is 90% disbursed.[13] Therefore, when an interest rate change has occurred that would materially affect the financial statements, agencies should calculate the interest rate reestimate and include the reestimate in the current year's financial statements.

[12]These four conditions are: (1) based on periodic schedules established in coordination with OMB, (2) when a major change in actual versus projected activity is detected, (3) when a material difference is detected through monitoring "triggers" developed in coordination with OMB, and (4) when a cohort is being closed out.

[13]If the interest rate assumption is a key assumption, agencies should consider using sensitivity analysis, as discussed on page 13, to determine whether the change in interest would have a material affect on the financial statements. To do this, agencies would need to repeatedly adjust the interest rate by predetermined increments, e.g., plus or minus 100 basis points, and re-run the revised cash flows through the OMB Credit Subsidy Model to determine the impact on the subsidy rate. Agencies should then multiply the revised subsidy rate by the assumed disbursement amount, to calculate financial statement impact. As a result, agencies will be able to document the amount of interest rate change that would be necessary, under an assumed disbursement amount, to materially affect the financial statements.

2. A technical/default reestimate of the subsidy cost of a cohort of direct loans or loan guarantees is made for all changes in assumptions other than discount rates. If OMB has approved a plan that permits an agency to make technical/default reestimates less often than annually, the agency should monitor the indicators specified in that plan to determine whether a reestimates is needed for other reasons: in particular, because it is needed to comply with other parts of that plan and/or because the reestimate has a material financial statement impact.

3. An agency that does not plan to perform technical/default reestimates annually must establish a systematic process to determine whether a reestimate is necessary and, if material to the financial statements as a whole, the reestimate must be reflected in the current year's financial statements. <u>If an acceptable monitoring process is not in place, reestimates must be made annually for the financial statements.</u> An acceptable process would generally include the following:

   (a) *A comparison between actual experience to date and the assumptions that had been previously used for the period to date.* -- An acceptable process would regularly (but not less than annually) compare the actual cash flows, by subsidy component, reported by the accounting office at the program level to those used in the previous budget estimates.[14]

   (b) *Differences between the current best estimate of future cash flows and the assumptions that had been previously used.* -- An acceptable process would also include procedures that identify and systematically monitor significant economic and other assumptions underlying cash flows in order to determine whether changes have occurred in the expected future cash flows that make a reestimate necessary. The significant assumptions would be expected to differ from program to program according to each

[14]OMB has begun to develop a new method of computing reestimates based on the "balances approach," which compares (a) the net present value of the best current estimate of the remaining cash flows with (b) the net balance owed to Treasury (for direct loan programs) or the net balance on deposit with Treasury (for loan guarantee programs). In estimating the net present value of the remaining cash flows, agencies would still need to estimate future cash flows based on actual experience with cash flows to date and forecasts of other factors. They would therefore still need to maintain historical cash flow data, at the subsidy component level, to analyze the sources of error in the estimates of cash flows for past periods.

program's own attributes. Economic changes could include, for example, recessions, changes in interest rates, changes in the market value of collateral, or international economic factors (such as trade disruptions). Other changes could include, for example, legislative or administrative program changes (of the kind that do not meet the OMB Circular A-11 definition of a modification), operational changes (such as reduction in staff because of budgetary constraints that would affect loan servicing), environmental changes, or war. The impact of these changes on the estimates of future cash flows (and, if necessary, the cash flow models) must be assessed and documented.

(c) *Special emphasis for programs that have peak periods* - Where applicable, an acceptable monitoring process should provide extra emphasis during periods when cohorts are experiencing significant increases or decreases in defaults, prepayments, recoveries, or other cash flows. For example, suppose for one particular program historical experience has demonstrated that a cohort usually experiences increased defaults starting in year 3 which peak in years 6 -8. Historical experience has further demonstrated that defaults decline steadily beginning in year 9, until a stabilized rate is reached in years 13 through 30. During years 3 - 13, the agency's monitoring efforts should compare actual cash flows for defaults reported by the accounting department to estimated default cash flows as a way of validating the default cash flow assumption and determining whether a reestimate or adjustment to the overall rate or timing is necessary. However, once the monitoring system has demonstrated that the cohort has stabilized and no significant unusual events have occurred, it is less likely that annual reestimates would be necessary.

4. In years for which reestimates are made, they should normally be made as of September 30 of the reporting period using a data base that is complete through the same date. If OMB has approved a plan to make reestimates at another time during the year, this will be acceptable for financial statement purposes if the following conditions are met:

(a) The technical/default reestimate of the subsidy cost is made for a 12-month period ending not earlier than June 30, using a data base with actual transactions through June 30 of the reporting

year. The reestimated subsidy cost is compared with the previous estimate of the subsidy cost for the year ended September 30.[15] The difference is the amount of the reestimate. Alternatively, for the last quarter of the fiscal year, agencies may estimate that quarter's cash flows on a reasonable basis e.g., the last quarter's cash flows from the previous fiscal year, or if the cash flows are relatively uniform, one quarter of the originally estimated cash flows, or the average cash flows of the previous three quarters. For cohorts with an interest rate reestimate, the interest rate reestimate would be calculated after September 30 using actual interest rates.

(b) In order to use this approach, agencies must ensure that the monitoring process described previously includes monitoring major events occurring during the fourth quarter that could have a significant impact on the subsidy reestimate. If such an event is identified, a reestimate of the affected cohorts may be necessary.

(c) Agencies may be unable to calculate, and reflect in the financial statements, a reestimate for major events occurring during the fourth quarter because, at this point, the effects of the major event may not yet be determinable. In this case, agencies must disclose such events in the footnotes as a potential material uncertainty. The disclosure will further acknowledge that this/these event(s) will be taken into consideration in making the reestimate for the following year or once the impact of the events is determinable.

(d) This policy, when adopted by an agency, with OMB's approval, will be disclosed in the footnotes to the agency's financial statements.

5. If the most recent estimated cash flows of a cohort are different from the actual experience, these differences and the reasons for these differences may affect the future estimated cash flows of that cohort. The effects on the future cash flows of that cohort need to be assessed and included in the reestimate, and the reasons for the estimated effects need to be documented.

[15]See footnote 10 for a discussion of the "balances approach" for calculating reestimates.

6. Reestimates for any of the reasons in this section should be completed, submitted to OMB, and included in the current year's financial statements, on a timely basis. If OMB has approved a plan that permits an agency to make technical/default reestimates less often than annually, written documentation of the plan and OMB's approval should be obtained. If a technical/default reestimate is not made in a particular year, documentation should explain why that is consistent with the approved plan and provide assurance (in the ways specified above) that the lack of a technical/default reestimate would not have a material financial statement impact.[16]

7. Reestimates submitted by the budget office and approved by OMB should be recorded in the accounting records.

8. If the cause of the reestimate affects the cash flows of future cohorts, the assumptions used to produce cash flow estimates and/or the method of estimating cash flows should be revised appropriately for the budget estimates of future cohorts.

[16]OMB's four process, outlined in OMB Circular A-11, allows for calculating budgetary technical/default reestimates at times other than the beginning of each fiscal year following the year in which the initial disbursement was made, as long as the loans are outstanding (subject to OMB approval) However, this does not allow agencies to omit material reestimates from the current year financial statements or to postpone including material technical/default reestimates in the financial statements until a subsequent year. Conversely, the OMB process may require agencies to make technical/default reestimates for the budget that are not material to the financial statements.

V. Audit Tests For Direct Loan And Loan Guarantee Subsidy Estimates

The overall purpose of auditing the subsidy estimation and reestimation process is to provide reasonable assurance that the reported credit program receivables and related foreclosed property and related allowance for subsidy, liabilities for loan guarantees, and subsidy expense, are reasonably stated in the financial statements and provide reliable and useful information for decision makers. Since the audit should be conducted in three phases--planning, internal control, and substantive testing--this section of the technical release is organized in the same way. Due to the complexity of credit subsidy estimates, thorough planning is key to an effective and efficient audit. The auditor must also assess the agency's internal controls and the risk of errors and irregularities that may cause a material misstatement in the financial statements. Based on this assessment, the auditor can determine the nature, timing, and extent of substantive testing to determine whether the credit subsidy estimate is reasonable in the context of the financial statements taken as a whole.

A. Planning the Credit Subsidy Audit

The audit of credit subsidy estimates should be considered in conjunction with other audit areas, e.g., claims, insurance in force, foreclosed property, premium receipts, and loan sales. In this way, the auditor will be able to leverage off the other audit areas to maximize audit efficiency and effectiveness. During the planning phase, the auditor should focus on four primary objectives (1) understanding the agency's credit subsidy estimate process, (2) identifying key estimate assumptions, (3) identifying material and high risk credit programs, (4) assessing inherent risk and the effects of EDP on inherent risk.

1. Understanding the Credit Subsidy Estimate Process

Without a thorough understanding of the agency's credit subsidy estimate process, the auditor is unable to efficiently and effectively audit the loans receivable and the related allowance, the liability for loan guarantees, and the subsidy expense, in accordance with applicable auditing standards. To gain an understanding of the credit subsidy process, the auditor should

1. Review the documented subsidy estimation procedures to gain an understanding of the process, including the types of underlying data used to develop cash flow assumptions, key formulas used in cash flow worksheets, and the person responsible for each phase of the process.

2. Identify significant external and internal factors that may affect the credit subsidy process. External factors may include economic

conditions, current political climate, and relevant legislation. Internal factors may include the size of the agency's budget and accounting staff, qualifications of key personnel, turnover of key personnel, and systems capabilities.

3. Develop a high-level understanding of the agency's use of electronic data processing (EDP), how EDP affects the subsidy estimate process, and which systems should be included with the EDP general and application control review.[17]

4. Determine, with the assistance of an EDP audit specialist as necessary, whether EDP-related controls are likely to be effective.[18] If controls are not likely to be effective, the auditor should determine the impact on control risk, appropriately adjust substantive testing, and focus on testing the effectiveness of manual controls during the internal control phase of the audit.

The auditor may gather planning information through different methods such as observing agency operations, interviewing agency staff, reviewing procedures manuals, and conducting walk-throughs. In addition, the auditor may gather information from relevant reports, including prior year financial statements, Federal Managers' Financial Integrity Act (FMFIA) reports and supporting documentation, Inspector General and internal audit reports, and congressional hearings and reports.

2. Identifying Key Estimate Assumptions

One way for the auditor to maximize audit efficiency is to focus on the key assumptions, i.e., those assumptions that have the greatest impact on the credit subsidy rate and hence, the credit subsidy amount. To identify key assumptions, the auditor should evaluate and retest selected areas of

[17]The auditor should actively coordinate EDP general and application control reviews to ensure that they focus on controls over key cash flow reports such as defaults or prepayments as well as the controls over the cash flow spreadsheets. Further, the auditor should consider evaluating EDP controls over the agency's use of the OMB credit subsidy model. For a detailed discussion of the audit procedures related to the OMB credit subsidy model, refer to GAO's report Credit Reform: Review of OMB's Credit Subsidy Model (GAO/AIMD-97-145, August 29, 1997). These audit procedures have been included in this technical release in summary form.

[18]Although the actual testing of technical EDP-related controls should generally be performed by an EDP audit specialist, the financial statement audit team should participate in identifying and testing general controls, user controls, and application controls to tentatively conclude on the effectiveness of EDP-related controls.

management's credit subsidy sensitivity analysis. For example, in performing this analysis, agency management may have varied the subsidy estimate assumptions by a fixed amount, such as 10 percent in either direction, and was thus able to identify which assumptions were more sensitive to fluctuations. Assumptions that are sensitive to fluctuations require agency management to be more precise. These assumptions often require greater audit effort because minor variations may have material effects on the subsidy amount. The auditor should review this sensitivity analysis carefully and retest selected portions as necessary to gain comfort with management's work before relying on it. In retesting the agency's sensitivity analysis, the auditor should consider recalculating the impact that changes in key assumptions have on a credit program's subsidy amounts.

When identifying key assumptions, additional consideration should also be given to those assumptions that fluctuate significantly. These assumptions may be more difficult to predict, and their normal fluctuation may materially affect the credit subsidy amount even though the credit subsidy amount may not change significantly during the sensitivity analysis. For example, prepayments may be difficult to predict since historically they fluctuated 10 percent or more over the past 5 years. Thus, even though the auditor did not identify prepayments as a key assumption during the review of the agency's sensitivity analysis, prepayments should be considered a key assumption because their normal fluctuation may materially affect the credit subsidy amount.

If management has not performed sensitivity analysis of the credit subsidy assumptions, the auditor may consider performing a sensitivity analysis or other analysis to identify the key cash flow assumptions. This analysis will allow the auditor to focus on key areas and will increase the auditor's efficiency in the substantive testing phase of the audit.

3. Identifying Material and High Risk Credit Programs for Internal Control and Substantive Testing

In order for the auditor to maximize efficiency and effectiveness when selecting programs for internal control testing and substantive testing, the auditor should focus efforts on material programs. Generally, material programs have higher inherent risk than immaterial programs. Materiality is defined in Financial Accounting Standards Board Statement of Financial Concepts no. 2, Qualitative Characteristics of Accounting Information, as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgement of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." Thus, items

of little importance are less likely to affect the financial statement users judgement. Materiality has both qualitative and quantitative factors,[19] since certain types of relatively immaterial misstatements from a quantitative standpoint could be significant for other reasons. For example, some programs that are immaterial in amount could be sensitive because of Congressional interest.

According to Statement on Auditing Standard 47, AU Section 312, Audit Risk and Materiality in Conducting an Audit, "audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures." The following list includes some of the factors that the auditor should consider in determining which direct loan or guarantee programs are material and/or high risk and therefore should be selected for testing.

- the amount of subsidy expense for a given program,
- the dollar value of the program's loans on the balance sheet,
- the dollar value of the program's loan guarantees and their related liability for default,
- the dollar amount of subsidy expense, magnitude of transactions, and variance of past reestimates,
- past audit experience for the program,
- the auditor's preliminary assessment of risk,
- recent significant changes in economic conditions,
- the complexity of the program (the number, size, and technical difficulty of the loans),
- the age of the program (new programs may have more risk than older established programs, other things being equal),
- the degree to which subrecipients, contractors, and private lenders make decisions about implementing the program, and
- Congressional and other public policy interest in a given program.

This list is designed to assist the auditor in identifying material and/or high risk programs. The above list is not designed to replace professional judgement. For example, a credit program could have a relatively small subsidy expense because the agency nets gross subsidy expense components with offsetting fees, in accordance with SFFAS no. 2 and the Credit Reform Act. However, the auditor should not focus solely on the net

[19] Government Auditing Standards 1994 Revision, p. 34.

subsidy expense. Rather, the auditor should consider the gross amounts of the subsidy expense and fees, the total loans receivable, and/or the total liability for loan guarantee account when determining whether the program is material.

Past audit experience should be considered since it may indicate that the program should be retested again this year when, for example, significant internal control weaknesses were discovered in the prior year's audit. Conversely, past audit experience may allow the auditor to reduce the level of current year testing for the program. Factors that should be considered in determining the appropriate level of detailed substantive testing for material programs include:

- the number of years since the last time the program was included in internal control and substantive testing,
- the results of the preliminary assessment of risk,
- changes in economic events that affect the current cash flow assumptions,
- the level of employee turnover, and
- changes in program characteristics, terms of credit, or implementation.

Finally, when inherent risk is low and the agency's control environment is strong, the auditor may consider testing credit programs on a rotating basis. In determining whether rotational testing is appropriate, the auditor should consider (1) the results of prior audit experience, (2) the length of time since the program was tested, (3) the materiality of the program, and (4) the auditor's assessment of inherent and control risk.

Upon completion of the internal control testing, the auditor may wish to revise the assessment of which programs are material and/or high risk. For example, the auditor's preliminary risk assessment may not be supported by the results of the internal control testing. When the results of the internal control testing lead the auditor to conclude that the internal controls are not operating effectively, the auditor may revise the risk assessment for programs originally expected to have low risk. As a result, the auditor should include these programs in the detailed substantive testing. On the other hand, the auditor may decide to reduce the extent of detailed substantive testing for a material program based on the results of internal control testing.

4. Assessing Inherent Risk and the Effects of EDP

Based on the auditor's understanding of the credit estimation process, the auditor identifies specific inherent risks[20] and control environment weaknesses. To identify inherent risk factors, the auditor generally focuses on (1) the nature of the agency's program, (2) prior history of audit adjustments, and (3) the nature of material transactions. The nature of an agency's program may increase inherent risk. For example, some loan guarantee programs may be more susceptible to errors because of loans issued and serviced by third parties. Significant audit adjustments in previous audits often identify problem areas that may continue to result in financial statement misstatements. Accounts involving subjective management judgements, such as credit subsidy estimates and the liability for loan guarantees, are usually higher risk than those involving objective determinations.

EDP can also introduce inherent risk factors. The auditor should assess EDP-related factors and determine the overall impact of EDP on inherent risk. For example, unusual or nonroutine transactions generally increase inherent risk. EDP programs or systems developed to estimate credit subsidy amounts, e.g., the agency's cash flow spreadsheets, may not be subjected to the same procedures and controls as EDP programs and systems developed to process routine transactions. The degree of existence and completeness of the audit trail may also increase inherent risk. The audit trail demonstrates how a specific transaction was initiated and processed. Some EDP financial management systems are designed so that the audit trail exists only for a short period, only in electronic format, or only in summary form. Uniform processing of transactions may also increase inherent risk because a programming error will consistently misstate transactions. For example, if an agency misstates a cash flow assumption, such as defaults, recoveries, or the interest rate, in a cash flow spreadsheet that has been electronically linked to other cash flow spreadsheets, the error will affect all of the linked cohorts or programs. As a result, the auditor must be aware that some errors may be systemic rather than isolated incidents and the auditor should be careful to distinguish between the two.

[20]Inherent risk is the susceptibility of a financial statement assertion to a material misstatement, assuming that there are no related internal controls. Financial statement assertions are representations by management that are embodied in financial statement components. See Codification of Statements on Auditing Standards, AU Section 326.

B. Testing Internal Controls

As noted above, the auditor should select material programs for internal control and detailed substantive testing. In this way, the auditor will more effectively and efficiently focus audit efforts on the programs that are most significant to the users of the financial statements. In some instances, more than one program will utilize the same system of internal controls. Thus, the auditor would need only test the system once to gain assurance on all related programs. This section provides guidance for the auditor to use in evaluating the agency's internal controls for material and/or high risk credit programs so that the auditor can determine the nature, timing, and extent of substantive tests to perform on credit reform related accounts such as subsidy expense, allowance for subsidy, and liabilities for loan guarantees. The auditor needs to evaluate the agency's internal controls before updating the preliminary assessment of the control risk.[21]

Due to the complexity of credit reform, it is necessary for the auditor to obtain a good understanding of the internal control components to design effective substantive tests. If, after evaluating the agency's internal controls, the auditor assesses control risk at a high level, the auditor will need to obtain most, if not all, of the audit assurance from substantive tests. Thus, the auditor will need to expand the level of detailed substantive testing. However, if the auditor determines that control risk is low based on the evaluation of the agency's internal controls, the auditor has more assurance concerning the accuracy of the information generated within that structure. Thus, the auditor may be able to reduce the level of detailed substantive testing.

Internal controls are a process--effected by an agency's management[22] and other personnel--to provide reasonable assurance regarding the achievement of reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Internal controls consist of the control environment, control activities, information and communication, risk assessment, and monitoring. The auditor should

[21]Control risk is the risk that a material misstatement could occur in a financial statement assertion and will not be prevented, detected, and corrected on a timely basis by the entity's internal control structure.

[22]In this technical release, the term "agency management" is used in the same context as it is used in OMB Circular A-123 and may include any individual Federal manager responsible for ensuring that credit reform is implemented efficiently and effectively to achieve intended program results. Agency management could include, but is not limited to, the Chief Financial Officer, Director of Budget, and Controller.

consider the following when obtaining an understanding of the agency's internal controls.

1. Assessing the Control Environment

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing the discipline and structure. When assessing the control environment, the auditor should consider management's philosophy and operating style (done elsewhere in the audit) and generally perform the following steps for the material programs' systems of internal controls.

1. Determine whether the same estimation process was used for other programs by comparing the documented procedures between programs. If the same process was used between programs, the results of the internal control testing for this program may help the auditor gain comfort with other programs.

2. Determine how management assures itself that established procedures and internal controls have been consistently implemented among the various divisions/branches responsible for preparing subsidy expense estimates.

3. Determine how management assures itself that the historical data used as the basis for the subsidy amounts accurately supports the cash flow assumptions.

4. Determine whether the agency has the appropriate supporting documentation for key assumptions as outlined in appendix I of this technical release.

5. Determine how management assures itself that assumptions or data requirements which are based on conditions affecting multiple programs and cohorts are uniformly applied. For example, identify and test the controls in place that management relies on to ensure that:

   - interest rates used when discounting cash flows are based on approved rates established by Treasury or OMB,
   - similar assumptions are made concerning economic conditions for a particular business sector where both direct and guaranteed credit programs are delivered,

- historical data for subsidy expense components are consistently collected and interpreted among similar programs, and
- options chosen for the OMB Credit Subsidy Model properly reflect the specific characteristics of the applicable credit program.

6. Review management's comparison of projected cash flows to actual cash flows from the accounting department. Determine whether management (1) appropriately identified material variances and the cause of these variances, (2) performed trend analysis of the credit subsidy components, (3) adjusted future cash flow estimates of those cohorts to reflect these variances, (4) determined whether there was a flaw in the cash flow spreadsheet that caused the variance and, if so, determined the impact this flaw had on all cohorts, and (5) reestimated subsequent years' subsidy amounts, as appropriate.

7. Determine whether the agency is appropriately using the latest version of the OMB Credit Subsidy Model by contacting and obtaining a copy of the Credit Subsidy Model from the agency's OMB budget examiner. This version should be compared with the version used by the agency to calculate the credit subsidy by using the "file compare" feature of desktop operating software. Any differences that are identified through this comparison should be investigated and explained.

8. If applicable, determine whether waivers were obtained from OMB for years in which subsidy reestimates were not performed in accordance with OMB guidance.

9. Determine how management assures itself that the agency used the proper scale for the cash flow spreadsheets. Some program subsidy rates, particularly those for programs disbursing over several years, may be influenced slightly by the scale of the program. Therefore, management should determine whether an appropriate scale has been used so that rounding to three decimal places has no significant effect on the cash flow spreadsheet values and the subsidy rate.

10. Determine how management assures itself that the agency has appropriately prepared cash flows using a cohort basis or disbursement year basis. For example, when a program disburses over more than one year, the auditor should determine whether the agency used a disbursement year basis. If the agency used a cohort basis, the auditor should determine why the agency did not use a disbursement

year basis and whether the use of cohort level cash flows has had a material effect on the subsidy calculation. If the effect is material, the auditor should recommend that the agency prepare cash flows on a disbursement year basis to eliminate the problem.

11. Determine whether agencies have controls over access to the OMB Credit Subsidy Model, e.g., confirmation of passwords, and determine whether these controls adequately protect the model from unauthorized use and corruption.

2. Control Activities

Control activities are the policies and procedures designed to ensure that management directives are carried out. Control activities have various objectives and are applied at various organizational and functional levels. Control activities can include physical controls, segregation of duties, performance reviews, and information processing. When assessing management's assignment of responsibility and delegation of authority for ensuring the efficient and effective implementation of credit reform, the auditor should consider doing the following.

1. Assess management's control methods for monitoring and following up on the agency's ability to prepare accurate subsidy estimates by reviewing, on a test basis for material programs, management's comparison of projected net cash flows with actual cash flows to determine whether over time projected cash flows are becoming more representative of actual cash flows and whether reestimates are the result of controllable factors (technical cash flow assumptions) or uncontrollable factors (discount rate assumptions).

2. Verify that the cash flow assumptions that the agency used in the OMB Credit Subsidy Model were reviewed and approved by the appropriate agency management.

3. Determine how management assures itself of the reliability and logic flow in formulas and mathematical functions within agency initial cash flow worksheets.

4. Assess the internal controls used by management to ensure that changes made to cash flow spreadsheet formulas are appropriate. For example, if changes made to one cash flow spreadsheet need to be carried forward to other spreadsheets, determine whether this is done automatically or if each spreadsheet must be updated individually. Assess the risk of errors being introduced during this process.

5. Determine whether management has a systematic process in place to identify significant changes in economic or other assumptions that will affect subsidy rates of existing cohorts. Determine whether management has a systematic process in place to calculate the differences between actual and estimated cash flows and the possible effect of these differences on the future cash flows of existing cohorts. Determine whether this process assesses the materiality of these changes on the cash flow estimates and the subsidy expense and appropriately concludes whether reestimates are required under OMB guidance. In evaluating potential changes in cash flow assumptions, the process should assess the impact that various factors may have on the program (which also may affect subsidy rates), such as:

   - legislative program changes,
   - administrative program changes,
   - environmental changes,
   - operational changes, e.g., a reduction in employees because of budgetary constraints that would impact the servicing of loans, war, and
   - international economic factors.

6. Determine how management assesses the impact of changes in laws or regulations on the reliability of estimates. For example, a legislative program change may include provisions about maturity or type of borrowers that are outside the scope of past agency experience or may include program changes that shift the composition of new lending toward more or less risky borrowers. Stratification of the portfolio by risk category may enable management to assess the effect of the changes on the estimates. If the agency's data bases do not permit such a stratification, the uncertainty associated with the estimates may increase.

7. Determine whether management has a systematic process in place to estimate the effect of the factors considered in number 6 above on the cash flows of new cohorts.

Once specific controls related to the above activities have been identified, additional tests should be designed to ensure that the agency's controls are operating as designed. The auditor should consider using dual purpose testing to combine the internal control testing with substantive testing as appropriate. Dual purpose testing is discussed in more detail in the section on substantive testing of subsidy estimates in this technical release.

3. Information and Communication

The quality of system-generated information affects management's ability to prepare reliable financial reports. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. The auditor should obtain an understanding of (1) the classes of transactions in the agency's operations that are significant to credit reform accounting in accordance with Treasury case studies, (2) how those transactions are initiated, (3) the accounting records, supporting information, and specific accounts in the financial statements involved in the processing and reporting of the transactions, (4) the accounting process involved from the initiation of a transaction to its inclusion in the financial statements, and (5) the financial reporting process used to prepare the agency's financial statements, including significant accounting estimates and disclosures. When assessing controls over information and communication, the auditor should consider doing the following:

1. Identify and test the controls in place designed to ensure that appropriate personnel are made aware of any concerns that result from reviewing key cash flow assumptions and comparing estimated to actual cash flows as well as the actions taken to resolve the concerns and update the subsidy estimate as appropriate.

2. Determine whether internal controls are in place to ensure that the data supporting the cash flow identifiers[23] used in the spreadsheets are appropriate and consistent with the description of the identifier contained in the applicable user's guide of the OMB Credit Subsidy Model. Effective internal controls are needed to ensure that disclosures concerning the amount of subsidy expense related to interest differential (direct loans), interest supplement (guaranteed loans), defaults (net of recoveries), fees, and other are reasonable. For example, the User's Guide to Version r.8 of the OMB Credit Subsidy Model with r.9 Supplement describes recoveries as the effect of losses recovered that resulted from disposition of collateral, actions by the borrower to restore the loan to good standing or similar actions. The auditor should identify and test controls designed to ensure that the amount estimated for recoveries is based on reliable, complete information from the agency's past experience. The auditor should

[23] Cash flow identifiers are listed in the OMB Credit Subsidy Model User's Guide and include various elements the agency must consider when estimating net cash flows, such as disbursements, principal payments, interest payments, fees and other income, defaults, etc.

also identify and test controls designed to ensure that when compiling the information upon which the estimate is made, transactions have been properly classified as a recovery rather than a reduction in the amount of another cash identifier such as "defaults" or "losses other than default."[24]

3. Determine whether controls are in place to ensure that all applicable credit program cash flows are addressed in the subsidy estimation process. For example, cash flows should be estimated for all transaction types that affect Standard General Ledger Account nos. 1399, Allowance for Subsidy, and 2180, Loan Guarantee Liability. Conversely, transactions in unrelated accounts should be excluded from the subsidy calculation. To test these controls, the auditor should consider reviewing the cash flow worksheet input and the program description to determine whether all applicable cash flow types have been included. In addition, the auditor should review the transaction types included in the Allowance for Subsidy and the Liabilities for Loan Guarantees accounts on a test basis to determine whether these transactions are appropriate.

4. Risk Assessment

The risk assessment process is an internal process used by the agency to (1) identify and analyze the relevant risks to achieving its objectives and (2) develop a plan to mitigate the identified risk. The auditor should obtain sufficient knowledge of the agency's risk assessment process to understand how management identifies, evaluates, and mitigates risks relevant to developing reliable credit subsidy estimates. In evaluating the risk assessment process, the auditor should determine if management developed a strategic plan with goals and objectives for ultimately improving the reliability of estimates. The auditor should determine whether this plan addresses (1) clearly defining the data requirements, (2) developing an effective information store and modeling methods as described in issue paper 96-CR-7 Model Credit Program Methods and Documentation for Estimating Subsidy Rates and the Model Information Store, (3) improving the methods of estimating cash flows, and (4) step-by-step resource allocations and target completion dates to meet the goals and objectives of the strategic plan. Also the auditor should assess

[24] A proposal has been developed to revise the financial statement disclosure requirements for credit subsidy component information. This technical release will be revised accordingly once the proposal has been finalized.

management's progress at meeting the plan's goals and the targeted completion dates.

5. Monitoring

Management should monitor controls to determine whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring is a process that assesses the quality of internal control performance over time. OMB Circular no. A-123, Management Accountability and Control, is issued under the authority of the Federal Managers' Financial Integrity Act (FMFIA) of 1982 and provides guidance to federal managers on improving the accountability and effectiveness of federal programs and operations by establishing, assessing, correcting, and reporting on management controls. During federal financial statement audits, the auditor is required to assess the agency's compliance with the FMFIA. The auditor should obtain sufficient knowledge of the major types of activities the entity uses to monitor internal controls over financial reporting, including how those activities are used to initiate corrective actions. When assessing control risk, the auditor should be cognizant of any material weaknesses reported in the agency's FMFIA report that relate to the efficient and effective implementation of credit reform.

C. Substantive Testing of Subsidy Estimates

Agencies are required by SFFAS no. 2 to account for subsidies at the cohort level in their accounting systems. This information is then aggregated for inclusion in the financial statements. As previously noted, footnote information related to credit programs is typically reported at the fund or program level and the total subsidy expense for the year is divided among three categories: the current year's direct loans or loan guarantees, modifications, and reestimates. The subsidy expense for the current year's direct loans or loan guarantees is segregated into four categories consisting of interest differential or supplement, defaults, fees, and other. The auditor needs to gain assurance about these cost categories at the aggregated fund/program level; however, it is difficult for the auditor to apply adequate procedures for summary amounts which represent numerous cohorts. It would be difficult to explain variations in aggregated amounts without addressing the more detailed cohort level. Determination of what level to disaggregate subsidy information for the purposes of an audit will vary for each agency and will be contingent on current practice and available information.

1. General Approach to Substantive Testing

The following four steps provide a general approach for performing substantive testing. Detailed guidance on implementing these four general steps follow. The nature, timing, and extent of substantive tests will be

significantly influenced by the auditor's assessment of the internal control environment. **This section is written under the premise that the agency has established effective internal controls.** See section 2 below for a discussion of the impact of ineffective controls on the nature, timing, and extent of substantive testing as well as the impact on the audit opinion.

1. Select a representative sample of cohorts for detailed testing, for those material programs selected for internal control testing.[25]

2. Test sampled cohort estimates to determine whether the credit reform process is working as defined and whether the account balance is reasonably stated.

3. Perform analytical review procedures to gain assurance that the estimates are reasonable for lines of business, funds, programs, or cohorts not selected for detail testing.

4. Conclude on audit differences identified during the testwork and determine the financial statement impact.

2. Impact of Ineffective Internal Controls on Substantive Testing

The auditor's assessment and conclusions regarding the effectiveness of the agency's internal control structure, including computer security and the effectiveness of EDP controls, will significantly impact the level of substantive testing. If the agency's internal control structure is not effective (i.e., does not adequately reduce the risk that a material misstatement related to credit reform in the financial statements would be detected and corrected), the auditor will need to design substantive tests to gain assurance on the account balance and propose audit adjustments as necessary.

For example, if there is no system in place to trigger reestimates, the auditor will need to review management's comparison of actual cash flows for material programs to projected cash flows to search for and identify material variances. In addition, the auditor will need to determine whether the agency identified other factors that may materially affect future cash flows, e.g., economic downturn, program changes, or drought, and may

[25] Professional standards stated in AU Section 350.24 that "sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected."

require a reestimate. If the budgeted to actual cash flow comparison was not done by the agency, the auditor should consider performing this analysis based on resource availability. Based on the auditor's analysis of the identified variances and other changes that may affect future cash flows, the auditor should determine whether a reestimate is necessary and urge the agency to calculate the reestimate. Once the reestimate is made, the auditor is then able to assess the impact of the reestimate on the financial statements.

If in the auditor's opinion (1) the internal control weaknesses are so significant that the subsidy expense is likely to be materially misstated, (2) resource constraints make it unreasonable for the auditor to conduct the level of substantive testing necessary to determine the possible audit adjustments, or (3) resource constraints at the agency make it unreasonable to calculate all the necessary material reestimates and include them in the financial statements, the auditor would likely be required to modify the audit opinion. For example, the monitoring process to determine whether reestimates are necessary is a key internal control. Without effective monitoring, the agency may not have reasonable assurance that material reestimates will be made timely and the auditor would need to expand the level of substantive testing. When an agency does not (1) reestimate credit subsidies for the most recently completed fiscal year and include the reestimate in the current year's financial statements or (2) provide assurance that there is no material financial statement impact (as specified in section III. C of this technical release), the auditor should consider modifying the audit opinion.

When assessing the financial statement impact of subsequent events related to credit subsidies, the auditor should follow the guidance in AU Section 342.13 for events occurring after the reestimate date but before the end of field work. In addition, auditors should consider AU Sections 508.19 and .29 - .32 when assessing the effect of uncertainties on the agency's financial statements and the auditor's opinion.

3. Selecting the Sample of Cohorts

The procedures for selecting a sample of cohorts depend upon the type of information to be gleaned from the sample and the desired precision of sample estimates. The sampled cohort is tested to determine whether the credit reform process is working as defined and more specifically, whether the related balance sheet and statement of net cost line items are reasonably stated. In order to gain audit efficiencies, the auditor should

consider utilizing dual purpose testing[26] for a representative sample of cohorts selected from material credit programs. In this way, the auditor will be able to gain assurance from the same sample that both the internal control structure is effective and that the account balance is reasonably stated in relation to the financial statements taken as a whole. When more than one program utilizes the same system of internal controls, the auditor should only test the system once to gain assurance on all related programs and their cohorts. To utilize representative sampling, the auditor must select sample items in such a way that each item in the population has an opportunity to be selected and the estimators are appropriate for the selection methods. In this way, the sample and the resulting estimate or projection are expected to be representative of the population from which the sample was selected. In addition, sufficient sample sizes are necessary in order for the auditor to arrive at meaningful conclusions.

The auditor may wish to stratify the population of cohorts into homogeneous groups prior to selecting the sample to improve sampling efficiency. For example, the auditor may stratify the cohort population into the following three significant groups: (1) material cohorts of such a magnitude that the auditor will test them all, (2) material cohorts that the auditor will sample for testing, and (3) immaterial cohorts that will be subjected to analytical review procedures. For some agencies, the small number of cohorts may prohibit using this sampling approach. In these instances, the auditor should focus on selecting a representative sample in a nonstatistical manner, i.e., using auditor's judgement to select material cohorts for testing to obtain sufficient coverage of the balance being audited or doing a 100 percent sample.

Alternatively, when the agency's control environment is strong and inherent risk is low, the auditor may test cohorts on a rotating basis. In determining whether rotational testing is appropriate, the auditor should consider (1) the results of prior audit experience, (2) the length of time since the cohort was tested, (3) the materiality of the cohort in terms of the relative effect of the cohort on total program expenditures or the size of the program in absolute dollars, and (4) the auditor's assessment of inherent and control risk. The auditor may wish to score these factors in determining the cohort's relative risk. Based on the cohort's score, the auditor may establish a rotation matrix for substantive testing. For example, all cohorts above a

[26]Dual purpose testing often improves audit efficiency by performing multiple audit procedures on a single sample, e.g., internal control attribute and substantive testing.

predetermined score would be considered high risk and selected for substantive testing while other cohorts below this score could be tested on a rotating basis.

4. Testing Sampled Cohorts

Professional standards call for the auditor to "analyze historical data used in developing the assumptions to assess whether the data are comparable and consistent with data of the period under audit, and consider whether such data are sufficiently reliable for the purpose."[27] In the planning phase, the auditor identified the key credit subsidy assumptions as those which were either sensitive to variations or varied significantly. Based on this work, and the results of the internal control analyses, the auditor should be able to focus on the key assumptions. However, these key assumptions may be tested in conjunction with the audit of other financial statement line items. For example, the default rate assumption for guaranteed loans can be tested as part of the audit of claim payments, recovery rate assumptions can be tested during the audit of foreclosed property, fees can be audited in conjunction with insurance premium or other cash receipts, and prepayments can be audited during the audit of insurance in force. In these cases, the auditor must carefully plan the audit samples for these areas in order to include information that will be applicable to the credit subsidy audit and gather sufficient evidence for the auditor to determine the reasonableness of the credit subsidy. For example, when auditing credit subsidy default, prepayment, and recovery assumptions, it is important to determine for which cohort the claim payment was made.

The following are examples of the types of tests the auditor can perform on a representative sample of cohorts selected for dual purpose testing:

1. Collect projected cash flow worksheets used for budget execution and the most recent reestimates for each cohort selected for testing to determine whether the program assumptions are utilized at the cohort level. Trace and compare key cash flow assumptions to the agency's supporting data, including reports on defaults, prepayments, recoveries, etc.

2. Verify the reliability of the data used in developing the assumptions and ensure that key assumptions are sufficiently reliable by

[27]Codification of Statements on Auditing Standards, AU Section 342, Auditing Accounting Estimates.

- comparing the reports to similar reports tested in related audit areas to assess consistency, and
- tracing summary reports to historical supporting documentation, on a test basis, to determine whether the reports are complete and accurate.

3. Determine whether management used reasonable and systematic methods to project key cash flow assumptions by reviewing, assessing, and recalculating, on a test basis, key portions of the cash flow worksheets.

4. Based on the results of EDP-related control tests, the auditor should consider obtaining an appropriate, unmodified version of the OMB Credit Subsidy Model, downloading the agency's cash flows into this version, and comparing the output to the agency's subsidy calculation. In performing these procedures, it is important for the auditor to use the same cash flows as those used to calculate the subsidy rate. Thus, the auditor should verify that the file name, range name, and the date and time the spreadsheet was last changed matches the information on the model output. If differences are identified through this comparison, the auditor should consider recalculating the subsidy rate using the agency's data and an appropriate copy of the model provided by the OMB budget examiner. Differences between the auditor's recalculated rate and the agency's rate should be investigated and explained.

5. The auditor should review the OMB Credit Subsidy Model output to determine whether any warning messages are listed and, if so, to determine why the situation causing the warning message was not resolved and whether not eliminating the error could have any impact on the subsidy rate calculation. Also, if applicable, auditors should determine whether the suppression of any error messages was appropriate by checking the agency's cash flow spreadsheet to determine whether the "suppress warnings" command was used and assess the impact these suppressed error messages could have on the cash flows.

6. The auditor should determine whether the OMB Credit Subsidy Model options that were selected properly reflect specific characteristics of the applicable credit program. For example, the OMB Credit Subsidy Model options for the timing of principal and interest payments for

direct loan programs and the percent of loans guaranteed for guarantee programs should agree with the program's credit terms.

7. Verify that reestimates were performed under the conditions specified in section III.C. of this technical release. Determine whether reestimates were performed in addition to those required under section III.C. of this technical release. For example, reestimates required for budgetary purposes may not be material to the financial statements.

8. Determine that these reestimates were completed, included in the financial statements, and submitted to OMB.

9. Determine whether the reestimation process included adjustments to subsequent years' estimates of cash flows for this cohort.

10. Determine why reestimates were not calculated[28] and included in the financial statements, if applicable. When reestimates are not prepared for the most recently completed fiscal year, the agency must document the reason for forgoing the reestimate otherwise required in Circular A-11 and SFFAS no. 2 and provide the necessary supporting documentation to OMB and the auditor. The documentation should address the requirements in section III.C. of this technical release.

11. Trace interest rates to approved OMB/Treasury rates to ensure that interest expense and income are calculated in accordance with OMB Circular A-34.

12. Verify that reestimates submitted by the budget office and approved by OMB have been recorded in the accounting records.

13. Determine whether modifications occurred as defined in SFFAS no. 2 and OMB Circulars A-11 and A-34 and whether the modification cost was estimated.

[28]OMB has established a four-step process, outlined in Circular A-11, for agencies to calculate technical/default reestimates for the budget less often than every fiscal year -- subject to OMB approval. However, this guidance does not allow agencies to omit material technical/default reestimates from the current year financial statements or to postpone including material technical/default reestimates in the financial statements until a subsequent year. Conversely, the OMB process may require agencies to make technical/default reestimates for the budget that are not material to the financial statements.

14. Verify whether the cash flows and discount rates used to calculate the premodification and postmodification values of the direct loans (or values of the loan guarantee liability) were determined appropriately.

15. Verify whether the modification cost was submitted to OMB, recorded in the accounting records, and included in the financial statements.

5. Analytical Review Procedures

Analytical review procedures can be performed on lines of business, funds, programs, or cohorts not selected for detailed testing. Generally, these procedures consist of comparing recorded balances of subsidy expense, fund balance with Treasury, debt owed to Treasury, credit program receivables and related foreclosed property, and the liabilities for loan guarantees, with the auditor's expectations. The basic premise of analytical review procedures is that plausible relationships among data may be expected to continue unless conditions are known that would change the relationship. Based on the results of the analytical review procedures outlined below, some programs may be selected for detail substantive testing. In applying analytical review procedures, the auditor should consider the following procedures.

1. Based on the information gathered during the internal control phase of the audit, including the auditor's understanding of the estimation process and economic events affecting the period under review, develop an expectation or estimate of what the recorded amount should be. For example, the auditor could compute an estimate of the subsidy expense by using averages as an overall test of reasonableness, i.e., average loans outstanding, average interest rate, average default rate, and average fees. Compare the results of the auditor's estimate to the actual recorded balance to identify significant differences that require investigation. When making estimates of an account balance, the auditor should assess the reliability of the data used and the impact faulty data could have on the auditor's expectation of the subsidy amount.

2. Compare the subsidy amounts for lines of business, funds, programs, or cohorts not selected for sampling for three or more years to identify trends and significant fluctuations in the subsidy rates.

3. Obtain explanations for these fluctuations from management to determine whether the fluctuations are reasonable. Scan[29] cash flow worksheets/reports to search for unusual items and investigate significant fluctuations.

4. Corroborate management's explanations as necessary. Corroboration generally consists of reviewing related supporting documentation or obtaining explanations from accounting or budget personnel or from the appropriate program department. These explanations should be quantified and address the direction and magnitude of the event causing the fluctuation.

5. If the explanation and/or corroborating evidence does not adequately explain the fluctuation, the auditor should consider

   - increasing the precision in the auditor's expectations,
   - increasing the extent of detailed testing for the cohorts discussed above and not relying on the analytical procedures, or
   - treating the difference as a misstatement.

6. Review and recalculate selected portions of the agency's trend analysis of the credit subsidy expense components to determine whether the agency identified and explained unusual or significant fluctuations in interest, defaults, fees, and other. If the agency has not done the credit subsidy component trend analysis, the auditor should consider performing this analysis. Once unusual or significant fluctuations have been identified, the auditor should obtain and corroborate management's explanation.

6. Compliance with Laws and Regulations

By using the audit approach described in this technical release, the auditor will test compliance with the Credit Reform Act of 1990. Thus, no separate audit procedures are necessary to test compliance with this act.

7. Concluding on the Reasonableness of Estimates

Statement on Auditing Standard no. 57 Auditing Accounting Estimates, AU §342, states that the auditor evaluates the reasonableness of accounting

[29] Although scanning is not usually considered an analytical procedure on its own, this technique could be used to investigate unusual fluctuations in subsidy amounts or corroborate management's explanation of variances between projected cash flows and actual cash flows.

estimates in relationship to the financial statements taken as a whole. It goes on to state:

> "Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement and aggregate it with other likely misstatements. The auditor should also consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statement, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate best supported by the audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole."

Uncertainties, among other qualitative aspects of information in financial reports, are discussed in Statement of Federal Financial Accounting Concepts (SFFAC) no. 1, *Objectives of Federal Financial Reporting*. According to SFFAC no. 1, "Reliability [of financial information] does not imply precision or certainty, but reliability is affected by the degree of estimation in the measurement process and by uncertainties inherent in what is being measured." Thus, an amount reported in the financial statements may be "fairly stated," but still imprecise. In addition, SFFAC no. 1 states that "Financial reporting may need to include narrative explanations about underlying assumptions and uncertainties inherent in this process. Under certain circumstances, a properly explained estimate provides more meaningful information than no estimate at all." In other words, imprecision of accounting estimates can be overcome, to some extent, by appropriate financial statement disclosures. In determining whether (1) the credit program receivables and related foreclosed property and the liabilities for loan guarantees line items on the balance sheet, (2) the subsidy expense included in the statement of net costs, and (3) related footnote disclosures regarding credit reform are reasonably stated, the auditor must evaluate and carefully consider all of the audit evidence gathered, including the results of the internal control testing, EDP reviews, detailed substantive testing, analytical review procedures, as well as the above authoritative guidance.

Appendix I: Acceptable Sources Of Documentation For Subsidy Estimates And Reestimates

Documentation must be provided to support the assumptions used by the agency in the subsidy calculations. This documentation will not only facilitate the agency's review of the assumptions, a key internal control, it will also facilitate the auditor's review. Documentation should be complete and stand on its own, i.e., an independent person could perform the same steps and replicate the same results with little or no outside explanation or assistance. If the documentation were from a source that would normally be destroyed, then copies should be maintained in the file for the purposes of reconstructing the estimate.

A. Management should ensure that the following documentation is available for initial subsidy estimates, reestimates, and modifications of existing credit programs:

1. procedures for calculating the subsidy estimate,

2. review and approval process of the subsidy estimate, including the sign-off procedure within the agency,

3. calculation of the recorded subsidy estimates, including the underlying assumptions and cash flow model,

4. historical supporting documents used in the underlying assumptions,

5. documentation of relevant supporting actual cash and economic experience (including the date and source of reports, and how recently the data were updated), which may include:

   - cash reports on historical performance,
   - historical data and trends, citing sources of information and relevant time frame,
   - sensitivity analysis or other analysis that identifies the most critical factors,
   - reports from the accounting or management systems showing trends
   - actuarial studies,
   - experience of other agencies with similar programs,
   - emergencies (acts of God) or legislated changes (acts of Congress), such as changes in the program terms, maximum

allowable loan amount, total program size, or characteristics of the credit program's borrower population, and

- economic and/or industry data and subsequent analyses, including industry studies, journal articles, trade papers, and third party studies.[30]

6. documentation of relevant program design factors, which may include:

   - program definition including fees, grace period, term to maturity, borrower interest rates, legal definitions, and enabling or enacted legislation,

   - legislation or regulations changing the terms, maximum allowable loan amount, total program size, or characteristics of the credit program's borrower population,

   - program eligibility requirements,

   - lender agreements detailing the terms of the guarantee, and

   - borrower contracts outlining the terms and conditions of the loan or guarantee.

B. Management should ensure that the following documentation is available for new programs or changes to existing programs that may not have historical supporting documentation for cash flow assumptions and spreadsheets. In the absence of valid and relevant historical experience as the support for cash flow assumptions, the agency should document the basis for cash flow assumptions. Typical support will include:

   - Relevant experiences from other agencies, including documentation of why another agency's experience is relevant, as well as similarities and differences (particularly possible biases) between the other agency's experience and the changes to existing programs or new programs,

[30] For example, past data may document the historical relationship between interest rates, whereas an independent study may demonstrate how trends in past data are expected to change in the future.

- Extrapolation from subsets of prior program activity, e.g., while prior loans were not targeted for single heads of households, it may be possible to identify prior loans that were made to single heads of households and the experience of such loans in prior records.
- Assumptions used by underwriters for the purposes of determining eligibility, loan approval, or credit scoring.
- Private sector proxies for risk, such as bond ratings to assess default risk, may be used when there is no relevant federal government experience. For example, an agency may consider using bond ratings for a state agency that finances similar loan programs, such as education, farm, or housing, with bonds.
- Extrapolations from private sector lending experience including documentation explaining why this experience is applicable to the agency's credit program and possible biases for which an adjustment is needed, e.g., different borrower characteristics.
- Expert opinion may also be used as an interim measure to support cash flow assumptions. In these cases, the agency must document the expert's qualifications, such as professional or academic certification or length of experience, as well as the basis of the stated opinion. In addition, the following documents should be maintained in support of the expert's opinion:
- memos from conversations with outside experts,
- reports and studies on similar industry conditions,
- minutes from internal meetings describing the basis for any assumptions or changes in assumptions,
- previous studies conducted by the expert, including industry studies, journal articles, and third party studies.

Appendix II: Technical Glossary

Assumptions

basic beliefs about the future operating and functional characteristics of the loan or group of loans or loan guarantees. Types of assumptions include:

cash flow assumptions - all known and/or forecasted information about the characteristics and performance of a loan or group of loans or loan guarantees. Examples include estimates of loan maturity, borrower interest rate, default/delinquency rate, timing of defaults, overall impact of changes in economic factors, etc.

model assumptions - determinations of how cash flow assumptions are applied through the life of the cohort. For example, determining whether the entire assumed amount of defaults should be applied in 1 year or whether a constant or variable proportion of the assumption value should be allocated to each year. The allocation of cash flows over time is the selected model form and is just as influential as the cash flow assumption.

Cash flow stream

the agency's projection of the dollar amount for the scheduled cash flows and deviations from scheduled cash flow items for each year over the life of the cohort.

Cash flows

Estimates or payments to or from the Government over the life of a loan or group of loans or loan guarantees. For direct loans, these may include: loan disbursements, repayments of principle, payments of interest, and any other payments such as defaults, prepayments, fees, penalties, and other recoveries. For loan guarantees, these may include: payments by the government to cover defaults and delinquencies, interest subsidies, payments to the government, such as origination and other fees, penalties and recoveries, and any other payments.

Financing Account

the non-budget account or accounts associated with each credit program account that holds balances, receives the subsidy cost payment from the

credit program account, and includes all other cash flows to and from the Government resulting from post-1991 direct loans or loan guarantees. Each program account is associated with one or two financing accounts, depending whether the account makes both direct loans and loan guarantees (separate financing accounts are required for direct loans and loan guarantees).

Inputs cash flow data elements used to develop spreadsheet calculations.

Internal controls are a process--effected by an agency's management and other personnel--to provide reasonable assurance regarding the achievement of reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Internal controls consist of the control environment, control activities, information and communication, risk assessment, and monitoring.

Key assumptions assumptions that have been established, through sensitivity analysis or other means, to be the elements that have a large impact on estimates, and thus are the most important factors in determining the cost of a loan or group of loans or loan guarantees.

Liquidating Account the budget account that includes all cash flows to and from the Government resulting from pre-1992 direct loans or loan guarantees.

Model a representation in mathematical symbols (or at least graphically) that depicts a formulated theory about the relationship among measurements of some phenomenon that varies. A model includes both cash flow assumptions and model assumptions.

Modeling the process of developing and selecting an appropriate set of cash flows and model which generally have two aspects: (1) a choice of a general mathematical function (equation) describing a basic shape or process and (2) a choice of the model parameters that distinguish one specific shape from the general class of functional forms. The mathematical functions may take many forms. Commonly known examples of models are simple

regression (y=ax+b), multiple regression (y=ax+by+z), and time series. Many other simple or more complex model forms related to cash flow modeling reform are possible.

Model parameters the values that identify a unique model from the general form. For example, y=2x+3 has parameters a=2 and b=3 for the simple regression model class. Note that "model parameter" is sometimes used in credit reform documents in lieu of the more appropriate term "input variable in the spreadsheet."

Negative Subsidy Account the budget account for the receipt and/or expenditure of amounts paid from the financing account when there is a negative subsidy for the original estimate or a downward reestimate (not necessarily used for mandatory programs).

OMB Credit Subsidy Model computer software developed by OMB for discounting cash flows in estimating credit subsidies. It uses agency cash flow inputs to compute the net present value at the point of disbursement and the subsidy rate associated with those cash flows.

Program Account the budget account into which an appropriation to cover the subsidy cost of a direct loan or loan guarantee program is made and from which such cost is disbursed to the financing account.

Spreadsheets computer code, often a collection of programs, used to make cash flow calculations according to the proposed models and assumptions. Spreadsheets are not models although the term "spreadsheet model" is sometimes used.

Technicals cash flow information input used to make spreadsheet calculations (spreadsheet elements needing completion).

Appendix III: Summary of Reestimate Requirements

	Budget	Financial Statement
Interest Rate Reestimate	*Frequency:* At least one time when the cohort is 90% disbursed	*Frequency:* Whenever the change in the interest rate materially affects the financial statements or, if no material change occurs prior to the cohort being 90% disbursed, at least one time when the cohort is 90% disbursed.
	Timing: At the end of the fiscal year	*Timing:* At the end of the fiscal year
Technical / Default Reestimate	*Frequency:* Annually unless a different plan is approved by OMB - regardless of financial statement materiality	*Frequency:* Any year when material. Also, agencies must disclose significant subsequent events after the reestimate date in the financial statement footnotes.
	Timing: At the end of the fiscal year unless otherwise approved by OMB.	*Timing:* At the end of the fiscal year or, if approved by OMB, a 12 month period ending not earlier than June 30 of the reporting year. Also, agencies must disclose if the reestimate was calculated at a time other than the end of the fiscal year.

Federal Financial Accounting And Auditing Technical Release No. 4: Reporting on Non-Valued Seized and Forfeited Property

Status

Issued	July 31, 1999
Effective Date	For fiscal periods beginning after September 30, 1999.
Volume I References	SFFAS No. 3, *Accounting for Inventory and Related Property*
Volume II References	Seized and Forfeited Property (S30)
Interpretations and Technical Releases	
Affects	
Affected by	SAS 91; FASAB's revised MOU

Summary

An analysis of changes for all material non-valued seized property should be disclosed in the financial statement footnotes in the same manner as prescribed for non-valued forfeited property.

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Introduction

Guidance for the accounting and reporting of seized and forfeited property held by Federal entities is provided in the Statement of Federal Financial Accounting Standard No. 3, *Accounting for Inventory and Related Property* (SFFAS No. 3), issued in October 1993. This Technical Release is intended to clarify the required reporting of non-valued seized and forfeited property.

Agencies that must deal with non-valued seized and forfeited property should first refer to the hierarchy of accounting standards contained in the current Office of Management and Budget (OMB) Bulletin on "Form and Content of Agency Financial Statements" for guidance. Standards issued by General Accounting Office (GAO) and OMB have precedence over other authoritative guidance for federal entities.[1] This technical release supplements the relevant federal standards, but is not a substitute for and does not take precedence over the standards.

This Technical Release includes a discussion of the issues and recommended implementation guidance that is intended to clarify the reporting of non-valued seized and forfeited property. This guidance also provides more detailed terminology relating to the measurement of these non-valued items (see Appendix A ... [See consolidated glossary in Appendix E of this document] for the list of terms).

Background

Federal entities implementing this standard have raised numerous questions requiring clarification of the reporting of non-valued seized and forfeited property. Numerous Federal entities' missions include the task of seizing non-valued property. Bureaus within the Departments of the Treasury and Justice are most directly affected by this issue.

Non-valued property either does not have a legal market in the United States, or does not have a salable value to the Federal government. These items may be abandoned, embargoed, prohibited, sensitive, or seized for forfeiture. Examples of such items could include illegal drugs, counterfeit currencies and monetary instruments, and firearms, which the Federal government, as a matter of law or policy, does not return to the owner or

[1] The Federal Accounting Standards Advisory Board recommends accounting concepts and standards to its principals; the Department of the Treasury, the Office of Management and Budget, and the General Accounting Office. If all three principals approve a recommendation it is issued by OMB and GAO.

sell upon forfeiture. Federal agencies that seize these types of items have had difficulty in applying the concept of materiality and in the reporting of these types of items since they do not have monetary value. Consequently, Federal agencies have independently determined what types of non-valued property should be disclosed in the financial statements under SFFAS No. 3 and the units of measure, resulting in inconsistent disclosures between agencies and disclosures that lacked meaningful information.

While non-valued seized property does not have a monetary value to the Federal government, the sensitive nature of much of this type of property requires the same level of accountability and security as valued property, if not more. Agencies should ensure that their systems of internal control are adequate to provide sufficient accountability and security over this property in order to meet the reporting requirements provided in SFFAS No. 3.

SFFAS No. 3 prescribes that seized property shall be accounted for in the financial records of the entity that is operating as the central fund (see SFFAS No. 3, para. 60). Central funds are established to finance the costs of the seizure, management, and disposition of property, and to receive the proceeds from the sale or disposition of that property. However, since non-valued items do not have a financial value, the central fund is not responsible for reporting these items.[2] Accordingly, the seizing or custodial entity is responsible for maintaining sufficient internal records to maintain control over these items and would have reporting responsibility for non-valued items.

Chapter 3 of the Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting* (SFFAC No. 1), identifies the users of Federal financial reports and their information needs. Federal financial report users need information to assess the accountability, stewardship, and operating performance of Federal agencies and programs. To address the information needs of Federal financial report users, Chapter 4 of SFFAC No. 1 defines the objectives of financial reporting as budgetary integrity, operating performance, stewardship, and systems and control. The discussion of these objectives emphasizes the concepts of the entity's control over, accountability of, and accomplishment of Federal programs and activities.

[2]This is generally because the central fund does not take custody of nonvalued items.

Furthermore, to provide additional useful perspective, SFFAS No. 3 includes a discussion on the concept of materiality. Specifically, the concept of materiality includes both quantitative and qualitative considerations. Thus, an item that is not considered material from a quantitative standpoint may be considered qualitatively material. Accordingly, items would be considered qualitatively material if the judgment of a person relying on the information presented about such items would be influenced by the omission or misstatement of information presented about those items. SFFAS No. 3 states that an item that is not considered material from a quantitative standpoint may be considered qualitatively material if it would influence or change the judgment of the financial statement user. It should be noted that SFFAS No. 3 also clearly states that items of a sensitive nature held by an entity that are not considered material to the entity's financial statements need not be reported.

Discussion of Issues

The disclosure requirements for seized and forfeited property are outlined in paragraphs 66 and 78 of SFFAS No. 3. Among the requirements is a footnote disclosure to contain: a description of the composition of the property; the methods of valuing the property; restrictions on the use of forfeited property; changes from prior year accounting methods, if any; and an analysis of changes in seized and forfeited property. The analysis of changes in seized and forfeited property should provide the dollar value and number of properties on hand at the beginning of the year, seizures and forfeitures made during the year, property disposed of and method of disposition, and property on hand at the end of the year. This information should be presented by type of property where material.

While SFFAS No. 3 provides adequate guidance for reporting seized and forfeited items with a financial value, the standard has not been interpreted and applied consistently with respect to non-valued items. Paragraph 148 of SFFAS No. 3 states that the standard was revised to address the disclosure requirements for non-valued items. For these items, the standard does not require the reporting of financial value, but it clearly requires the disclosure of all material forfeited property, including those items with no financial value. However, the standard does not address the disclosure of non-valued seized items. As a result, some reporting entities with seizing authority disclose non-valued seized items, and others do not. Clarification of the standard as it relates to non-valued seized items is needed to ensure consistent implementation.

With numerous professional disciplines involved in activities related to the seizure and reporting of non-valued items, some terminology has different meanings depending on whether it is used in a legal, accounting, or program management context. To provide for consistent and meaningful reporting, clarified definitions and standard units of measure are necessary.

Recommended Implementation Guidance

An analysis of changes for all material non-valued seized property should be disclosed in the financial statement footnotes in the same manner as prescribed for non-valued forfeited property.

The definitions in **Appendix A** ... [See consolidated glossary in Appendix E of this document] provide for consistent and meaningful reporting among Federal agencies that seize and/or forfeit non-valued items. The units of measurement for non-valued items provided in the **Attachment** are also designed to facilitate consistency in reporting among agencies. It is recognized that some agencies may be currently reporting in different measurement units and may be unable to convert their units of measurement for FY 199~~8~~9 reporting. Such agencies may continue to report on their current basis for FY 199~~8~~9 but should conform with the units of measurement provided in the **Attachment** for-FY ~~1999~~ 2000 and subsequent years.

Attachment: Measurement Of Non-valued Items

Category	Standard Unit Of Measurement
Illegal Drugs	
Cannabis	Kilograms
Cocaine	Kilograms
Heroin	Kilograms
Methamphetamine/Amphetamine	Various
Other Categories[3]	Various
Firearms and Explosives	
Legal Firearms	Number
Illegal Firearms	Number
Ammunition	Rounds
Explosives	Number
Counterfeit	
Currency - Completed (U.S. & Foreign)	Number of counterfeit bills
Credit Cards	Number
Other (e.g., other counterfeit monetary instruments)	Number

Note: This is not intended to be an all-inclusive list. Other categories should be considered as appropriate.

[3]Other categories include material amounts of other drugs seized, to be separately reported by liquid weight, dry weight, tablets, or other appropriate measurement.

Appendix A: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary” on page 1273.

Federal Financial Accounting and Auditing Technical Release No. 5: Implementation Guidance on Statement of Federal Financial Accounting Standards 10: Accounting for Internal Use Software

Status

Issued	May 14, 2001
Effective Date	for periods ending after September 30, 2001
Volume I References	SFFAS 5, *Accounting for Liabilities of the Federal Government* SFFAS 6, Accounting for Property, Plant, and Equipment SFFAS 10, Accounting for Internal Use Software
Volume II References	Software (S50)
Interpretations and Technical Releases	None.
Affects	None.
Affected by	None.

Summary

I. This technical release is intended to provide guidance on implementing SFFAS 10.

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Introduction

1. The AAPC was asked to provide guidance to Federal entities on the implementation of Statement of Federal Financial Accounting Standards 10, *Accounting for Internal Use Software* (SFFAS 10). This Technical Release (TR) is intended to provide guidance on implementing SFFAS 10. This TR was prepared in conjunction with the Chief Financial Officers Council Task Force on the implementation of SFFAS 10; the AAPC agreed to publish in this TR certain issues raised by the task force.

2. Readers of this technical release should first refer to the American Institute of Certified Public Accountants' (AICPA) Auditing Standards Board hierarchy of accounting standards applicable to Federal entities[1]. Standards issued by FASAB have precedence over other authoritative guidance for Federal entities. This technical release is considered a Level C. pronouncement in the hierarchy.

3. This guidance is based on the provisions of the following Federal standards

   a. SFFAS 10, *Accounting for Internal Use Software*

   b. SFFAS 5, *Accounting for Liabilities of the Federal Government*

   c. SFFAS 6, *Accounting for Property, Plant, and Equipment*

Questions And Responses

Question 1

4. *Trigger Point for Capitalization and Amortization*[2] - How can management determine the point in time when it is more likely than not that a proposed software project will be implemented, and thus the capitalization and amortization periods start?

[1] AICPA Statement on Auditing Standards 91, *Federal GAAP Hierarchy.*

[2] SFFAS 10, paragraph 16a.

Response

5. SFFAS 10 states that "for internally developed software, capitalized costs should include the full cost (direct and indirect costs) incurred during the software development stage. Such costs should be limited to cost incurred after (a) management authorizes and commits to a computer software project and believes that it is more likely than not that the project will be completed and the software will be used to perform the intended function with an estimated service life of 2 years or more, and (b) the completion of conceptual formulation, design, and testing of possible software project alternatives (the preliminary design stage). "[3] Each Federal agency should develop and document agency specific policies and procedures for this determination so that it is consistently implemented across new software developments.

6. In terms of amortization, SFFAS 10 states that "for each module or component of a software project, amortization should begin when that module or component has been successfully tested. If the use of the module is dependent on completion of another module(s), the amortization of that module should begin when both that module and the other module(s) have successfully completed testing. "[4] Generally, this point in time is before the Federal agency starts to realize the benefits of the new computer software system.

Question 2

7. *Capability vs. Functionality* - Certain costs extend the ability of a computer software system to perform tasks or make the application easier to use. Neither of these terms is defined in the Glossary, which may lead to a wide variety of interpretations. Are these terms synonymous within the context of SFFAS 10?

Response

8. The meaning of the term "capability" used in SFFAS 10 is very similar to the meaning of "functionality." "Capability" is used in SFFAS 10 in the sense meaning an ability to perform an indicated use. "Functionality" is used in the sense meaning an ability to perform a specific function (an action for which a person or piece of equipment is specially fitted or used). SFFAS 10 states that an "enhancement"

[3] Ibid., Paragraph 16.

[4] Ibid., Paragraph 33.

occurs when, for example, a new "capability or function [is added] to existing software."[5] In applying the provisions of SFFAS 10, "capability" is synonymous with "functionality."

Question 3

9. *Useful Life of Software Based on Hardware* - To what extent should the useful life of software be based on the hardware on which it runs?

Response

10. In situations where software and the hardware on which it runs have independent service lives, the determination of the useful life of the software should be viewed independently of the useful life of the hardware. This determination should be made on a case by case basis for each Federal agency and is at the discretion of management of the agency. The rationale for this determination should be documented.

11. For integrated software, SFFAS 10, Paragraph 22, states the following.

    "Computer software that is integrated into and necessary to operate general PP&E, rather than perform an application, should be considered part of the PP&E of which it is an integral part and capitalized and depreciated accordingly (e.g., airport radar and computer-operated lathes). The aggregate cost of the hardware and software should be used to determine whether to capitalize or expense the costs."

Question 4

12. *Capitalizing License Fees* - Full ownership of commercial software is rarely, if ever, transferred from the owner of the software to a Federal agency that desires to implement the functionality provided by that software. Rather, agencies acquire the right to use the software through the purchase of a license. When should software license fees be capitalized?

Response

13. Although SFFAS 10 did not address licensing within the body of the standard, the FASAB did state its belief in the Basis for Conclusions[6]

[5] SFFAS 10, paragraph 25.

[6] SFFAS 10, paragraphs 66-67.

that it would be appropriate for Federal entities to apply lease accounting concepts to licenses. The Committee therefore believes that when Federal agencies are making the determination as to whether software license fees should be capitalized, it would be appropriate for the agency to follow the lease accounting concepts as provided in SFFAS 5[7] and SFFAS 6[8], as well as appropriate policies for capitalization thresholds.

14. The Committee noted that the following Financial Accounting Standards Board (FASB) and AICPA standards provide guidance on accounting for software and licensing in general, and may be relevant to this topic.

- SFAS 50, *Financial Reporting in the Record and Music Industry*
- SFAS 63, *Financial Reporting by Broadcasters*
- SFAS 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*
- SFAS 139, Rescission of SFAS 53, *Financial Reporting by Producers and Distributors of Motion Picture Films and Amendments to SFAS Nos. 63, 89, and 121*
- FASB Highlights, *Computer Software: Guidance on Applying Statement 86*
- AICPA SOP 97-2, *Software Revenue Recognition*
- AICPA SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*
- AICPA SOP 00-2, *Accounting by Producers or Distributors of Film*
- EITF 00-2, *Accounting for Web Site Development Costs*
- EITF 00-3, Application of AICPA Statement of Position 97-02 (*Software Revenue Recognition)* to Arrangements that Include the Right to Use Software Stored on Another Entity's Hardware.

Question 5

15. *Capitalizable Costs vs. Executory Costs* - How should a Federal agency capitalize a license agreement that may include executory costs (i.e., maintenance and technical support), as well as software

[7] SFFAS 5, paragraphs 43-46.

[8] SFFAS 6, paragraph 20.

upgrades? This may include upgrades that may either extend the useful life of the software or provide additional functionality.

Response

16. Agency judgment should apply in determining what portions of license fees are attributable to software capitalizable costs versus executory costs. Assuming lease capitalization criteria and thresholds are met, software license capitalization amounts[9] may be derived from the payment schedule contained in the license agreement. As stated in SFFAS 5, if the portion of the minimum lease payments representing executory cost is not determinable from the lease provisions, the amount should be estimated.[10] Agencies may also want to consider having each license agreement specifically identify the various costs throughout the license lifecycle, e.g., initial license, maintenance, enhancement, etc.

Question 6

17. *Bulk Purchases* - Rather than buy individual packages of typical desktop software, many Federal agencies will acquire either a site or enterprise license, which allows unlimited use of a single package at a site or across the enterprise, or will buy, at a single time, a sufficient number of individual licenses to cover the use of a large percentage of the site or enterprise population (frequently referred to as a "seat license"). These acquisitions will in most cases exceed the capitalization threshold, but would not exceed the threshold if purchased separately. Should these types of purchases be capitalized?

Response

18. For these types of bulk purchases Federal entities should follow the guidance as stated in SFFAS 10, paragraph 24.

    "Each federal entity should establish its own threshold as well as guidance on applying the threshold to bulk purchases of software programs (e.g., spreadsheets, word-processing programs, etc.) and to modules or components of a total software system. That guidance should consider whether period cost would be distorted or asset values understated by expensing the purchase of numerous copies of a

[9] SFFAS 5, paragraph 44.

[10] Ibid., paragraph 44.

software application or numerous components of a software system and, if so, provide that the collective cost should be capitalized.

Appendix A: Topical Index

This index provides references to the topics in this Volume. References to the original statements are organized as follows: The first character indicates that it is a Concepts Statement (C), a Standards Statement (S), or an Intrepretation (I), or a Technical Release (T). This letter is followed by a number to indicate which statement it refers to. The number is followed by a "P" for paragraph which is followed by the paragraph number(s).

In addition to accounting topics, the index lists certain agencies or programs that have been used in illustrations or that have unique provisions within the standards.

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2002-1	Assigning to Component Entities Costs and Liabilities that Result from Legal Claims Against the Federal Government	7/1/02
2002-2	Disclosures Required by Paragraph 79(g) of SFFAS 7	9/1/02
2003-1	Certain Questions and Answers Related to the Homeland Security Act of 2002	6/1/03

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I-3	Measurement Date for Pension and Retirement Health Care Liabilities	8/29/97
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TR-4	Reporting on Non-valued Seized and Forfeited Property	7/31/99
TR-5	Implementation Guidance on SFFAS 10: Accounting for Internal Use Software	5/14/02

Appendix C: Memorandum of Understanding Among The General Accounting Office, The Department of The Treasury, and The Office of Management and Budget on Federal Government Accounting Standards and A Federal Accounting Standards Advisory Board

This Memorandum of Understanding reflects the agreement of the General Accounting Office ("GAO"), the Department of the Treasury ("Treasury"), and the Office of Management and Budget ("OMB") on the procedures to be followed in setting federal government accounting standards and the composition and operation of the Federal Accounting Standards Advisory Board.

Whereas GAO, Treasury, and OMB conduct a continuous program for improving accounting and financial reporting in the federal government; and

Whereas the Comptroller General, the Secretary of the Treasury, and the Director of the Office of Management and Budget established an advisory board under the Federal Advisory Committee Act, as amended (5 U.S.C. App.), to consider and recommend accounting concepts and standards for the federal government;

The Comptroller General, the Secretary of the Treasury, and the Director of the Office of Management and Budget (the Sponsors) each hereby agree to continue and serve as sponsors of the Federal Accounting Standards Advisory Board ("Board"). The Board will work under the general oversight of its Sponsors. In addition, the Sponsors each hereby agree to take related actions regarding federal government accounting standards. The Board shall be established as follows:

Section 1. Establishment.

A. Composition. The Board shall have the following ten members:

- one GAO member,
- one OMB member,
- one Treasury member,
- one member from the Congressional Budget Office (CBO), and
- six non-federal members selected from the general financial community, the accounting and auditing community, and academia.

B. Selections and Appointments. The GAO, OMB, Treasury and CBO members will be selected by their respective agencies. The six non-federal members will be selected by the Sponsors. In selecting the non-federal members, the Sponsors shall:

(1) seek nominations from a wide variety of sources, including the Director of CBO;

(2) consider, among other criteria, an individual's

(A) broad professional background, and

(B) expertise in federal government accounting, financial reporting, and financial management; and consider the recommendations of a panel convened by the chairperson.

The Sponsors will select a chairperson, who will be a non-federal member. At least one Sponsor shall obtain the view of the Director of CBO before any appointments or selections of non-federal members are made.

C. Tenure. The GAO, OMB, Treasury and CBO members shall serve at the discretion of their respective agency heads. The six non-federal members will serve initial terms of up to five years with a possible reappointment for one additional term of up to five years.

D. Duties. The Board will consider accounting concepts and standards. The Board will not set or propose budget concepts, standards, and principles. In considering accounting concepts and standards, consideration will be given to the budgetary information needs of executive agencies and the needs of users of Federal financial information. Board recommendations on accounting concepts or standards will be submitted to the Comptroller General, the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Director of the Congressional Budget Office.

E. Meetings and Agendas. The Board will meet whenever necessary or at the request of the Comptroller General, the Secretary of the Treasury, or the Director of OMB, and will establish detailed working procedures. Board members will be expected to attend all meetings.

F. Funding. The Sponsors shall share in funding the Board on an equitable basis. The Director of CBO shall fund the Board to the same extent as the Secretary of the Treasury.

Section 2. Support Staff and Other Groups.

A. Staff. A core group of qualified technical staff will support the Board in carrying out its duties and functions. The staff will spend its time working on Board matters and, from time to time, may be augmented with staff assigned from government departments or agencies or other organizations.

B. Task Forces. The Board may appoint task forces as necessary to advise it on a variety of accounting matters. Task forces will play an important role in the accounting standard-setting process. They will provide expert views and recommend solutions to issues or problems. A task force shall include a CBO member if the Director of CBO wishes to participate in the task force and concludes that CBO has expertise in the issue or problem being addressed.

Section 3. Accounting Standard-Setting Process. The Board will follow a six-step process for considering accounting standards. The steps in the process are:

(1) Identification of accounting issues and agenda decisions,

(2) Preliminary deliberations,

(3) Preparation of initial documents (issues papers and/or discussion memorandums),

(4) Release of documents to the public, public hearings, and considerations of comments,

(5) Further deliberations, exposure draft, and consideration of comments, and

(6) General consensus (at least a majority vote) reached among Board members and documents submitted to the Comptroller General, the Secretary of the Treasury, the Director of OMB and the Director of CBO.

The Board will determine the detailed procedures necessary to implement these steps.

Section 4. Concepts and Standards. Concepts and standards provide a frame of reference for resolving accounting issues.

When the Board has developed a proposed concept or standard, the Board shall submit it to the Comptroller General, the Director of OMB, the Secretary of the Treasury and the Director of CBO for their review. If, within 90 days after its submission, the Comptroller General or the Director of OMB, or both, objects to the concept or standard, then it shall not be issued and will be returned to the Board for further consideration. If, within 90 days after its submission, neither of these officials objects to the concept or standard, then it shall be issued and become a final concept or standard of the Board. Concepts and standards will be announced in *The Federal Register*.

A proposed Interpretation or Technical Release shall be submitted to the members of the Board representing the three Sponsors for their review. If, within 45 days after its submission, any one of the members representing a Sponsor objects to the proposed Interpretation or Technical Release, then it shall be returned to the Board for further consideration. If, within 45 days after its submission, none of these officials objects to the Interpretation or Technical Release, then it shall become final. Final Interpretations and Technical Releases will be announced in *The Federal Register*.

The Sponsors agree that standards set and promulgated following the Board's Rules of Procedure are recognized to have substantial authoritative support, and those accounting standards contrary to such promulgation are not. The Sponsors retain their authorities, separately and jointly, to establish and adopt accounting standards for the federal government.

Section 5. Transition. Each of the non-federal members serving on January 11, 2002 shall have their current term extended to June 30, 2004, and be eligible for an additional term of up to five years to the extent total service on the Board does not exceed 10 years.

Section 6. Termination. Any modification to this memorandum shall be effective if agreed to by each of the three signatory agencies. This memorandum shall remain in effect until 120 days after one of the Sponsors provides notice of intent to terminate the agreement.

Section 7. Effective Date. This memorandum of understanding is effective when executed by the Sponsors except that provisions involving the Congressional Budget Office will become effective on October 1, 2003.

/s/ _____ _____

John W. Snow May 7, 2003
Secretary of the Treasury

/s/ _____ _____

Mitchell Daniels May 7, 2003
Director, Office of Management
and Budget

/s/ _____ _____

David M. Walker May 7, 2003
Comptroller General of the
United States

Appendix D: Federal Accounting and Auditing Resources

[This appendix lists sources where one can get "individual documents that are issued between updates" of the Codification. "These and other relevant resources" are listed here.]

FASAB -- www.fasab.gov

Office of Management and Budget -- www.whitehouse.gov/omb

General Accounting Office -- www.gao.gov

Treasury Financial Management Service -- www.fms.treas.gov

Appendix E: Consolidated Glossary

This glossary is a compilation of all terms presented in Statements of Federal Financial Accounting Standards. Some terms are designated as "Special Term from SFFAS #" and are terms defined specifically for the standard indicated. These terms are not intended for general application to other federal financial transactions.

Abandoned Property

Property of any type over which the rightful owner has relinquished possession and any claim of an ownership interest, without assertion of an adverse right to possession and control by the federal government. This would include property left at a government facility and unclaimed by the rightful owner following notice of intent to dispose. This property is a type of seized property.

Abatement

A reduction or cancellation of an assessed tax.

Accountability Reports

These reports are broader in scope than traditional general purpose financial reports. As explained by OMB: "Six pilot agencies volunteered to produce an 'Accountability Report' for FY 1995 to provide more useful information to decision makers by linking together information required by several management statutes. . . . Accountability Reports integrate the following information: the FMFIA report, the CFOs Act Annual Report (including audited financial statements); management's Report on Final Action as required by the IG Act; Civil Monetary Penalty and Prompt Payment Act reports; and available information on agency performance compared with its stated goals and objectives, in preparation for implementation of GPRA." *Federal Financial Management Status Report and Five Year Plan*, June 1996, pages 33-34. Twelve agencies produced accountability reports for FY 1997; eighteen plan to do so for FY 1998; the number will increase to 23 for FY 2000. (The requirement to include Civil Monetary Penalty and Prompt Payment Act reports has been deleted.)

Accrual Accounting

Records the effects on a reporting entity of transactions and other events and circumstances in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the entity. Accrual accounting is concerned with an entity's acquiring of goods and services and using them to produce and distribute other goods and services. It recognizes that the buying,

producing, selling, distributing, and other operations of an entity during a period, as well as other events that affect entity performance, often do not coincide with the cash receipts and payments of the period. Compare with cash accounting. [See Financial Accounting Standards Board Statement of Financial Accounting Concepts (SFAC) No. 4, Objectives of Financial Reporting by Nonbusiness Organizations, paragraph 50, SFAC No. 6, Elements of Financial Statements, pars. 139-141, 144-5; and Congressional Budget Office, Glossary of Budgetary and Economic Terms, "Accrual Accounting."] (SFFAS 24)

Activity

The actual work task or step performed in producing and delivering products and services. An aggregation of actions performed within an organization that is useful for purposes of activity-based costing.

Activity Analysis

The identification and description of activities in an organization. Activity analysis involves determining what activities are done within a department, how many people perform the activities, how much time they spend performing the activities, what resources are required to perform the activities, what operational data best reflect the performance of the activities, and what customer value the activity has for the organization. Activity analysis is accomplished with interviews, questionnaires, observation, and review of physical records of work. It is the foundation for agency process value analysis, which is key to overall review of program delivery.

Activity-based Costing

A cost accounting method that measures the cost and performance of process related activities and cost objects. It assigns cost to cost objects, such as products or customers, based on their use of activities. It recognizes the causal relationship of cost drivers to activities.

Actual Cost

An amount determined on the basis of cost incurred including standard cost properly adjusted for applicable variance.

Actual Custody

Physical possession and control of property by government personnel.

Actuarial Balance	The difference between the summarized cost rate and the summarized income rate over a given valuation period.
Actuarial Cost Methods	A recognized actuarial technique used for establishing the amount and the incidence of employer contributions or accounting charges for pension costs under a pension plan.
Actuarial Liability	A liability based on statistical calculations and actuarial assumptions (actuarial assumptions are conditions used to resolve uncertainties in the absence of information concerning future events affecting insurance, pension expenses, etc.).
Actuarial Present Value	The value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of actuarial assumptions. (Actuarial Standards of Practice No. 4)
Actuarial Status	The status of a program based on statistical calculations and actuarial assumptions about future economic, demographic, and other conditions and events.
Aggregate Entry Age Normal	A system of applying the entry age normal actuarial cost methodology using aggregate population models or groups instead of applying it individual by individual.
Allocations	As used in the context of the federal budget, the amount of obligational authority transferred from one agency, bureau, or account that is set aside in a transfer appropriation account to carry out the purpose of the parent appropriation or fund. (JFMIP, *Project on Standardization of Basic Financial Information Requirements of Central Agencies*, dated October 1991, hereafter cited as JFMIP Standardization Project)

Allotment	A distribution made within an entity of amounts available for obligation. [See OMB Bulletin A-34, *Instructions on Budget Execution*, Section 11, Terms and Concepts, "Allotment."]
Ammunition	A generic term that includes a great variety of devices designed and constructed to inflict damage upon enemy personnel or material by action of an explosive, pyrotechnic, or chemical agent.
Amortization	The gradual extinguishment of any amount over a period of time through a systematic allocation of the amount over a number of consecutive accounting periods such as the retirement of a debt by serial payments to a sinking fund.
Anticipated	The word "anticipated" is used in a broad, generic sense in this document. In this context the term may encompass both "probable" losses arising from events that have occurred, which should be recognized on the face of the basic or "principal" financial statements, as well as "reasonably possible" losses arising from events that have occurred, which should be disclosed in notes to those statements. "Anticipated" may include the effects of future events that are deemed probable, for which a financial forecast would be appropriate. The term may also encompass hypothetical future trends or events that are not necessarily deemed probable, for which financial projections may be appropriate. (See below for definitions of "*forecast*" and "*projection*.")
Applied Research	Systematic study to gain knowledge or understanding necessary for determining the means by which a recognized and specific need may be met.
Apportionment	A distribution made by OMB of amounts available for obligation in an appropriation or fund account into amounts available for specified time periods, programs, activities, projects, objects, or combinations thereof. The apportioned amount limits the obligations that may be incurred. (OMB *Circular A-34*)

Appropriation

In most cases, appropriations are a form of budget authority provided by law that permits federal agencies to incur obligations and make payments out of the Treasury for specified purposes. An appropriation usually follows enactment of authorizing legislation. An appropriation act is the most common means of providing budget authority, but in some cases the authorizing legislation itself provides the budget authority.

Assessments

Enforceable claims for nonexchange revenue for which specific amounts due have been determined and the person from whom the tax or duty is due has been identified. They include both self-assessments made by persons filing tax returns and assessments made by the collecting entities as a result of audits, investigations, and litigation. Although the term is normally used in connection with taxes, as used in this Statement (SFFAS 7) assessments also include determinations of amounts due for any other kind of nonexchange revenue. Specifically excluded from the definition of assessments, as used in this Statement, are compliance assessments. Compliance assessments, as defined by IRS and Customs, do not represent financial receivables.

Assets

Tangible or intangible items owned by the federal government which would have probable economic benefits that can be obtained or controlled by a federal government entity. (Adapted from Financial Accounting Standards Board, Statement of Concepts No. 6, *Elements of Financial Statements*)

Attribution

The process of assigning pension benefits or costs to periods of employee service. [Financial Accounting Standard Board, Statement of Financial Accounting Standard No. 87, *Employers' Accounting for Pensions*]

Assumptions

Basic beliefs about the future operating and functional characteristics. Types of assumptions include:

Actuarial: Assumptions as to the occurrence of future events affecting projected costs, such as mortality, withdrawal, disability, and future interest rates.

Cash flow assumptions - all known and/or forecasted information about the characteristics and performance of a cash flow, e.g., a loan or group of

loans or loan guarantees. Examples of assumptions pertaining to loans and loan guarantees include estimates of maturity, borrower interest rate, default/delinquency rate, timing of defaults, overall impact of changes in economic factors, etc.

Hospital assumptions: Assumptions related to medical treatment including differentials between hospital labor and nonlabor indices compared to general economy labor and nonlabor indices; rates of hospital admission; the trend toward treating less complicated cases in outpatient settings; and continued improvement in the classification of patients according to type of treatment, age, diagnosis, etc.

Key assumptions - Assumptions that have been established, through sensitivity analysis or other means, to be the elements that have a large impact on estimates, and thus are the most important factors in determining the cost of a loan or group of loans or loan guarantees.

Model assumptions - determinations of how cash flow assumptions are applied through the life of the cohort. For example, determining whether the entire assumed amount of defaults should be applied in 1 year or whether a constant or variable proportion of the assumption value should be allocated to each year. The allocation of cash flows over time is the selected model form and is just as influential as the cash flow assumption.

Social Security: Values relating to future trends in certain key factors. Demographic assumptions include fertility, mortality, net immigration, marriage, divorce, retirement patterns, disability incidence and termination rates, and changes in the labor force. Economic assumptions include unemployment, average earnings, inflation, interest rates, and productivity. Projections are normally provided based on the following three sets of economic assumptions • the “low cost” set (Alternative I) that assumes relatively rapid economic growth, low inflation, and demographic conditions favorable to the plan;

- the “intermediate cost” set (Alternative II) that represents the trustees’ “best estimate” of future trends; and
- the “high cost” set (Alternative III) that assumes slow economic growth, more rapid inflation, and demographic conditions unfavorable to the plan.

Authority To Borrow

Authority to borrow is a subset of budget authority. (See *budget authority.*)

Avoidable Cost	A cost associated with an activity that would not be incurred if the activity were not performed.
Basic Financial Statements	As used in SFFAS 7, the basic financial statements are those on which an auditor would normally be engaged to express an opinion. The term "basic" does not necessarily mean that other financial information not covered by the auditor's opinion is less important to users than that contained in the basic statements; it merely connotes the expected nature of the auditor's review of, and association with, the information. The basic financial statements in financial reports prepared pursuant to the Chief Financial Officers Act, as amended, are called the "principal financial statements." The Form and Content of these statements are determined by OMB. (see also Principal Financial Statements)
Basic Research	Systematic study to gain knowledge or understanding of the fundamental aspects of phenomena and of observable facts without specific applications toward processes or products in mind.
Betterment	An expenditure having the effect of extending the useful life of an existing asset, increasing its normal rate of output, lowering its operating cost, increasing rather than merely maintaining its efficiency or otherwise adding to the worth of benefits it can yield. A betterment is distinguished from repair or maintenance in that the latter have the effect of merely keeping the asset in its customary state of operating efficiency without the expectation of added future benefits.
Black Lung Benefits Program	The Black Lung program consists of two parts: Part B and Part C. Recipients who filed claims from 1970 to mid-1973 are covered by Part B; all other recipients are covered by Part C. • Part B is currently administered by the Social Security Administration (SSA). Former coal miners and their dependents are eligible for monthly cash benefits if the miner is totally disabled or died due to black lung disease. Benefits under Part B are reduced if the beneficiary receives state workers' compensation, unemployment compensation, or state disability compensation. Certain pension benefits are subject to an excess-earnings test. The

program is wholly funded by annual appropriations from the general fund.

- Part C is administered by the U.S. Labor Department, although some services are provided by SSA on a reimbursable basis. The program serves a declining population. Increased mechanization of coal mining operations and the industry's improved health and safety regulations have resulted in very few new entrants into the program. Most current beneficiaries entered the program in the 1970s. Former coal miners who have black lung disease are eligible for Part C benefits if a responsible mine owner cannot be determined. Two-thirds of Part C benefits are funded by earmarked excise taxes on coal and one-third by general fund revenues. The latter takes the form of "repayable advances" rather than appropriations.

Book Value

The net amount at which an asset or liability is carried on the books of account (also referred to as carrying value or amount). It equals the gross or nominal amount of any asset or liability minus any allowance or valuation amount.

Budget

The Budget of the United States Government setting forth the President's comprehensive financial plan for allocating resources. The Government uses the budget system to allocate resources among its major functions and individual programs. The budget process has three main phases: formulation, congressional action on the budget, and execution. Some presentations in the budget distinguish between "on-budget" and "off-budget" totals. "On-budget" totals reflect the transactions of all Government entities except those excluded from the unified budget totals by law. Likewise, "off-budget" totals reflect the transactions of Government entities that are excluded from the unified budget totals by law. Currently excluded are the social security trust funds and the Postal Service Fund. The on- and off-budget totals are combined to derive unified or consolidated totals for Federal activity. The budget amounts and references in this exposure draft refer to the unified budget. [See FY 2003 *Budget of the United States Government: Analytical Perspectives*, "Budget System and Concepts and Glossary."]

Budget Authority

The authority provided by Federal law to incur financial obligations that will result in immediate or future outlays. Specific forms of budget authority include:

- Appropriations -- which may be provided in appropriations acts or other laws and which permit obligations to be incurred and payments to be made;
- Borrowing authority -- which permits obligations to be incurred but requires funds to be borrowed to liquidate the obligation;
- Contract authority -- which permits obligations to be incurred but requires a subsequent appropriation or offsetting collections to liquidate the obligations; and
- Spending authority from offsetting collections -- which permits offsetting collections to be credited to an expenditure account and permits obligations and payments to be made using the offsetting collections (the offsetting collections credited to an account are deducted from gross budget authority of the account.)

Budget authority may be classified by period of availability (one year, multiple-year, or no year), by nature of the authority (current or permanent), by the manner of determining the amount available (definite or indefinite), or as gross (without reduction of offsetting collections) and net (with reductions of offsetting collections). (OMB *Circular A-11*, *Preparation and Submission of Budget Estimates*, Executive Office of the President, Office of Management and Budget, hereafter cited as OMB *Circular A-11*; OMB, *The Budget System and Concepts*; and GAO, *A Glossary of Terms Used in the Federal Budget Process*, Exposure Draft, January 1993; hereafter referred to as GAO *Budget Glossary.*)

Budget Obligation

See Obligation below.

Budget Outlay

See Outlay below.

Budget Receipt

See Receipt below.

Budget Surplus Or Deficit, Unified

The unified budget surplus is the excess of budget receipts over budget outlays during a fiscal year and a deficit is the excess of budget outlays over budget receipts during a fiscal year. [See *FY 2003 Budget of the United States Government: Analytical Perspectives*, "Budget System and Concepts and Glossary."] (SFFAS 24)

Budget, Unified

The budget presents combined on- and off-budget totals to derive totals for Federal activity, which is sometimes called the unified budget. The off-budget receipts and outlays of the Social Security trust funds and the Postal Service Fund are added to the on-budget receipts and outlays to calculate the unified budget totals.

Budgetary Accounting

Budgetary accounting is the system that measures and controls the use of resources according to the purposes for which budget authority was enacted; and that records receipts and other collections by source. It tracks the use of each appropriation for specified purposes in separate budget accounts through the various stages of budget execution from appropriation to apportionment and allotment to obligation and eventual outlay. This system is used by the Congress and the Executive Branch to set priorities, to allocate resources among alternative uses, to finance these resources, and to assess the economic implications of federal financial activity at an aggregate level. Budgetary accounting is used to comply with the Constitutional requirement that "No Money shall be drawn from the Treasury, but in Consequence of Appropriations Made by Law; and a regular Statement and Account of the Receipts and Expenditures of all public money shall be published from time to time." (See Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, September 1993, Paragraphs 45-46, 112-114, and 186-191.)

Budgetary Resources

The forms of authority given to an agency allowing it to incur obligations. Budgetary resources include the following: new budget authority, unobligated balances, direct spending authority, and obligation limitations. (GAO *Budget Glossary*)

Business Type Activity

Significantly self-sustaining activity which finances its continuing cycle of operations through collection of exchange revenue.

Capital Leases

Leases that transfer substantially all the benefits and risks of ownership to the lessee.

Capitalize

To record and carry forward into one or more future periods any expenditure the benefits or process from which will then be realized.

Cash Accounting	A system of accounting in which revenues are recorded when received in cash and expenses or expenditures are recorded when cash is disbursed. [See Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, paragraph 50; and Congressional Budget Office, *Glossary of Budgetary and Economic Terms*, "Cash Accounting."] (SFFAS 24)
Cash Flow Stream	The agency's projection of the dollar amount for the scheduled cash flows and deviations from scheduled cash flow items for each year, e.g., over the life of a cohort of loans.
Cash Flows	Estimates or payments to or from the Government. For example, for direct loans, these may include: loan disbursements, repayments of principle, payments of interest, and any other payments such as defaults, prepayments, fees, penalties, and other recoveries. For loan guarantees, these may include: payments by the government to cover defaults and delinquencies, interest subsidies, payments to the government, such as origination and other fees, penalties and recoveries, and any other payments.
Central Fund	A federal entity established to finance the costs of seizure, management and disposition of property seized for forfeiture, and to receive any proceeds from the sale or other disposition of that property.
Changes In Accounting Principles	A change in accounting principle is a change from one generally accepted accounting principle to another one that can be justified as preferable. For the purposes of SFFAS 21, changes in accounting principles also include those occasioned by the adoption of new federal financial accounting standards. (SFFAS 21)
Cleanup Costs	The costs of removing, containing, and/or disposing of (1) hazardous waste from property, or (2) material and/or property that consists of hazardous waste at permanent or temporary closure or shutdown of associated PP&E.

Closed Group	See *"Closed group (to new entrants)."*
Closed Group (To New Entrants)	Those persons who, as of a valuation date, are participants in a social insurance program as beneficiaries, covered workers, or payers of earmarked taxes or premiums.
Cohort	Those direct loans obligated or loan guarantees committed by a program in the same year even if disbursements occur in subsequent years. Post-1991 direct loans or loan guarantees will remain with their original cohort throughout the life of the loan, even if the loan is modified. Pre-1992 loans and loan guarantees that are modified shall each, respectively, constitute a single cohort. (OMB *Circular A-11*)
Collateral	Real or personal property pledged as part or full security on a debt.
Collections	Amounts received by the federal government during the fiscal year. Collections are classified as follows:-- Budget receipts or off-budget receipts are collections from the public based on the government's exercise of its sovereign powers, including collections from participants in compulsory social insurance programs. -- Offsetting collections are collections from government accounts (intragovernmental transactions) or from the public that are offset against budget authority and outlays rather than reflected as receipts in computing the budget and off-budget totals. They are classified as (a) offsetting receipts (i.e., amounts deposited to receipt accounts), and (b) collections credited to appropriation or fund accounts. The distinction between these two major categories is that collections credited to appropriation or fund accounts are offset within the account that contains the associated disbursements (outlays), whereas offsetting receipts are in accounts separate from the associated disbursements. Offsetting collections are deducted from gross disbursements in calculating net outlays. (Based on *A Glossary Of Terms Used in the Federal Budget Process; and Related Accounting, Economic, and Tax Terms*, Third Edition, General Accounting Office, March 1981.)

Common Cost	The cost of resources employed jointly in the production of two or more outputs and the cost cannot be directly traced to any one of those outputs.
Common Data Source	All of the financial and programmatic information available for the budgetary, cost, and financial accounting processes. It includes all financial and much non-financial data, such as environmental data, that are necessary for budgeting and financial reporting as well as evaluation and decision information developed as a result of prior reporting and feedback.
Component Entities	The term "component entity" is used to distinguish between the U.S. Federal Government and its components. The U.S. Federal Government as a whole is composed of organizations that manage resources and are responsible for operations, i.e., delivering services. These include major departments and independent agencies, which are generally divided into suborganizations, i.e., smaller organizational units with a wide variety of titles, including bureaus, administrations, agencies, and corporations. (SFFAC No. 2, *Entity and Display*, pars. 11-12). Use of "component entity" in this standard is only intended to distinguish between the U.S. Federal Government's consolidated financial statements and financial statements of its components.
Composite Depreciation Methodology	The composite methodology is a method of calculating depreciation that applies a single average rate to a number of heterogeneous assets that have dissimilar characteristics and service lives.
Condition	The physical state of an asset. The condition of an asset is based on an evaluation of the physical status/state of an asset, its ability to perform as planned, and its continued usefulness. Evaluating an asset's condition requires knowledge of the asset, its performance capacity and its actual ability to perform, and expectations for its continued performance. The condition of a long-lived asset is affected by its durability, the quality of its design and construction, its use, the adequacy of maintenance that has been performed, and many other factors, including: accidents (an unforeseen and unplanned or unexpected event or circumstance), catastrophes (a tragic event), disasters (a sudden calamitous event bringing great damage, loss, or destruction), and obsolescence.

Condition Assessment Surveys	Periodic inspections of PP&E to determine their current condition and estimated cost to correct any deficiencies.
Constant Dollar	A dollar value adjusted for changes in the average price level. A constant dollar is derived by dividing a current dollar amount by a price index. The resulting constant dollar value is that which would exist if prices had remained at the same average level as in the base period. Any changes in such constant dollar values would therefore reflect only changes in the real volume of goods and services, not changes in the price level. Constant dollar figures are commonly used to compute the real value of the gross domestic product and its components and to estimate the real level of Federal receipts and outlays. (GAO *Budget Glossary*)
Constructive Custody	Legal possession of property by federal government personnel through a non-federal agent, such as a commercial contractor or state or local official, under a legal agreement or court order that the agent maintains physical possession and control of the property on behalf of, and subject to the orders of, the Federal government personnel.
Contributions	Also referred to as "taxes," "payroll taxes," or "premiums," these terms refer to amounts paid into social insurance programs. The payments can be paid by (1) employers and employees based on wages from employment covered under a program; (2) the self-employed based on net earnings from selfemployment; (3) governments based on wages of state and local government employees; and (4) policyholders based on coverage under certain programs.
Consumption Method	A method of accounting for goods, such as materials and supplies, where the goods are recognized as assets upon acquisition and are expensed as they are consumed.
Contingency	An existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur.

Contra Account	One of two or more accounts which partially or wholly offset another or other accounts; on financial statements, they may be either merged or appear together.
Contract Authority	Contract authority is a subset of budget authority. (See *budget authority.*)
Controllable Cost	A cost that can be influenced by the action of the responsible manager. The term always refers to a specified manager since all costs are controllable by someone.
Cost	Defined in SFFAC No. 1, *Objectives of Federal Financial Reporting* as the monetary value of resources used (para. 195). Defined more specifically in SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, as the monetary value of resources used or sacrificed or liabilities incurred to achieve an objective, such as to acquire or produce a good or to perform an activity or service (page 105). Depending on the nature of the transaction, cost may be charged to operations immediately, i.e., recognized as an expense of the period, or to an asset account for recognition as an expense of subsequent periods. In most contexts within *Accounting for Revenue and Other Financing Sources*, "cost" is used synonymously with expense. See also "*Full Cost*."
Cost Allocation	A method of assigning costs to activities, outputs, or other cost objects. The allocation base used to assign a cost to objects is not necessarily the cause of the cost. For example, assigning the cost of power to machine activities by machine hours is an allocation because machine hours are an indirect measure of power consumption.
Cost Assignment	A process that identifies costs with activities, outputs, or other cost objects. In a broad sense, costs can be assigned to processes, activities, organizational divisions, products, and services. There are three methods of cost assignment: (a) directly tracing costs wherever economically feasible, (b) cause-and-effect, and (c) allocating costs on a reasonable and consistent basis.

Cost-benefit Analysis	The weighing of benefits against costs usually expressed as a ratio of dollar benefits to dollar costs for each of a variety of alternatives to provide a comparable basis of choice among them.
Cost Driver	Any factor that causes a change in the cost of an activity or output. For example, the quality of parts received by an activity, or the degree of complexity of tax returns to be reviewed by the IRS.
Cost Finding	Cost finding techniques produce cost data by analytical or sampling methods. Cost finding techniques are appropriate for certain kinds of costs, such as indirect costs, items with costs below set thresholds within programs, or for some programs in their entirety. Cost finding techniques support the overall managerial cost accounting process and can represent non-recurring analysis of specific costs.
Cost Object (Also Referred To As Cost Objective)	An activity, output, or item whose cost is to be measured. In a broad sense, a cost object can be an organizational division, a function, task, product, service, or a customer.
Cost Rate	The ratio of expenditures for the program to the taxable payroll for the year.
Covered Employment	All employment and self-employment creditable for purposes of the social insurance program. For Social Security, almost every kind of employment and self-employment is covered. In a few employment situations, coverage must be elected by the employer. Covered employment for HI includes all federal employees, whereas covered employment for OASDI includes some, but not all, federal employees.
Covered Worker	A person having earnings creditable for a social insurance program. For Social Security, “creditable earnings” are based on earnings taxable under the program. The number of HI covered workers is slightly larger than the number of OASDI covered workers because of different coverage status for federal employment.

Credit Program	For the purpose of this Statement (SFFAS 19), a federal program that makes loans and/or loan guarantees to nonfederal borrowers.
Current Discount Rate	With respect to the modification of direct loans or loan guarantees, it is the discount rate used to measure the cost of a modification. It is the interest rate applicable at the time of modification on marketable Treasury securities with a similar maturity to the remaining maturity of the direct or guaranteed loans, under either pre-modification terms, or post-modification terms, whichever is appropriate. [*Special Term from SFFAS 2*]
Current Liabilities	Amounts owed by a federal entity for which the financial statements are prepared, and which need to be paid within the fiscal year following the reporting date.
Current Services Assessment	Projections of future receipts and outlays from future activities based on the programs established by current law. The CSA focuses on the totality of Government operations rather than on individual programs, and shows the short- and long-term direction of current programs.
Custodial Agency	The federal agency that has actual possession of seized or forfeited property, or constructive possession of property through a non-federal agent. The custodial agency would be responsible for reporting material quantities of non-valued items.
Dedicated Collections (Or Taxes)	See "*earmarked taxes*."
Default	The failure to meet any obligation or term of a credit agreement, grant, or contract. Often used to refer to accounts more than 90 days delinquent. (*Treasury Financial Manual Supplement*)

Deferred Maintenance	Maintenance that was not performed when it should have been or was scheduled to be and which, therefore, is put off or delayed for a future period.
Depreciation Accounting	The systematic and rational allocation of the acquisition cost of an asset, less its estimated salvage or residual value, over its estimated useful life.
Development	Systematic use of the knowledge and understanding gained from research for the production of useful materials, devices, systems, or methods, including the design and development of prototypes and processes.
Differential Cost	The cost difference expected if one course of action is adopted instead of others.
Direct Cost	The cost of resources directly consumed by an activity. Direct costs are assigned to activities by direct tracing of units of resources consumed by individual activities. A cost that is specifically identified with a single cost object.
Direct Loan	A disbursement of funds by the government to a nonfederal borrower under a contract that requires the repayment of such funds within a certain time with or without interest. The term includes the purchase of, or participation in, a loan made by another lender. (Adapted from OMB *Circular A-11*)
Directed Flows Of Resources	Expenses to nonfederal entities imposed by federal laws or regulations without providing federal financing. In the case of state and local governments, directed flows are known as "unfunded mandates." The costs and financing of federal regulations do not flow through the Government, but their effects are similar to direct federal expenditures and revenue.
Disclosure	Reporting information in notes or narrative regarded as an integral part of the basic financial statement.

Discount	The difference between the estimated worth of a future benefit and its present value; a compensation for waiting or an allowance for returns from using the present value of these returns in other ways.
Discount Rate	An interest rate that is used in present value calculations to equate amounts that will be received or paid in the future to their present value.
Dividend Fund Interest Rate	The interest rate determined at policy issuance used to determine the amount of the dividend fund. It is the rate used to credit interest to the dividend fund, and against which experience is measured to determine the amount of the interest portion of dividends paid to individual policyholders. (AICPA Statement of Position 95-1, Glossary, p. 33]
Donated Capital	The amount of nonreciprocal transfers of assets or services from State, local, and foreign governments; individuals; or others not considered parties related to the Government. (JFMIP Standardization Project)
Drawbacks	Refunds of all or part of duties on imported goods that are subsequently exported or destroyed. Typically these arise when imported materials are used to manufacture a product that is later exported. In such cases, most of the duties originally paid are refundable when the finished product is exported.
Earmarked Taxes	Taxes levied by the Government that are dedicated by law to finance a specific federal program.
Econometric Model	An equation or a set of related equations used to analyze economic data through mathematical and statistical techniques. Such models may be devised in order to depict the essential quantitative impact of alternative assumptions or government policies. (*Dictionary of Banking and Finance*, Jerry M. Rosenberg, Ph.D., Wiley & Sons, New York, 1982, hereafter cited as Rosenberg's Dictionary.)

Economic Life	The period during which a fixed asset is capable of yielding services of value to its owner. (See "*useful life*".)
End User	Any component of a reporting entity that obtains goods for direct use in its normal operations. The component may also be a contractor.
Entitlement Period	The period (such as, monthly) for which benefits become due.
Entitlement Program	A program in which the federal government becomes automatically obligated to provide benefits to members of a specific group who meet the requirements established by law.
Entity	A unit within the federal government, such as a department, agency, bureau, or program, for which a set of financial statements would be prepared. Entity also encompasses a group of related or unrelated commercial functions, revolving funds, trust funds, and/or other accounts for which financial statements will be prepared in accordance with OMB annual guidance on Form and Content of Financial Statements.
Entry Age Normal Actuarial Method	A method under which the actuarial present value of projected benefits of each employee is allocated on a level basis over the earnings or the service of the employee between entry age and assumed exit age. The portion of this actuarial present value allocated to a valuation year is called the normal cost. The portion of this present value not provided for at a valuation date by the present value of future normal cost is called the actuarial accrued liability. The assumption is made under this method that every employee entered the plan (entry age) at the time of initial employment or at the earliest eligibility date, if the plan had been in existence, and that contributions have been made from the entry age to the date of the actuarial valuation. The term "aggregate entry age normal" refers to an approach whereby costs are determined for the group as a whole rather than for each individual participant separately.

Errors	Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. (SFFAS 21)
Estimated Cost	The process of projecting a future result in terms of cost, based on information available at the time. Estimated costs, rather than actual costs, are sometimes the basis for credits to work-in-process accounts and debits to finished goods inventory.
Event	A happening of consequence to an entity. It may be an internal event that occurs within an entity, such as the transforming of raw materials into a product. Or it may be an external event that involves interaction between an entity and its environment, such as a transaction with another entity, an act of nature, theft, vandalism, a tort caused by negligence, or an accident. (Adapted from Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*)
Exchange Revenue	Inflows of resources to a governmental entity that the entity has earned. They arise from exchange transactions, which occur when each party to the transaction sacrifices value and receives value in return.
Exchange Transaction	A transaction that arises when each party to the transaction sacrifices value and receives value in return.
Executory Contract	A contract which has not been performed by all parties to it. (Trascona, Joseph L., *Business Law*, William C. Brown C. Publishers, 1981)
Executory Cost	Those costs such as insurance, maintenance, and taxes incurred for leased property, whether paid by the lessor or lessee. (Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 13, *Accounting for Leases*)
Expected Value	A statistical measurement attribute that is the sum of the products of each potential outcome multiplied by the probability of that potential outcome.

Expended Appropriations	The dollar amount of appropriations used to fund goods and services received or benefits or grants provided.
Expenditure	With respect to provisions of the Antideficiency Act (31 U.S.C. 1513-1514) and the Congressional Budget and Impoundment Control Act of 1974 (2 U.S.C. 622(i)), a term that has the same definition as outlay. (GAO *Budget Glossary*)
Expense	Outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from providing goods, rendering services, or carrying out other activities related to an entity's programs and missions, the benefits from which do not extend beyond the present operating period.
Expired Appropriations (Accounts)	Appropriation accounts in which the balances are no longer available for incurring new obligations because the time available for incurring such obligations has expired. (JFMIP Standardization Project)
Federal Entities (Units, Components)	See *entity*.
Fair Value (Or fair market value)	Value determined by bona fide bargain between well-informed buyers and sellers, usually over a period of time; the price for which an PP&E item can be bought or sold in an arm's length transaction between unrelated parties; value in a sale between a willing buyer and a willing seller, other than in a forced or liquidation sale; an estimate of such value in the absence of sales or quotations.
Financing Account	A non-budget account associated with each credit program account. The financing account holds fund balances, receives the subsidy cost payment from the credit program account, and includes all other cash flows to and from the government resulting from post-1991 direct loans or loan guarantees. (OMB *Circular A-11*, and OMB *Circular A-34*, Instructions on

Budget Execution, Credit Apportionment and Budget Execution, hereafter cited as OMB *Circular A-34*.)

Financing Sources, Other

Inflows of resources other than exchange and nonexchange revenue, including appropriations used, transfers of assets from other Government entities, and imputed financing. [See SFFAS 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting, paragraph 70.]

First-in, First-out (FIFO)

A cost flow assumption; the first goods purchased or produced are assumed to be the first goods sold.

Fixed Cost

A cost that does not vary in the short term with the volume of activity. Fixed cost information is useful for cost savings by adjusting existing capacity, or by eliminating idle facilities. Also called Non-Variable Cost or Constant Cost.

Fixed Value Securities

Securities that have a known maturity or redemption value at the time of issue.

Forecast

The term "forecast" in this document refers to prospective financial information, including but not limited to prospective financial statements, based on management's assumptions about future conditions and actions that are deemed probable during the period covered. Forecasts are distinguished from "projections," which provide prospective financial information based on one or more hypothetical assumptions or sets of assumptions. The hypothetical assumptions used in projections relate to future conditions and actions that may occur, but which are not necessarily deemed probable to occur. Both forecasts and projections may contain a range.

Foreclosure

A method of enforcing payment of a debt secured by a mortgage by seizing the mortgaged property. Foreclosure terminates all rights that the mortgagor has in the mortgaged property upon completion of due process through the courts. (*Treasury Financial Manual Supplement*)

Full-absorption Costing	A method of costing that assigns (absorbs) all labor, material, and service/manufacturing facilities and support costs to products or other cost objects. The costs assigned include those that do and do not vary with the level of activity performed.
Full Cost	The total amount of resources used to produce the output. More specifically, the full cost of an output produced by a responsibility segment is the sum of (1) the costs of resources consumed by the responsibility segment that directly or indirectly contribute to the output, and (2) the costs of identifiable supporting services provided by other responsibility segments within the reporting entity and by other reporting entities. (SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, para. 89) All direct and indirect costs to any part of the Federal Government of providing goods, resources, or services. (OMB *Circular A-25*).
General Fund	Accounts for receipts not earmarked by law for a specific purposes, the proceeds of general borrowing, and the expenditure of these moneys. (OMB, *The Budget System and Concepts*)
General PP&E Land	Land and land rights owned by the Federal Government that are acquired for or in connection with items of general PP&E.
General Purpose Financial Reports	Reports intended to meet the common needs of diverse users who typically do not have the ability to specify the basis, form, and content of the reports they receive.
Good	A tangible product produced to provide to a customer.
Government-acknowledged Events	Events that are not a liability in themselves, but are those events that are “of financial consequence” to the federal government because it chooses to respond to the event.

Governmental Receipts	Collections from the public that result primarily from the exercise of the Government's sovereign or governmental powers. Governmental receipts consist mostly of individual and corporation income taxes and social insurance taxes but also include excise taxes, compulsory user charges, customs duties, court fines, certain license fees, gifts and donations, and deposits of earnings by the Federal Reserve System. They are compared to outlays in calculating a surplus or deficit. (OMB, *The Budget System and Concepts*)
Government-related Events	Nontransaction-based events that involve interaction between federal entities and their environment.
Gross Domestic Product	The total dollar value of all goods and services produced by labor and property located in the United States, regardless of who supplies the labor or property.
Group Depreciation Methodology	The group methodology is a method of calculating depreciation that applies a single, average rate to a number of homogeneous assets having similar characteristics and service lives.
Hazardous Waste	A solid, liquid, or gaseous waste, or combination of these wastes, which because of its quantity, concentration, or physical, chemical, or infectious characteristics may cause or significantly contribute to an increase in mortality or an increase in serious irreversible, or incapacitating reversible, illness or pose a substantial present or potential hazard to human health or the environment when improperly treated, stored, transported, disposed of, or otherwise managed.
Heritage Assets	Property, plant, and equipment that are unique for one or more of the following reasons: historical or natural significance; cultural, educational or artistic (e.g., aesthetic) importance; or, significant architectural characteristics.

Historical Cost	Initially, the amount of cash (or its equivalent) paid to acquire an asset; subsequent to acquisition, the historical amount may be adjusted for amortization.
Human Capital	Expenses incurred for education and training programs financed by the Federal Government for the benefit of the public and designed to increase or maintain national economic productive capacity.
Impacts	In the context of discussing performance measurement, SFFAC 1 defines "impacts" as the difference between what actually occurred and what would have occurred in the absence of a Government program. SFFAC 1, paragraph 206 notes that, to the extent feasible and practical, effectiveness evaluation should focus on program results or effects in the sense of "impacts." Assessing impacts of Governmental action in this sense typically requires program evaluations or other techniques that transcend annual performance reporting, though these techniques often will avail of information in the annual performance reports. These evaluations often require several years of data, are expensive to conduct, and typically are not performed on an annual basis for a given program.
Imputed Financing	Financing provided to the reporting entity by another Government entity covering certain costs incurred by the former. For example, part of Federal employee retirement benefits have been paid by the Government's central personnel office. A reporting entity would recognize the full accruing cost of the benefits as well as the imputed financing so provided. [See SFFAS 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting, paragraph 73.]
Imputed Inter-departmental Costs	The unreimbursed (i.e. non-reimbursed and under-reimbursed) portion of the full costs of goods and services received by the entity from a providing entity that is not part of the same department or larger reporting entity other than the U.S. government as a whole. (Interpretation 6)
Imputed Intra-departmental Costs	The unreimbursed portion of the full costs of goods and services received by the entity from a providing entity that is part of the same department or larger reporting entity (i.e. other bureaus, components or responsibility

segments within the department or larger reporting entity). (Interpretation 6)

Income Rate	The ratio of contributions and tax income to taxable payroll for the year.
Incremental Cost	The increase or decrease in total costs that would result from a decision to increase or decrease output level, to add a service or task, or to change any portion of operations. This information helps in making decisions such as to contract work out, undertake a project, or increase, decrease, modify, or eliminate an activity or product.
Indirect Cost	A cost that cannot be identified specifically with or traced to a given cost object in an economically feasible way.
Internal Controls Insurance And Guarantee Programs	Federal government programs that provide protection to individuals or entities against specified risks. Because the federal government frequently commingles aspects of insurance and guarantees within the same program, this Statement (SFFAS 5) treats the terms as a single type of activity. (Also see *separate definition of social insurance*).
Inter-entity	A term meaning between or among different federal reporting entities. It commonly refers to activities or costs between two or more agencies, departments, or bureaus.
Interest	The service charge for the use of money or capital, paid at agreed intervals by the user, commonly expressed as an annual percentage of outstanding principal.
Interest Method	(1) Under the interest method of amortization, an amount of interest equal to the carrying amount of the investment times the effective interest rate is calculated for each accounting period. This calculated interest is the effective interest of the investment (referred to as “effective yield” in some literature). The effective interest is compared with the stated interest of the investment. (The stated interest is the interest that is payable to the

investor according to the stated interest rate.) The difference between the effective interest and the stated interest is the amount by which the discount or the premium should be amortized (i.e., reduced) for the accounting period. (2) A method used to amortize the premium or discount of an investment in bonds, or, as used in SFFAS 2, to amortize the subsidy cost allowance of direct loans. Under this method, the amortization amount of the subsidy cost allowance equals the effective interest minus the nominal interest of the direct loans times the effective interest rate (the discount rate). The nominal interest equals the nominal amount (face amount) of the direct loans times the stated interest rate (the rate stated in the loan agreements). [Special Term from SFFAS 2]

Interest Rate

The price charged per unit of money borrowed per year, or other unit of time, usually expressed as a percentage.

Internal Control

"Internal control" is a process, effected by an agency's management and other personnel, designed to provide reasonable assurance that the objectives of the agency are being achieved in the following categories:

- Effectiveness and efficiency of operations including the use of the entity's resources.
- Reliability of financial reporting, including reports on budget execution, financial statements, and other reports for internal and external use.
- Compliance with applicable laws and regulations. Internal controls consist of the control environment, risk assessment, control activities, information and communication, and monitoring. A necessary implication or subset of these objectives is the safeguarding of agency assets against unauthorized acquisition, use, or disposition.

Consequently, the definition of internal control, as it relates to safeguarding assets can be extended to include processes, effected by an agency's management and other personnel, designed to provide reasonable assurance regarding prevention of or prompt detection of unauthorized acquisition, use, or disposition of the agency's assets." (From *Standards for Internal Control in the Federal Government*, Exposure Draft, U.S. GAO, December 1997.)

Job Order Costing	A method of cost accounting that accumulates costs for individual jobs or lots. A job may be a service or manufactured item, such as the repair of equipment or the treatment of a patient in a hospital.
Land	Land is the solid part of the surface of the earth. Excluded from the definition of land are the natural resources (that is, depletable resources such as mineral deposits and petroleum; renewable resources such as timber, and the outer-continental shelf resources) related to land.
Last-in, First-out (LIFO)	A cost flow assumption; the last goods purchased are assumed to be the first goods sold.
Latest Acquisition Cost (LAC) Method	A method that provides that all like units that are held be valued at the invoice price of the most recent like item purchased, less any discounts, plus any additional costs incurred to bring the item to a form and location suitable for its intended use.
Latest Acquisition Cost	Includes all amounts, except interest, paid to a vendor to acquire an item.
Legacy Entity	An entity from which a smaller entity or specific function is being transferred. (Technical Bulletin 2003-1)
Liability	For Federal accounting purposes, a probable future outflow or other sacrifice of resources as a result of past transactions or events.
Life-cycle Costing	An acquisition or procurement technique which considers operating, maintenance, and other costs in addition to the acquisition cost of assets.
Liquidating Account	The budget account that includes all cash flows to and from the government resulting from pre-1992 direct loans or loan guarantees (those originally obligated or committed before Oct. 1, 1991), except those pre-

1992 direct loans and loan guarantees that have been directly modified and transferred to a financing account. (See OMB *Circular A-11*)

Loan Guarantee

Any guarantee, insurance, or other pledge with respect to the payment of all or part of the principal or interest on any debt obligation of a nonfederal borrower to a nonfederal lender but does not include the insurance of deposits, shares, or other withdrawable accounts in financial institutions. (OMB *Circular A-11*)

Loan Guarantee Commitment

A binding agreement by a federal agency to make a loan guarantee when specified conditions are fulfilled by the borrower, the lender, or any other party to the guarantee agreement. (OMB *Circular A-11*)

Loss

Any expense or irrecoverable cost, often referred to as a form of nonrecurring charge, an expenditure from which no present or future benefit may be expected.

Lower Of Cost Or Market

A valuation rule that recognizes impairment of asset values but avoids anticipated gains. The rule is typically applied to individual items or groups of like items, such as inventory or marketable securities. In this rule, “cost” refers to historical cost and “market” refers to the current replacement cost by purchase or production.

Maintenance

The act of keeping fixed assets in usable condition. It includes preventive maintenance, normal repairs, replacement of parts and structural components, and other activities needed to preserve the asset so that it continues to provide acceptable services and achieves its expected life. Maintenance excludes activities aimed at expanding the capacity of an asset or otherwise upgrading it to serve needs different from, or significantly greater than, those originally intended.

Managerial Cost Accounting System

The organization and procedures, whether automated or not, and whether part of the general ledger or stand-alone, that accumulates and reports consistent and reliable cost information and performance data from various

agency feeder systems. The accumulated and reported data enable management and other interested parties to measure and make decisions about the agency's/segment's ability to improve operations, safeguard assets, control its resources, and determine if mission objectives are being met.

Marketable Treasury Securities	Debt securities, including Treasury bills, notes, and bonds, that the U.S. Treasury offers to the public and are traded in the marketplace. Their bid and ask prices are quoted on securities exchange markets.
Market-based Treasury Securities	Treasury securities issued to governmental accounts that are not traded on any securities exchange but mirror the prices of marketable securities with similar terms. (See *Treasury Financial Manual* 2-4100, Federal Agencies' Financial Reports, Exhibit No. 3.)
Market Value	(1) The estimated amount that can be realized by disposing of an item through arm's length transactions in the marketplace; the price (usually representative) at which bona fide sales have been consummated for products of like kind, quality, and quantity in a particular market at any moment of time. (2) For investments in marketable securities, the term refers to the value of such securities determined by prices quoted on securities exchange markets multiplied by the number of bonds or shares held in an investment portfolio.
Measurable	Can be determined with reasonable certainty or is reasonably estimable.
Medicare	A national, federally administered health insurance program authorized in 1965 to cover the cost of hospitalization, medical care, and some related services for most people over age 65, people receiving Social Security Disability Insurance payments for two years, and people with End-Stage Renal Disease. Medicare consists of two separate but coordinated programs: Part A, Hospital Insurance (HI) and Part B, Supplementary Medical Insurance (SMI). All persons entitled to HI are eligible to enroll in the SMI program on a voluntary basis by paying a monthly premium. Health insurance protection is available to Medicare beneficiaries without regard to income.

Military Missions	Functions performed by the Department of Defense or its component entities to prepare for the effective pursuit of war and military operations short of war; to conduct combat, peacekeeping, and humanitarian military operations; and to support civilian authorities during civil emergencies.
Model	A representation in mathematical symbols (or at least graphically) that depicts a formulated theory about the relationship among measurements of some phenomenon that varies. A model includes both cash flow assumptions and model assumptions.
Modeling	The process of developing and selecting an appropriate set of cash flows and model which generally have two aspects: (1) a choice of a general mathematical function (equation) describing a basic shape or process and (2) a choice of the model parameters that distinguish one specific shape from the general class of functional forms. The mathematical functions may take many forms. Commonly known examples of models are simple regression (y=ax+b), multiple regression (y=ax+by+z), and time series. Many other simple or more complex model forms related to cash flow modeling reform are possible.
Model Parameters	The values that identify a unique model from the general form. For example, y=2x+3 has parameters a=2 and b=3 for the simple regression model class. Note that “model parameter” is sometimes used in credit reform documents in lieu of the more appropriate term “input variable in the spreadsheet.”
Modification	A federal government action, including new legislation or administrative action, that directly or indirectly alters the estimated subsidy cost and the present value of outstanding direct loans (or direct loan obligations), or the liability of loan guarantees (or loan guarantee commitments). Direct modifications are actions that change the subsidy cost by altering the terms of existing contracts or by selling loan assets. Indirect modifications are actions that change the subsidy cost by legislation that alters the way in which an outstanding portfolio of direct loans or loan guarantees is administered. The term modification does not include subsidy cost reestimates, the routine administrative workouts of troubled loans, and actions that are permitted within the existing contract terms.

Modification Adjustment Transfer	A non-expenditure transfer from a financing account to the Treasury, or vice versa, to offset the difference between the cost of modification of direct loans (or loan guarantees) and the change in the book value of direct loans (or loan guarantee liabilities). (See also OMB *Circular A-11*)
Moving Average	An inventory costing method used in conjunction with a perpetual inventory system. A weighted average cost per unit is recomputed after every purchase. Goods sold are costed at the most recent moving average cost.
Multi-use Heritage Assets	Heritage assets whose predominant use is general government operations.
Negative Subsidy Account	the budget account for the receipt and/or expenditure of amounts paid from the financing account when there is a negative subsidy for the original estimate or a downward reestimate (not necessarily used for mandatory programs).
Net Cost Of Operations	Total costs incurred by the reporting entity less exchange revenue earned during the period. This is the "bottom line" of the statement of net costs. [See SFFAC 2, Entity and Display, pars. 86-99 and Appendix 1-B; and OMB Bulletin 01-09, Form and Content, Section 4.8, "Net Cost of Operations."]
Net Level Premium Reserve	The excess, if any, of the present value of future guaranteed death endowment benefits over the present value of future net premiums. The net level premium reserve should be calculated based on the dividend fund interest rate, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contracts. (AICPA Statement of Position 95-1)
Net Operating Revenue (Or Cost)	At the CFR level, the difference between the net cost of operations and, essentially, all non-exchange revenue. (SFFAS 24)

Net Realizable Value	The estimated amount that can be recovered from selling, or any other method of disposing of an item less estimated costs of completion, holding and disposal.
Nominal Dollar	The dollar value assigned to a good or service in terms of prices current at the time of the good or service is required. This contrasts with the value assigned to a good or service measured in constant dollars.
Nominal (Or Face Or Par) Value Or Amount	The amount of a bond, note, mortgage, or other security as stated in the instrument itself, exclusive of interest or dividend accumulations. The nominal amount may or may not coincide with the price at which the instrument was first sold, its present market value, or its redemption price. Often referred to as the stated value.
Nonexchange Revenue	Inflows of resources to the Government that the Government demands or that it receives by donations. The inflows that it demands include taxes, duties, fines, and penalties.
Nonexchange Transaction	A transaction that arises when one party to a transaction receives value without giving or promising value in return or one party to a transaction gives or promises value without receiving value in return.
Nonfederal Physical Property	Physical properties financed by grants from the Federal Government, but owned by state and local governments.
Normal Cost	That portion of the actuarial present value of pension plan benefits and expenses that is allocated to a valuation year by the actuarial cost method. (From Actuarial Standard of Practice No. 4)
Obligated Balances	The net amount of obligations in a given account for which payment has not yet been made. (JFMIP Standardization Project)

Obligation	Following the enactment of budget authority and the completion of required apportionment action, Government agencies incur obligations to make payments. Obligations are binding agreements that will result in outlays immediately or in the future. Obligations include, for example: current liabilities for salaries, wages, and interest; contracts for the purchase of supplies and equipment, construction, and the acquisition of office space, buildings, and land; and other arrangements requiring the payment of money. [See *FY 2003 Budget of the United States Government: Analytical Perspectives*, "Budget System and Concepts and Glossary" (Obligations Incurred).]
Obligations	Amounts of orders placed, contracts awarded, services received, and other transactions occurring during a given period that would require payments during the same or a future period. (JFMIP Standardization Project)
Offsetting Collections	Collections from the public that result from business-type or market oriented activities and collections from other Government accounts. These collections are deducted from gross disbursements in calculating outlays, rather than counted in governmental receipts. Some offsetting collections are credited directly to appropriation or fund accounts; others, called offsetting receipts, are credited to receipt accounts. The authority to spend offsetting collections is a form of budget authority. (OMB, *The Budget System and Concepts*)
Offsetting Receipts	Offsetting receipts are a subset of offsetting collections. (See *collections*.)
OMB Credit Subsidy Model	Computer software developed by OMB for discounting cash flows in estimating credit subsidies. It uses agency cash flow inputs to compute the net present value at the point of disbursement and the subsidy rate associated with those cash flows.
Open Group Population	Those persons who are participating or who eventually will participate, during a specified period, in a social insurance program as contributors or beneficiaries. They include, for example, current workers, retirees, survivors, disabled persons, and new participants entering the workforce or

	becoming beneficiaries, including those who will be born or immigrate to the United States in the future.
Operating Lease	An agreement conveying the right to use property for a limited time in exchange for periodic rental payments.
Opportunity Cost	The value of the alternatives foregone by adopting a particular strategy or employing resources in a specific manner. Also called Alternative Cost or Economic Cost.
Original Discount Rate	The discount rate originally used to calculate the present value of direct loans or loan guarantee liabilities, when the direct or guaranteed loans were disbursed. [*Special Term from SFFAS 2*]
Other Postemployment Benefits (OPEB)	Forms of benefits provided to former or inactive employees, their beneficiaries, and covered dependents outside pension or ORB plans.
Other Financing Sources	Inflows of resources that increase net position of a reporting entity but that are not revenues or gains. Borrowing is not included as other financing sources, since it does not increase the net resources of the reporting entities.
Other Retirement Benefits (ORB)	Forms of benefits, other than retirement income, provided by an employer to retirees. Those benefits may be defined in terms of specified benefits, such as health care, tuition assistance, or legal services, which are provided to retirees as the need for those benefits arises, such as certain health care benefits. Or they may be defined in terms of monetary amounts that become payable on the occurrence of a specified event, such as life insurance benefits. (Financial Accounting Standards Board, Statement of Financial Accounting Standard No. 106, *Employers' Accounting for Postretirement Benefits Other than Pensions*)
Outcome	(1) Defined in broad terms in SFFAC No. 1 (para. 204-208) as accomplishments or results that occur (at least partially) because of the

service efforts of Government entities. Some authorities use terms like "impact," "effect," or "results" to distinguish the change in outcomes specifically caused by the Government activity from the total change in conditions that can be caused by many factors. (2) Defined in SFFAS No. 8 as an assessment of the results of a program compared to its intended purpose. They shall: 1) be capable of being described in financial, economic, or quantitative terms; and 2) provide a plausible basis for concluding that the program has had or will have this intended effect. For measuring outcomes for research and development programs, results may be reported by a narrative discussion of the major results achieved by the program during the year. (See SFFAS No. 8, *Supplementary Stewardship Reporting*, para. 93 & 99, and SFFAC No. 1, *Objectives of Federal Financial Reporting*, paras. 204-208, for further discussion of outcome.)

Outlay

The issuance of checks, disbursement of cash, or electronic transfer of funds made to liquidate a Federal obligation. Outlays also occur when interest on the Treasury debt held by the public accrues and when the Government issues bonds, notes, debentures, monetary credits, or other cash-equivalent instruments in order to liquidate obligations. Also, under credit reform, the credit subsidy cost is recorded as an outlay when a direct or guaranteed loan is disbursed. (GAO *Budget Glossary*)

Output

A tabulation, calculation, or recording of activity or effort that can be expressed in a quantitative or qualitative manner. They shall have two key characteristics: 1) they shall be systematically or periodically captured through an accounting or management information system, and 2) there shall be a logical connection between the reported measures and the program's purpose.

Output Measure

A tabulation, calculation, or recording of activity or effort that can be expressed in a quantitative or qualitative manner. It shall have two key characteristics: 1) it shall be systematically or periodically captured through accounting or management information system, and 2) there shall be a logical connection between the reported measures and the program's purpose.

Performance Measurement	A means of evaluating efficiency, effectiveness, and results. A balanced performance measurement scorecard includes financial and nonfinancial measures focusing on quality, cycle time, and cost. Performance measurement should include program accomplishments in terms of outputs (quantity of products or services provided, e.g., how many items efficiently produced?) and outcomes (results of providing outputs, e.g., are outputs effectively meeting intended agency mission objectives?). See Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, para. 192.
Post-1991 Direct Loans	Direct loans obligated after September 30, 1991. [*Special Term from SFFAS 2*]
Post-1991 Loan Guarantees	Loan guarantees committed after September 30, 1991. [*Special Term from SFFAS 2*]
Post-modification Liability	The present value of the net cash outflows of the loan guarantees estimated at the time of modification under the post-modification terms, and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to the remaining maturity of the guaranteed loans under post-modification terms (simply stated, the post-modification terms at the current rate). (*Special Term from SFFAS 19*)
Post-modification Value	The present value of the net cash inflows of direct loans estimated at the time of modification under post-modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to the remaining maturity of the direct loans under post-modification terms (simply stated, the post-modification terms at the current rate). (*Special Term from* SFFAS 19)
Pre-modification Value	The present value of the net cash inflows of direct loans estimated at the time of modification under pre-modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to the

remaining maturity of the direct loans under pre-modification terms (simply stated, the pre-modification terms at the current rate). (*Special Term from* SFFAS 19)

Pre-modification Liability

The present value of the net cash outflows of loan guarantees estimated at the time of modification under the pre-modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to the remaining maturity of the guaranteed loans under pre-modification terms (simply stated, the pre-modification terms at the current rate). (*Special Term from* SFFAS 19)

Pre-1992 Loan Guarantees

Loan guarantees committed before October 1, 1991. [*Special Term from SFFAS 2*]

Pre-1992 Direct Loans

Direct loans obligated before October 1, 1991. [*Special Term from SFFAS 2*]

Premium Deficiency

A condition under which a liability for future policy benefits using current conditions exceeds the liability for future policy benefits using contract conditions. In such cases, the difference should be recognized as a charge to operations in the current period.

Present Value (PV)

The value of future cash flows discounted to the present at a certain interest rate (such as the reporting entity's cost of capital), assuming compound interest. (Adapted from Kieso and Weygandt, *Intermediate Accounting*, 7th ed., p. 264.)

Principal Financial Statements

See SFFAC 2, paragraph 74, for a listing of the financial statements and other information that a financial report should include. The FASAB considers principal financial statements an essential part of a reporting entity's financial reporting, and therefore recommends authoritative guidelines for the measurement and presentation of the information. [SFFAC 2, *Entity and Display*, paragraph 71, footnote 12.] (See also Basic Financial Statements)

Probable	That which can reasonably be expected or believed to be more likely than not on the basis of available evidence or logic but which is neither certain nor proven.
Process	The organized method of converting inputs (people, equipment, methods, materials, and environment), to outputs (products or services). The natural aggregation of work activities and tasks performed for program delivery.
Process Costing	A method of cost accounting that first collects costs by processes and then allocates the total costs of each process equally to each unit of output flowing through it during an accounting period.
Process Value Analysis	Tools and techniques for studying processes through customer value analysis. Its objective is to identify opportunities for lasting improvement in the performance of an organization. It provides an in-depth review of work activities and tasks, through activity analysis, which aggregate to form processes for agency program delivery. In addition to activity-based costing, quality and cycle time factors are studied for a complete analysis of performance measurement. Each activity within the process is analyzed, including whether or not the activity adds value for the customer.
Product	Any discrete, traceable, or measurable good or service provided to a customer. Often goods are referred to as tangible products, and services are referred to as intangible products. A good or service is the product of a process resulting from the consumption of resources.
Program Account	The budget account into which an appropriation to cover the subsidy cost of a direct loan or loan guarantee program is made and from which such cost is disbursed to the financing account. Usually, a separate amount for administrative expenses is also appropriated to the program account. (OMB *Circular A-11*)
Projected Unit Credit Actuarial Method	A method under which the projected benefits of each individual included in an actuarial present valuation are allocated by a consistent formula to valuation years. The actuarial present value of benefits allocated to the

valuation year is called the normal cost. The actuarial present value of benefits allocated to all periods before a valuation year is called actuarial liability. (Actuarial Standard of Practice)

Projection	The term "projection" refers to prospective financial information, including but not limited to prospective financial statements, based on one or more hypothetical assumptions or sets of assumptions. The hypothetical assumptions relate to future conditions and actions that may occur, but which are not necessarily deemed probable (unlike the case with forecasts). Both forecasts and projections may contain a range.
Property, Detained	Property taken into custody temporarily for purposes of preserving the status quo (items in or around a crime scene) or to protect the government from liability for loss (luggage of an arrested traveler, vehicle of an arrested drunk driver), or determining Customs admissibility, with the intent to release the property as soon as it is no longer necessary to preserve the status quo or the owner can assume responsible custody. This action is not a seizure under the law and thus detained property is not considered seized property.
Property, Embargoed	Property that may be legal to possess or own in the U.S., but whose import/export is prohibited (e.g., Iranian carpets, Cuban cigars).
Property, Forfeited	Property of any type (currency, monetary interests, realty, intangible property, and tangible personal property) for which title has vested in the Federal government, over any other asserted legal interest in the property, by exercise of a legal forfeiture process.
Property, Plant, And Equipment, General	PP&E used to provide government services or goods. The cost of general PP&E is capitalized, i. e. recorded as assets on the balance sheet. For detailed characteristics of and accounting for general PP&E, see paragraphs 23 through 34, SFFAS No. 6.
Property, Prohibited	Property for which no private right of ownership is recognized under U.S. law, or of which mere private possession is prohibited under U.S. law.

Examples include certain controlled substances, counterfeit currency, counterfeit monetary and financial instruments, and certain firearms. This property is a type of seized property.

Property, Seized

Property of any type (currency, monetary interests, realty, intangible property, and tangible personal property) over which the federal government has exercised its power under law to assert possession and control in opposition to any other party asserting a legal interest in the property.

Seized for evidence - Property the federal government has seized for the sole purpose of preserving and protecting the property for possible use in civil or criminal judicial proceeding. The expectation is that the property will be returned to its rightful owners upon conclusion of the judicial proceedings. However, circumstances can allow the status of property seized for evidence to change to property seized for forfeiture.

Seized for forfeiture - Property the federal government has seized for the purpose of transferring title to the federal government through exercise of a legal forfeiture process. This includes property seized for forfeiture that also may be used in an evidentiary proceeding.

Seized for tax purposes - Property the federal government has seized for the purpose of satisfying a tax liability to the federal government through exercise of a legal tax enforcement process. This includes property seized for tax purposes that also may be used in an evidentiary proceeding.

Seized for other purposes - Property the federal government has seized for purposes other than for evidence, for forfeiture, or for tax purposes. Examples of property in this category include seizures for satisfaction of debts owed the government, for protection of public safety or navigation (adrift vessel), and for preservation of environmental conditions (sinking vessel). This includes property seized for these other governmental purposes that also may be used in an evidentiary proceeding.

Proprietary Accounting

Also known as financial accounting, a process that supports accrual accounting and financial reporting that attempts to show actual financial position and results of operations by accounting for assets, liabilities, net position, revenues, and expenses. (See Tierney, Cornelius E., *Handbook of*

Federal Accounting Practices, Reading Massachusetts: Addison-Wesley, 1982:122).

Purchases Method	A method of accounting for goods, such as materials and supplies, in which the acquisition cost is recognized as an expense upon purchase of the goods rather than upon their use.
Open Group Population	Those persons who are participating or who eventually will participate, during a specified period, in a social insurance program as contributors or beneficiaries. They include, for example, current workers, retirees, survivors, disabled persons, and new participants entering the workforce or becoming beneficiaries, including those who will be born or immigrate to the United States in the future.
Railroad Retirement Program	A federal program somewhat similar to Social Security, designed for workers in the railroad industry. The provisions of the Railroad Retirement Act provide for a system of coordination and financial interchange between the Railroad Retirement program and the Social Security program.
Reappropriation	Enacted legislation that continues the availability of unexpended funds that expired or would otherwise expire. (JFMIP Standardization Project)
Receipts	Collections that result from the Government's exercise of its sovereign power to tax or otherwise compel payment, and gifts of money to the Government.
Receiving Entity	An entity to which functions are transferred. (Technical Bulletin 2003-1)
Recognition (Or Recognize)	The term recognition bears the same meaning as used by the Financial Accounting Standards Board in its conceptual statements. Recognition is the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like. A recognized item is depicted in both words and numbers, with the amount included in the statement totals. Recognition comprehends both initial

recognition of an item and recognition of subsequent changes in or removal of a previously recognized item. (Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 5, *A Replacement of FASB Concepts Statement No. 3*, para. 6.)

Recognize — To determine the amount, timing, classification, and other conditions precedent to the acceptance and entry of a transaction. Hence, to give expression on the books of account; said of transactions.

Record — To give expression to a transaction on (or in) the books of account; to enter.

Recourse — The rights of a holder in due course of a financial instrument (such as a loan) to force the endorser on the instrument to meet his or her legal obligations for making good the payment of the instrument if dishonored by the maker or acceptor. The holder in due course must have met the legal requirements of presentation and delivery of the instrument to the maker of a note or acceptor of a draft and must have found that this legal entity has refused to pay for or defaulted in payment of the instrument.

Reestimate — Refers to estimates of the subsidy costs performed subsequent to their initial estimates made at the time of a loan's disbursement.

Reimbursements — Sums received as payment or advance payment for goods or services furnished either to the public or to another federal government account. If authorized by law, these sums are credited directly to specific appropriation and fund accounts. These amounts are deducted from the total obligations incurred (and outlays) in determining net obligations (and outlays) for such accounts. (Budget Glossary) Reimbursements are offsetting collections. (See *offsetting collections.*)

Repairable — An inventory item that is expected to be repaired when broken or worn out.

Replacement Cost	The cost to reproduce an inventory item by purchase or manufacture. In lower of cost or market computations, the term "market" means replacement cost, subject to ceiling and floor limitations.
Required Supplementary Information (RSI)	RSI was added to the accounting literature by Statement of Financial Accounting Standards (SFAS) 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies*, published by the Financial Accounting Standards Board (FASB) in 1979. That Statement has been amended, but the RSI category continues to be used in a variety of standards published by the FASB, the Governmental Accounting Standards Board (GASB), and the FASAB. The auditor's responsibility for RSI is discussed in section AU 558 of the codification of professional auditing standards published by AICPA. (SFFAS 25)
Required Supplementary Stewardship Information (RSSI)	(1) Information reported outside the principal financial statements that is an essential part of an entity's financial reporting; therefore the statement contains recommendations for its measurement and presentation. (2) The category defined by the Board for reporting information required by the stewardship standards. Stewardship information may be presented as RSSI, in the financial statements, or in the notes to them. Stewardship information will be necessary for a fair presentation of financial position and results of operations.
Research And Development	Federal investment in research and development refers to those expenses incurred in support of the search for new or refined knowledge and ideas and for the application or use of such knowledge and ideas for the development of new or improved products and processes with the expectation of maintaining or increasing national economic productive capacity or yielding other future benefits. Research and development is composed of basic research, applied research, and development.
Responsibility Segment	A significant organizational, operational, functional, or process component which has the following characteristics: (a) its manager reports to the entity's top management; (b) it is responsible for carrying out a mission, performing a line of activities or services, or producing one or a group of products; and (c) for financial reporting and cost management purposes, its

resources and results of operations can be clearly distinguished, physically and operationally, from those of other segments of the entity.

Responsibility Center	An organizational unit headed by a manager or a group of managers who are responsible for its activities. Responsibility centers can be measured as revenue centers (accountable for revenue/sales only), cost centers (accountable for costs/expenses only), profit centers (accountable for revenues and costs), or investment centers (accountable for investments, revenues, and costs).
Restatement (Of Direct Loans Or Loan Guarantees)	Refers to establishing a new book value of a direct loan or the liability of a loan guarantee.
Revenue Adjustment	A contra revenue account that is used to report reduction in revenue when realization is not probable (less likely than not). It includes, returns, allowances, and price redeterminations but not credit losses (due to the inability of the debtor to pay the established or negotiated price).
Revolving Fund	A fund consisting of permanent appropriation and expenditures of collections, from both the public and other Governmental agencies and accounts, that are earmarked to finance a continuing cycle of business-type operations. (OMB *Circular A-34*)
Risk Category	Subdivisions of a cohort of direct loans or loan guarantees into groups of loans that are relatively homogeneous in cost, given the facts known at the time of obligation or commitment. Risk categories will group all loans obligated or committed for a program during the fiscal year that share characteristics predictive of defaults and other costs. (OMB *Circular A-11*)
Seizing Agency	The agency that seizes property as a part of its law enforcement activities.

Selling Expense (Cost)	Expenses incurred in selling or marketing, e.g., salaries, commissions, and promotion expenses.
Sensitive Items	Items that could be a hazard or threat to public safety or the economy in Federal custody that would cause discredit or embarrassment to the Federal government if it lost accountability over those items.
Service	An intangible product or task rendered directly to a customer.
Social Security Act	The Social Security Act governs most operations of the Social Security program. The original Social Security Act is Public Law 74-271, enacted August 14, 1935. With subsequent amendments, the Social Security Act consists of 20 titles, of which four have been repealed. The OASDI program is authorized by Title II of the Social Security Act.
Social Insurance Programs	Income transfer programs financed by compulsory earmarked taxes and also, in certain cases, general revenues of the federal government. (Also see *separate definition of insurance and guarantees*).
Special Fund	Federal fund accounts for receipts earmarked for specific purposes and the associated expenditure of those receipts. (OMB, *The Budget System and Concepts*)
Specific Identification	An inventory system in which the seller identifies which specific items are sold and which remain in ending inventory.
Spreadsheets	Computer code, often a collection of programs, used to make calculations (e.g., cash flow estimates) according to the proposed models and assumptions. Spreadsheets are not models although the term “spreadsheet model” is sometimes used.

Standard Costing	A costing method that attaches costs to cost objects based on reasonable estimates or cost studies and by means of budgeted rates rather than according to actual costs incurred. The anticipated cost of producing a unit of output. A predetermined cost to be assigned to products produced. Standard cost implies a norm, or what costs should be. Standard costing may be based on either absorption or direct costing principles, and may apply either to all or some cost elements.
Standard Costs	Predetermined expected unit costs, which are acceptable for financial reporting purposes if adjusted periodically to reflect actual results.
State And Local Governments	State and local governments generally include: the 50 States and the District of Columbia; cities, counties, townships, school districts, special districts, public authorities, and other local governmental units as defined by the Bureau of the Census; and Puerto Rico, the Virgin Islands, and other US territories.
Stewardship	The Federal Government's responsibility for the general welfare of the nation in perpetuity.
Stewardship Investments	Items recognized as expense in calculating net cost, but meriting special treatment to highlight the substantial investment and long-term benefit of the expenses. This would include nonfederal physical property, human capital, and research and development.
Stewardship Land	Land and land rights owned by the Federal Government that are not acquired for or in connection with items of general PP&E.
Stewardship Responsibilities	The projected financial impact on the Government of sustaining the current services that it provides pursuant to laws already enacted. The commitments and constraints reflected in "current services" are inherent in the tax and spending policies contained in current law.

Subsidy Cost

The cost of a grant of financial aid, usually by a governmental body, to some person or institution for particular purposes. Credit subsidy cost is the estimated long-term cost to the government of direct loans or loan guarantees calculated on a net present value basis, excluding administrative costs. (Adapted from OMB *Circular A-11*) Direct loan subsidy cost is the estimated long-term cost to the government of direct loans calculated on a present value basis, excluding administrative costs. The cost is the present value of estimated net cash outflows at the time the direct loans are disbursed. The discount rate used for the calculation is the average interest rate (yield) on marketable Treasury securities of similar maturity to the loan, applicable to the time when the loans are disbursed. (Adapted from OMB *Circular A-11*) Loan guarantee subsidy cost is the estimated long-term cost to the government of loan guarantees calculated on a present value basis, excluding administrative costs. The cost is the present value of estimated net cash outflows at the time the guaranteed loans are disbursed by the lender. The discount rate used for the calculation is the average interest rate (yield) on marketable Treasury securities of similar maturity to the loan guarantees, applicable to the time when the guaranteed loans are disbursed. (Adapted from OMB *Circular A-11*)

Support Costs

Costs of activities not directly associated with production. Typical examples are the costs of automation support, communications, postage, process engineering, and purchasing.

Tax Expenditure

A revenue foregone attributable to a provision of the federal tax laws that allows a special exclusion, exemption, or deduction from gross income or provides a special credit, preferential tax rate, or deferral of tax liability. (GAO *Budget Glossary*)

Tax Gap

An estimate of taxes (including duties) that are unpaid because of noncompliance with existing laws and regulations.

Taxable Payroll

Taxable wages and taxable self-employment income. When multiplied by the combined employee-employer tax rate, it yields the total amount of taxes incurred by employees, employers, and the self-employed for work during the period.

Terminal Dividends	Dividends to policyholders calculated and paid upon termination of a contract, such as on death, surrender, or maturity. If the payment of terminal dividends is probable and the amount can be reasonably estimated, the liability should be recognized. AICPA Statement of Position 95-1.
Title	The right to property; the means by which such right is established.
Total Cost Method	An accounting method that includes the actual acquisition cost of each item held plus the costs of any additions, improvements, alterations, rehabilitations, or replacements that extend the useful life of an asset.
Traceability	The ability to assign a cost directly to a specific activity or cost object by identifying or observing specific resources consumed by the activity or cost object.
Transaction	A particular kind of external event involving the transfer of something of value concerning two or more entities. The transfer may be a two way or one way flow of resources or of promises to provide resources. (Adapted from Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 6*, Elements of Financial Statements)
Transferred Entity	An entity preparing stand-alone financial statements consolidated with a legacy entity's financial statements prior to transfer and with a receiving entity's financial statements after transfer. (Technical Bulletin 2003-1)
Transfers Between Appropriation/Fund Accounts	Occur when all or part of the budget authority in one account is transferred to another account when such transfers are specifically authorized by law. The nature of the transfer determines whether the transaction is treated as an expenditure transfer or a non- expenditure transfer. (JFMIP Standardization Project)

Treasury Warrant	An official document that the Secretary of the Treasury issues pursuant to law and that establishes the amount of monies authorized to be withdrawn from the central accounts that Treasury maintains. Warrants for currently unavailable special and trust fund receipts are issued when requirements for their availability have been met. (GAO *Budget Glossary*)
Trust Funds	Accounts that are designated by law as trust funds, for receipts earmarked for specific purposes and the associated expenditure of those receipts. Collections may come from the public (e.g., earmarked taxes or user charges) or from intra-budgetary transfers. More than 150 Federal Government trust funds exist, of which the largest and best known finance several major benefit programs (including Social Security and Medicare) and certain infrastructure spending (the Highway and the Airport and Airway trust funds).
Trust Revolving Funds	Accounts that record permanent appropriation and expenditure of collections used to carry out a cycle of business type operations in accordance with a statute that designates the fund as a trust fund. (OMB *Circular A-34*)
Trustees, Boards Of, OASDI And Medicare	Boards established by the Social Security Act to oversee the financial operations of the Old-Age, Survivors, and Disability Insurance ("Social Security" or OASDI), the Hospital Insurance (HI), and the Supplementary Medical Insurance (SMI) trust funds. The Boards are composed of six members, four of whom serve automatically by virtue of their positions in the Federal Government: the Secretaries of Treasury (the managing trustee), Labor, and Health and Human Services and the Commissioner of Social Security (since March 1995). The other two members are appointed by the President and confirmed by the Senate to serve as public representatives to serve 4 year terms.
Uncontrollable Cost	The cost over which a responsible manager has no influence.
Unemployment Insurance (UI)	The UI program was created in 1935 to provide income assistance to unemployed workers who have lost their jobs through no fault of their own. The UI program is administered through a unique system of federal-state partnerships, established in federal law but executed by state officials

through conforming state laws. The Federal Government provides broad policy guidance and program direction through the oversight of the U.S. Department of Labor. The UI program is financed by federal and state unemployment taxes. Federal unemployment taxes are used to pay for the UI administrative costs, to pay the federal share of extended UI benefits, and to maintain a loan account from which states may borrow to pay UI benefits. State UI taxes are used exclusively for the payment of regular UI benefits and the state's share of extended benefits. In addition to the federal tax, individual states finance their UI programs through state tax contributions from subject employers on the wages of covered employees. (Three states also collect contributions from employees.) Within federal guidelines, state tax rates are assigned in accordance with an employer's experience with unemployment. Actual tax rates vary greatly among the states.

Unit Cost

The cost of a selected unit of a good or service. Examples include dollar cost per ton, machine hour, labor hour, or department hour.

Unobligated Balances

Balances of budgetary resources that have not yet been obligated. (JFMIP Standardization Project) Unobligated balances expire (cease to be available for obligation) for:—1-year accounts at the end of the fiscal year;—multiple-year accounts at the end of the period specified;—no-year accounts only when they are 1) rescinded by law, 2) purpose is accomplished, or 3) when disbursements against the appropriation have not been made for 2 full consecutive years. (GAO *Budget Glossary*).

Useful Life

The normal operating life in terms of utility to the owner.

Valuation Account (Allowance Or Reserve)

An account that partly or wholly offsets one or more other accounts; for example, accumulated depreciation is a valuation account related to specific depreciable assets and allowance for bad debts is a valuation account related to accounts receivable. If a valuation account is deducted from the related asset or liability it is sometimes referred to as a contra-asset or contra-liability account.

Valuation (Or Accounting Valuation)	Valuation methods and bases are numerous and varied; and may be expressed quantitatively and in monetary terms. Application may be made to a single asset, a group of assets, or an entire enterprise, as determined by various bases and methods.
Value-added Activity	An activity that is judged to contribute to customer value or satisfy an organizational need. The attribute "value-added" reflects a belief that the activity cannot be eliminated without reducing the quantity, responsiveness, or quality of output required by a customer or organization. Value-added activities should physically change the product or service in a manner that meets customer expectations.
Variable Cost	A cost that varies with changes in the level of an activity, when other factors are held constant. The cost of material handling to an activity, for example, varies according to the number of material deliveries and pickups to and from that activity.
Variable Value Securities	Securities that have unknown redemption or maturity values at the time of issue. Values of these securities can vary on the basis of regulation or specific language in the offering.
Variance	(1) The amount, rate, extent, or degree of change, or the divergence from a desired characteristic or state. (2) The difference for a year or less between the elements (direct material, direct labor, factory overhead) of standard cost and actual cost. The term applies to (a) a money difference or (b) changes in the character or purpose of amounts expended.
Weighted-average	A periodic inventory costing method where ending inventory and cost of goods sold are priced at the weighted-average cost of all items available for sale.
Whole Life Policies	Policies that provide insurance over the insured's entire life and the proceeds (face amount) are paid only upon death of the insured.

Write-off	An action to remove an amount from an entity's assets. A write-off of a loan occurs when an agency official determines, after all appropriate collection tools have been used, that a debt is uncollectible. Active collection on an account ceases, and the account is removed from an entity's receivables. (*Treasury Financial Manual Supplement*)

Appendix F: Consolidated List of Abbreviations

AAPC	Accounting and Auditing Policy Committee
ABA	American Bar Association
AEAN	aggregate entry age normal
AFDC	Aid to Families with Dependent Children
AICPA	American Institute of Certified Public Accountants
ANPV	actuarial net present value
APB	Accounting Principles Board
APV	actuarial present value
ARB	Accounting Research Bulletin
AU	Auditing Standards
CBO	Congressional Budget Office
CCC	Commodity Credit Corporation
CERCLA	Comprehensive Environmental Response Compensation and Liability Act of 1980
CFO Act	Chief Financial Officers Act
CFS	consolidated financial statements
COLA	cost of living adjustment
CPI	Consumer Price Index
CSRS	Civil Service Retirement System
D&D	decontamination and decommissioning
DI	Disability Insurance
DoD	Department of Defense
DOL	U.S. Department of Labor
DOJ	Department of Justice
ED	exposure draft
EDP	electronic data processing
EPA	Environmental Protection Agency
ESAA	Employment Security Administration Account
EUCA	Extended Unemployment Compensation Account
FASAB	Federal Accounting Standards Advisory Board
FASB	Financial Accounting Standards Board
FECA	Federal Employees Compensation Account
FEMA	Federal Emergency Management Agency
FERS	Federal Employees Retirement Plan
FIFO	first-in, first-out
FMFIA	Federal Manager's Financial Integrity Act
FTCA	Federal Tort Claims Act
FUA	Federal Unemployment Account
FUTA	Federal Unemployment Tax Act
GAAP	generally accepted accounting principles
GAO	General Accounting Office
GDP	Gross Domestic Product

GLTDAG	General Long-Term Debt Account Group
GPFFR	general purpose federal financial report
GPFS	general-purpose financial statements
GPRA	Government Performance and Results Act
GSE	government sponsored enterprises
HI	Hospital Insurance (Medicare)
IBNR	incurred but not reported
JFMIP	Joint Financial Management Improvement Program
LAC	latest acquisition cost
LCM	lower of cost or market
LIFO	last-in, first-out cost flow
MD&A	management's discussion & analysis
MRS	Military Retirement System
NCGAS	National Council on Government Accounting Statement
NIPA	national income and product accounts
NPR	National Performance Review
NPV	net present value
O&M	operation and maintenance
OASDI	Old-Age, Survivors, and Disability Insurance
OASI	Old-Age and Survivors Insurance
OMB	Office of Management and Budget
ORB	other retirement benefits
OPEB	Other postemployment benefits
PBGC	Pension Benefit Guaranty Corporation
PRP	potentially responsible parties
PSA	Personal Security Accounts
PUC	projected unit credit
PV	present value
RCRA	Resource Conservation and Recovery Act)
RI/FS	remedial investigation/feasibility study
RSI	required supplementary information
RSSI	required supplementary stewardship information
SAS	Statement of Auditing Standards
SEC	Securities Exchange Commission
SFAS	Statements of Financial Accounting Standards
SFFAC	Statements of Federal Financial Accounting Concepts
SFFAS	Statements of Federal Financial Accounting Standards
SGL	Standard General Ledger
SMI	Supplementary Medical Insurance (Medicare)
SNA	System of National Accounts
SOP	Statement of Position
SSA	Social Security Administration

UI	Unemployment Insurance
UTF	Unemployment Trust Fund
VA	Veterans Affairs