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FASAB VOLUME 1 ORIGINAL STATEMENTS

Statements of Federal Financial Accounting Concepts and Standards

GAO/AIMD-21.1.1

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Comptroller General
of the United States

Washington, D.C. 20548

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HEADS OF DEPARTMENTS AND AGENCIES

Subject: Guidance of Federal Agencies: Accounting Standards

Accounting principles, standards, and related requirements for executive agencies have been published in Title 2, "Accounting," of the General Accounting Office's (GAO) Policy and Procedures Manual for Guidance of Federal Agencies, in accordance with 31 U.S.C. 3511. In December 1993, GAO issued a memorandum explaining that the accounting principles, standards, and related requirements adopted by the three principals (the Secretary of the Treasury, the Comptroller General, and the Director of the Office of Management and Budget) as a result of the Financial Accounting Standards Advisory Board (FASAB) recommendations would be published by GAO after a sufficient number had been approved. Two accounting concept statements and eight accounting standards have now been approved.

The attached Volume 1, "Original Statements," Statements of Federal Financial Accounting Concepts and Standards, contains the two concept statements and eight standards as approved and now being issued as a single document. It supersedes appendix I of Title 2, except for the following 13 areas in appendix I of Title 2 which have not yet been addressed by FASAB. These 13 still may be used as authoritative guidance:

- Standard C30, "Compensated Absences."
- Standard E10, "Entitlements."
- Standard E20, "Equity of the US Government," related to reversionary interest in property and trust funds.
- Standard F30, "Foreign Currency."
- Standard F40, "Fund Accounting," related to deposit, trust, and fiduciary funds.
- Standard G10, "Grants and Cooperative Agreements."
- Standard I10, "Imputed Interest," related to the cost of capital.

Standard I40, "Investments."
Standard L10, "Leases," where the agency is the lessor.
Standard L40, "Long-term Contracts," related to cost and expense recognition.
Standard P40, "Property, Plant, and Equipment," related to reversionary interest in property.
Standard R20, "Regulatory Accounting."
Standard R40, "Research and Development."

The FASAB staff are also working on a second volume which will contain the materials in the approved concept statements and eight standards arranged alphabetically by subject matter. As with Volume 1, that document will also be considered as the publication of standards superseding Title 2, except for the 13 areas just listed. Volume 1 is available in electronic format on Financenet, **http://www.financenet.gov/**, federal page, accounting standards. For a hard copy, call the Government Printing Office (202) 512-1800.

James F. Hinchman
Acting Comptroller General
of the United States

Attachment

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FOREWORD

This volume is the first of a two volume set referred to as the "Codification." It contains the original text that currently constitutes the body of accounting concepts and standards for the U.S. Government. Specifically, the volume incorporates the following documents published through February 28, 1997:

- Statements of Federal Financial Accounting Concepts 1 & 2, and
- Statements of Federal Financial Accounting Standards 1-8.[1]

Origins of the Statements

The concepts and standards presented in the two volume set resulted from the joint efforts of the Department of the Treasury (Treasury), the Office of Management and Budget (OMB), and the General Accounting Office (GAO). These three central agencies, referred to collectively as the "principals", established the Federal Accounting Standards Advisory Board (FASAB) in 1990. FASAB was created to consider and recommend accounting standards and principles.[2] The principals ultimately decide upon the principles and standards.

The Codification includes only those principles and standards agreed to by the principals. FASAB is publishing the Codification as a comprehensive basis of accounting for Federal reporting entities. It is expected that FASAB will continue to recommend statements on specialized topics. As new statements and interpretations are adopted, the Codification will be updated.

Purpose of the Codification

The Codification of Federal accounting concepts and standards is a two volume set with extensive cross-referencing and indexing. The volumes are designed to meet the needs of users for references to original statements (Volume I) and to standards alphabetized by topic (Volume II). Both volumes serve as authoritative references to the standards and interpretations.

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[1]Statement of Federal Financial Accounting Standards No. 8, *Supplementary Stewardship Reporting*, has been approved by the Board's principals but may not be implemented until it has undergone a 45-day review by Congress. The review was not completed at the time this Volume was published. SFFAS No. 8 is provided herein for your convenience and future use. An announcement will be made in the Federal Register when the review has been completed and SFFAS No. 8 can be implemented.

[2]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.

Volume I

This volume, Volume 1--*Federal Financial Accounting Concepts and Standards-Original Statements*, is a compilation of the documents produced by the Federal Accounting Standards Advisory Board and adopted by the principals: the Secretary of the Treasury, the Director of OMB, and the Comptroller General of the United States. Once adopted, the documents are referred to as Statements of Federal Financial Accounting Concepts (SFFAC or Concepts) and Statements of Federal Financial Accounting Standards (SFFAS or Standards) respectively.

This volume presents the Concepts in their entirety. Concepts do not establish Federal financial accounting standards; rather they describe the concepts used by FASAB as a framework as it considers and recommends accounting principles for the Federal government. Concepts are meant to guide others involved in Federal financial reporting such as preparers and auditors.

This volume extracts the authoritative portions of the Standards originally published in individual statements as well as the explanatory text contained in any appendices. It does not reprint the summaries or all introductory and background material since these sections are not always essential to applying the standards or understanding the Board's conclusions. The *Basis for the Board's Conclusions* for each standard is included since it serves to explain the specific provisions of the standards.

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

Volume II

Volume II of this set, *A User's Guide to Federal Financial Accounting Standards*, is a codification of the standards. Volume II presents the standards alphabetized by topic, pulls together all references to a particular topic in one section, and integrates illustrative material from both the SFFASs and the original Exposures Drafts wherever possible.

Applicability

The mission of FASAB is to recommend accounting concepts and standards that result in federal agencies' financial reports including understandable, relevant, and reliable information about the financial position, activities, and results of operations of the United States government and its component units. In addition, the standards should foster the improvement of accounting systems and internal controls that will help provide reasonable assurance to users that government activities have been conducted economically, efficiently, and effectively, and in compliance with applicable laws and regulations. Therefore, FASAB believes that federal financial accounting concepts and standards should be considered in establishing systems and in maintaining day-to-day financial records as well as being applied to general purpose financial reports of U. S. Government reporting entities. This belief is consistent with the requirements of the Federal Financial Management Improvement Act of 1996 which states that "each agency shall implement and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level."[3]

The specific applicability of the standards to components of the Federal government was considered during the development of Statement of Federal Financial Accounting Concepts No. 2 (SFFAC No. 2), *Entity and Display.* SFFAC No. 2 lists criteria for including components in Federal reporting entities (see pp. 75-77) and provides the following guidance with regard to components required by law or policy to issue financial statements prepared in accordance with accounting standards other than those constituting Federal GAAP. For example, some components are required to apply accounting standards issued by the Financial Accounting Standards Board or a regulatory agency. Those components should continue to apply the standards required by law or policy for their financial statements. The reporting entities of which the components are a part, however, need to be sensitive to differences that may arise from the different accounting standards. If these differences are material, the standards constituting Federal GAAP should be applied for purposes of including the components in entity-wide statements. In such cases, the components may need to provide additional disclosures or different measurements required to comply with Federal GAAP.

The standards need not be applied to immaterial items.

Hierarchy of Federal Generally Accepted Accounting Principles

The hierarchy of generally accepted accounting principles[4] (GAAP) governs what constitutes GAAP for all U.S. government reporting entities. OMB publishes the hierarchy in its bulletin entitled *Form and Content of Agency Financial Statements*. It lists the priority sequence of sources that an entity should look to for accounting and reporting guidance.

[3]Title VIII--*Federal Financial Management Improvement Act of 1996*, Sec. 803(a).

[4]"Accounting principles" are those conventions, rules, and procedures necessary to define acceptable accounting practice at a particular time.

In 1996, through the joint efforts of the Treasury, OMB, and GAO, a body of generally accepted accounting principles (GAAP) covering most transactions was promulgated 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. While many of the standards comprising Federal GAAP have already been made effective, three of those standards will not be effective until fiscal year 1998. The following hierarchy[5] determines GAAP for U.S. government reporting entities beginning in fiscal year 1998:

1. Individual standards agreed to by the Director of OMB, the Comptroller General, and the Secretary of the Treasury and published by OMB and the General Accounting Office.

2. Interpretations related to the SFFASs issued by OMB in accordance with the procedures outlined in OMB Circular A-134, *Financial Accounting Principles and Standards.*

3. Requirements contained in OMB's Form and Content Bulletin in effect for the period covered by the financial statements.

4. Accounting principles published by authoritative standard setting bodies and other authoritative sources (a) in the absence of other guidance in the first three parts of this hierarchy, and (b) if the use of such accounting principles improves the meaningfulness of the financial statements.

The above hierarchy may be implemented earlier than fiscal year 1998 with approval from OMB. Until the above hierarchy is effective, U.S. government reporting entities will continue to follow the hierarchy established[6] for an *"Other Comprehensive Basis of Accounting"* (OCBOA) and presented below:

1. Individual statements agreed to and published by the JFMIP principals.

2. Form and content requirements included in OMB Bulletin 93-02, dated October 22, 1992, and subsequent issuances.

3. Accounting standards contained in agency accounting policy, procedures manuals, and/or related guidance as of March 29, 1991, so long as they are

[5]The hierarchy was published in OMB Bulletin 97-01 dated October 16, 1996.

[6]The hierarchy was published in OMB Bulletin 94-01 dated November 16, 1993.

prevalent practices.

4. Accounting principles published by authoritative standard setting bodies and other authoritative sources (1) in the absence of other guidance in the first three parts of this hierarchy, and (2) if the use of such accounting standards improve the meaningfulness of the financial statements.

Source for Interpretations

OMB Circular A-134 describes the policies for seeking and providing interpretations and other advice related to the standards. An interpretation is a document of narrow scope that provides clarifications of original meaning, additional definitions, or other guidance pertaining to an existing SFFAS. Requests for interpretations should be directed to OMB's Office of Federal Financial Management or to the Executive Director, FASAB.

OMB and FASAB will respond to the request for guidance by providing technical assistance unless they determine that the response should be an Interpretation. In that event, FASAB staff will provide written copies of the request to the Board members. FASAB staff will examine, as appropriate, applicable literature and consult with knowledgeable persons and draft an Interpretation of Federal Financial Accounting Standards. FASAB will consider the draft interpretation at an open meeting. After a majority agrees and the representatives of the three principals (Treasury, GAO, and OMB) approve and sign the interpretation; the interpretation will be published by OMB and GAO.

Organization of the Codification

Volume I presents the text of the original statements as described above. Each statement is presented as a separate chapter. The issue date and effective date of each statement are presented first. Next, references to relevant sections within Volume I and to Volume II are provided. Any interpretations that relate to the statements are also identified.

In some cases, the statements have been affected by later statements or affect earlier statements. References direct the reader to the affected paragraphs and indicate the source of the change. Within the text of the statements, provisions deleted as a result of other statements are marked with strikeouts and provisions affected by other statements are double-underlined. Double-underlined text remains as originally published. The double-underlining is intended to alert the reader to the fact that it has been modified or affected by a later statement.

A brief summary of the statement is presented. A table of contents referenced to both page and paragraph numbers follows the summary. Note that the paragraph numbers are those originally expressed in the individual statements despite the omission of some paragraphs. Any omitted paragraphs are indicated in the table of contents.

Volume I also presents the following appendices:

Appendix A:	Topical Index
Appendix B:	Effective Dates of Statements
Appendix C:	Listing of Interpretations Published by OMB
Appendix D:	Topics Not Yet Addressed
Appendix E:	Consolidated Glossary

Volume II is under development at this time and will be organized alphabetically by topic. Topics will be specific financial statement items. Each topical section will be identified by an alpha-numeric code (for example, P10 for "Pensions"), with numbers selected to allow addition of future topics.

Paragraphs within each section will be numbered consecutively. The following numeric format has been proposed:

Paragraphs .100 - .599:	Standards and Potential Note Disclosures
Paragraphs .600 - .699:	Interpretations Published by OMB
Paragraphs .700 - .799:	Nonauthoritative Discussion & Illustrations

Source references will be provided in paragraphs .100 - .599 to indicate the original statement from which material was drawn. The references will appear in brackets at the end of each paragraph or illustration. For example, the reference [SFFAS 7, para. 81] refers to Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting,* paragraph 81. Source references will be provided in the nonauthoritative paragraphs as footnotes to permit more descriptive identification of the sources.

Volume II will present the following appendices and may present others:

-- Topical Index
-- FASAB Active and Future Projects
-- Topics Not Yet Addressed
-- Consolidated Glossary

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STATEMENTS OF FEDERAL FINANCIAL ACCOUNTING CONCEPTS

Volume I, Version 1.0
February 28, 1997

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:	
Affects:	No other statements.
Affected by:	No other statements.

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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Paragraphs 1-20 omitted.

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

23. 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]

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 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

[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 1991.

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]

[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.

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 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 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.

[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.

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 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.

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

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

[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).

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.

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

[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).

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.

<u>Federal financial reporting should provide information that helps the reader to determine</u>:

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 <u>accounting</u> unit for this objective would be the budget account, although accounts are often aggregated for some <u>reporting</u> 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.**

[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.

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

- 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]

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

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 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,

[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."

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, 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 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.

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

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.

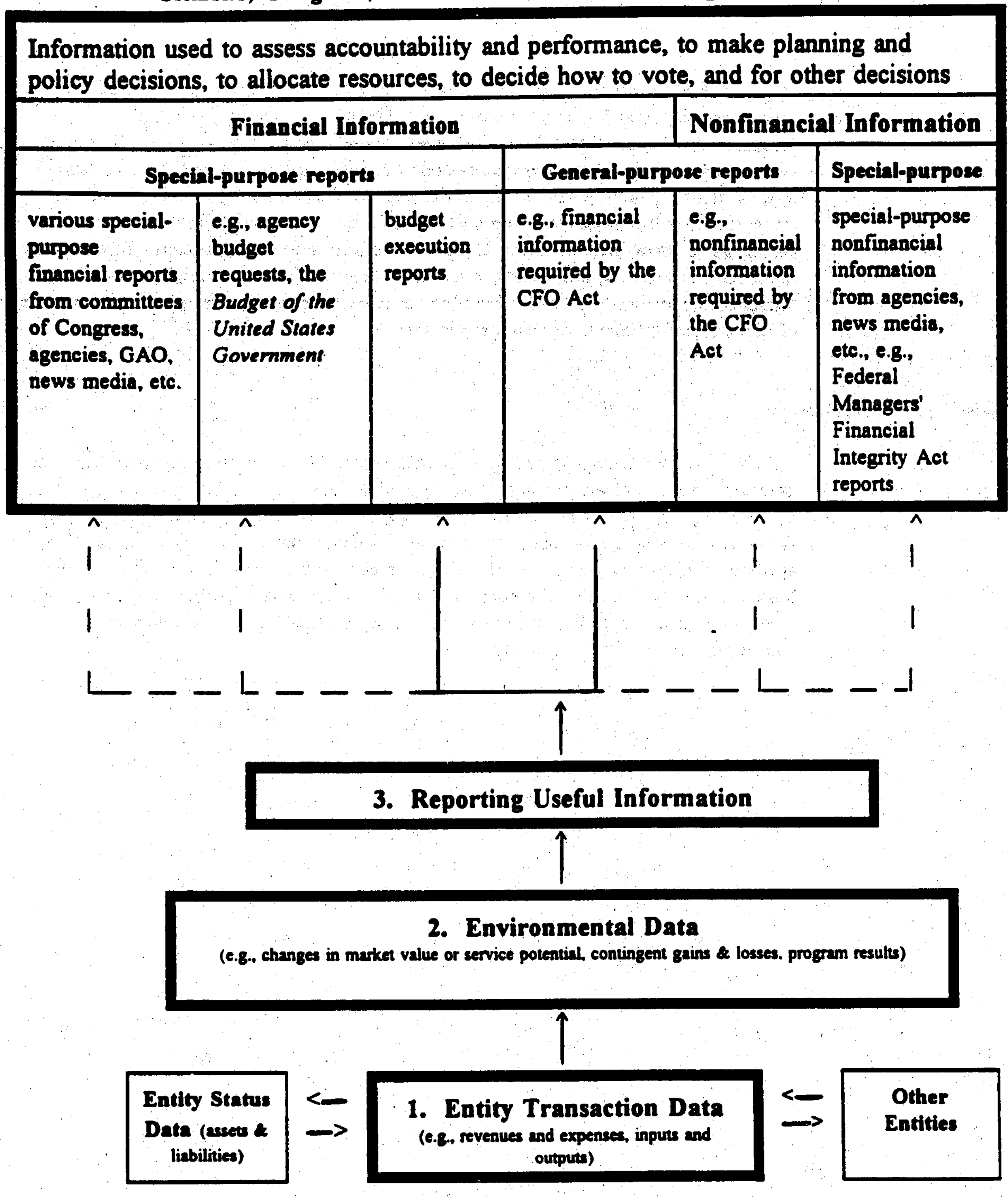
CHAPTER 7: HOW ACCOUNTING SUPPORTS FEDERAL FINANCIAL REPORTING

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.

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



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.

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

[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," *Studies in Accounting Research # 10*, American Accounting Association (1975).

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 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.

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[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.

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

[15]Such a discussion and analysis is required in federal financial reports prepared pursuant to the CFO Act of 1990. 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.

- 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.

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 1990.

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 1990. 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.

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.

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

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 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

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

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.

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.

[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 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. 7, *Accounting for Revenue and Other Financing Sources*
Volume II References:	
Interpretations:	
Affects:	No other statement.
Affected by:	SFFAS No. 7, the designated material in paragraphs 90-102 added to SFFAC No. 2.

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.. Sections of SFFAC No. 2 that are amended are marked with double underscores.

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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, 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.

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[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.

[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.

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 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 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

[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.

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 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

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

GSE(s) and other information that would provide an understanding of the possibility of a contingent liability.[5]

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.

[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.

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]

[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.

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.

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 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

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[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.

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.)

RECONCILIATION STATEMENT--BUDGETARY AND FINANCIAL ACCOUNTING

[The heading above and the text below were added to SFFAC No. 2 through amendment by SFFAS No. 7. Text from SFFAS No. 7 is inserted to assist readers -- in most cases amendments are noted in the status page and amended text is marked but not modified in the original statements.]

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.

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.

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.

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

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[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."*

[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.

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 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 financing;*
- statement of program performance measures;[13]
- accompanying footnotes;

[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.

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

- 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.

*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.

[The bullet item and text above were added to SFFAC No. 2 through amendment by SFFAS No. 7. Text from SFFAS No. 7 is inserted to assist readers -- in most cases amendments are noted in the status page and amended text is marked but not modified in the original statements.]

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 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

[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.

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.

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.

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

[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 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.

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[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.

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

[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.

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 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 FINANCING

[The heading above and the text below were added to SFFAC No. 2 through amendment by SFFAS No. 7. Text from SFFAS No. 7 is inserted to assist readers -- in most cases amendments are noted in the status page and amended text is marked but not modified in the original statements.]

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.

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.

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.

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.

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).

Financing sources yet to be provided are the financing amounts needed in a future period to cover cost incurred in the current period.

The bottom line of this reconciliation would be the **net cost of operations**.

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.

[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.

- **Comparability**. The measures should provide a frame of reference for assessing, and comparing, if appropriate, the 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 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.

[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.

APPENDIX 1 - A

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**

APPENDIX 1 - A

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

EXAMPLE FINANCIAL STATEMENT FORMATS

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

	Sub-organization A	Sub-organization B	Sub-organization 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

EXAMPLE FINANCIAL STATEMENT FORMATS

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

	Sub-organization A	Sub-organization B	Sub-organization 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

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

EXAMPLE FINANCIAL STATEMENT FORMATS

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

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

APPENDIX 1 - F
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 1 - G

[The appendix was added to SFFAC No. 2 through amendment by SFFAS No. 7. Text from SFFAS No. 7 is inserted to assist readers -- in most cases amendments are noted in the status page and amended text is marked but not modified in the original statements.]

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 adjustments	(X)
Donations not in the budget	X
Financing imputed for cost subsidies	X
Transfers-in (out)	X
Exchange revenue not in the budget	(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

LIST OF ACRONYMS

FASAB	Federal Accounting Standards Advisory Board
OMB	Office of Management and Budget
SGL	Standard General Ledger
SFFAC	Statement of Federal Financial Accounting Concepts

STATEMENTS 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 revenue)
Volume II References:	Accounts Payable (A10), Accounts Receivable (A20), Advances and Prepayments (A30), Cash (C20), Entity and Nonentity Assets (E20), Fund Balance with Treasury (F50), Governmental and Intragovernmental Assets and Liabilities (G60), Interest Payable (I60), Interest Receivable (I80), Investments in Treasury Securities (I110), Liabilities (L40), Other Current Liabilities (O40)
Interpretations:	
Affects:	No other statements.
Affected by:	SFFAS No. 5 amends Paragraph 96 by providing a definition of "liability." SFFAS No. 7, Paragraph 53 amends Paragraph 41.

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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Paragraphs 1-15 omitted

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 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.

[2] Source of definition: OMB Circular A-34.

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.

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. *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.

[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 sTtatements 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.

[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.

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 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.

[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.

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 expenses expire. A travel advance, for

[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.

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.[8] 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. 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

[8] A comprehensive definition of "liabilities" is being considered by the Board in its project concerning liabilities in general.

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 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 delivered 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[10]

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 amount of 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.

[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*.

EXAMPLES[11]

In the first example, 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 $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.

[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.

TABLE 2: PREMIUM AMORTIZATION

DATE	STATED INTEREST 7%	EFFECTIVE INTEREST 6%	PREMIUM AMORTZATION	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

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:	Direct Loans (D40), Loan Guarantees (L60), Foreclosed Property (F40)
Interpretations:	
Affects:	No other statements.
Affected by:	No other statements.

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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Paragraphs 1-3 and 20 omitted.

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.

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.)

[1]Terms included in Appendix C: Glossary are printed in CAPITAL LETTERS when they appear for the fist time. (NOTE: See consolidated Glossary – Appendix E.)

-- 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

[2] Congressional Budget Office, "Credit Reform: Comparable Budget Costs for Cash and Credit" (Dec. 1989), p.33.

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.

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."

[Paragraph 20 omitted.]

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.

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 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).

[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).

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 repsect 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 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

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[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).

[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.)

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).

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

[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. 5 for an explanation of "modification adjustment transfer."

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 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 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,

[11] FASAB Exposure Draft, *Objectives of Federal Financial Reporting*, Vol. 1, par. 13.

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]

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)		
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
Allowance for bad debts	(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

[12] Tables are provided only for illustration. They do not represent a reporting format.

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 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

[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).

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 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

[14]See Exposure Draft, Vol. 2, pars. 221 through 231, and Appendix 2, pages 139 through 143.

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).

[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.

**TABLE 1:
PAYMENT SCHEDULE
(in thousands of dollars)**

	Payment (a)	Interest (b)	Principal (c)	Year-End Loan Balance (d)
FY 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 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.

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[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.

TABLE 2:
PROJECTED CASH FLOWS DISCOUNTED TO THE END OF FY1994
(in thousands of dollars)

	Fee Collections	P & I Payments*	Default Losses	Net Cash Inflows
FY 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

*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.

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)**

	P & I Payments	Default Losses	Net Cash Flows
FY 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.

[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.

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		

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		

(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

[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.)

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 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.

[22]The disclosure will not be illustrated for other modifications explained in this Appendix.

**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 costs	(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	(774)		
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 (a)	DEFAULT LOSSES (b)	NET CASH FLOWS (c)
1997	$439	$(55)	$384
1998	439	(55)	384
1999	439	(55)	384
2000	439	(55)	384
PV at 6%	$1,521	$(190)	$1,331

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.

[23] This assumes that the sales proceeds were not included in the cash flow estimates for the initial subsidy calculation.

(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 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 5%	$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

[24]If there is a book value gain, the gain to be recognized equals the book value gain plus the cost of modification.

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 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 inflows discounted at 4 percent is $3,172. This is the pre-modification value of the loans.

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[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.

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.

[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.

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 when the loans mature at the end of the 5th 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.

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 SUPPLE-MENTS	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 mi..us 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 FY1994, 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	$2,450

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 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

[27]The definition of the current discount rate is provided in Appendix C, Glossary. [See Appendix E of this Volume.]

(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.

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.

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[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.)

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 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.

[29]This assumption is made only to avoid repetitious illustrations.

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.

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

[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.

[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

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 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]

[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.

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.

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.

[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.

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]

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.

[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.

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) SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees* (information related to foreclosed property)
Volume II References:	Foreclosed Property (F40), Goods Held Under Price Support and Stabilization Programs (G40), Inventory Held For Sale (I100), Nonrecourse Loans (N80), Operating Materials and Supplies (O20), Purchase Agreements (P80), Revenue (R40), Seized and Forfeited Property (S40), and Stockpiled Materials (S60)
Interpretations:	
Affects:	No other statements.
Affected by:	SFFAS No. 7, Paragraphs 264-269 amend Paragraph 76 regarding revenue recognition for property seized to satisfy taxpayer liabilities.

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) excees, 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 values must be adjusted 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). 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.

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 loans 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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Paragraphs 1- 16 and Glossary omitted.

INVENTORY HELD FOR SALE

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.

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

[2]This unit value is referred to as the latest acquisition cost for the remainder of this standard.

[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.

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 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.

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.

[4]The decline in value shall be considered an expense if it is an expected decline in the normal course of operations.

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).
- 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 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

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[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.

[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.

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.

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	Upon 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.

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[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 ne: 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 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,

[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.

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: Beginning Inventory at LAC Purchases Cost of Goods Available for Sale less: Ending Inventory at LAC Cost of Goods Sold	Cost of Goods Sold: Beginning Inventory at LAC less Allowance Purchases Cost of Goods Available for Sale 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 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

[11] FASAB Exposure Draft, Objectives of Federal Financial Reporting, Vol. 1, par. 13.

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

STATUS

Issued:	July 31, 1995
Effective Date:	for fiscal years beginning after September 30, 1996.
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)
Volume II References:	Managerial Cost Accounting (M20)
Interpretations:	Interpretation No. 2, *Accounting for Treasury Judgment Fund Transactions*
Affects:	No other statements.
Affected by:	No other statements.

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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Paragraphs 1-12 and 28-30 omitted.

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.

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

[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.

[4] 104 Stat. 2938 (See particularly 31 U.S.C. sec 902).

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 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.

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[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.

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.

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

[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.

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 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.

[Paragraphs 28-30 omitted.]

[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).

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 economy and society. Nevertheless, the costs of federal resources

[9] OMB Circular A-25, User Charges (Revised July 8, 1993).

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

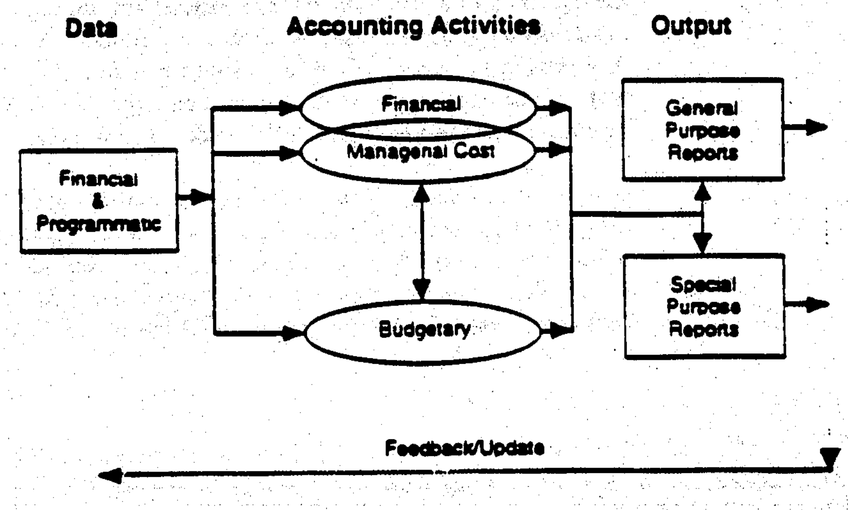
Managerial cost accounting should be a fundamental part of the financial management system and, to the extent practicable, should be integrated with other parts of the system. Managerial costing should use a basis of accounting, recognition, and measurement appropriate for the intended purpose. Cost 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 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*

[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.

[11] Coulthurst, Nigel and John Piper, "The State of Cost and Management Accounting," Management Accounting, April 1986.

which states that "financial accounting is largely concerned with assigning the value of past transactions to appropriate time periods."[12]

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.

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

[12] Statement of Federal Financial Accounting Concepts No.1, *Objectives of Federal Financial Reporting*, par. 168.

[13] Memorandum of Understanding establishing the FASAB, October 10, 1990.

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 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

[14] Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, par. 174.

[15] Ibid., pars. 23, 25, and par. 75.

[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.

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 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

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[17] Ibid., par. 174 and par. 192.

[18] Ibid., par. 191.

[19] Ibid., par. 196.

[20] Ibid., par. 197.

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.

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.

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

[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).

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 managemen'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 evaluations or decisions. At the same time, unnecessary precision and refinement of data should be avoided.

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[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.

- 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;

(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

[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).

[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.

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 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.

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[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 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.

[28] A similar explanation is provided in FASAB Statement of Recommended Accounting Concepts No. 2, *Entity and Display*, par. 95.

95. Federal financial accounting standards require tha: 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 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.

[29] FASAB Exposure Draft, *Accounting for Liabilities of the Federal Government* (November 7, 1994), pars. 62-99.

[30] Ibid., pars. 100-102.

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

[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.

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.

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.

[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.

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.

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.

[33] OMB Circular A-25 addresses user charges by federal entities.

- 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

* 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 to 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 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.

[34] Some literature, the CASB pronouncements for example, use the term "cost objective" for the same meaning.

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 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

[35] Cost Accounting Standards Board, Restatement of Objectives, Policies and Concepts, par. 2915.

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.[34] 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.

[34] 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.

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.

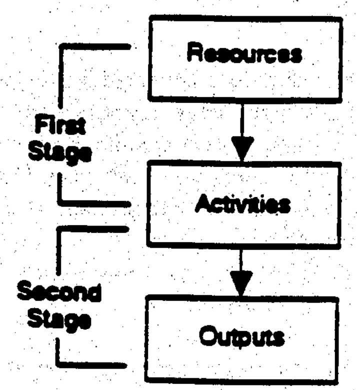
146. The standard requires that a costing methodology, once adopted, be used consistently. Consistent use provides cost information that can be compared from year to year. However, this requirement does not preclude necessary improvements and refinements to the system or methodology, so long as the effect 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]

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.

[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.

[38] Cooper, Kaplan, et al. page 20.

(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.

(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.

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.

[39] Horngren, Charles T. and George Foster, Cost Accounting, A Managerial Emphasis, 7th ed. (Prentice Hall, Englewood Cliffs: New Jersey, 1991), page 222.

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

[40] Office of the Vice President, Improving Financial Management, Accompanying Report of the National Performance Review (September 1993), page 24.

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 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 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.

[41] FASAB Statement of Recommended Accounting Concepts 2, *Entity and Display*, par. 75.

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.

<u>Usefulness of full cost information</u>

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.

[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.

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, 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.

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.

[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.

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 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

[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.

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.

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.

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[46] FASAB Exposure Draft, *Accounting for Liabilities of the Federal Government* (Nov. 1994), pars. 80-99, pages 32-46.

[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, 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

[49] The Government Performance and Results Act of 1993, PL 103-62, sec 4.

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 important for use by the entity's top-level management (and to a lesser degree by line managers) in controlling and assessing the

[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.

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.

<u>Recognition Criteria</u>

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."

<u>Consolidation</u>

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.

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)
Volume II References:	Capital Leases (C40), Contingencies (C60), Exchange Liabilities (E40), Federal Debt (F10), Insurance and Guarantee Programs (I40), Liabilities (L40), Nonexchange Liabilities (N20), and Pensions, Other Retirement Benefits and Other Postemployment Benefits (P20)
Interpretations:	Interpretation No. 2, *Accounting for Treasury Judgment Fund Transactions*
Affects:	No other statements.
Affected by:	SFFAS No. 7, paragraph 36(b) creates 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 paragraphs 6, 104 and 105 of this Statement.

SUMMARY

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 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*, Statement of Federal Financial Accounting Standards Number 2, *Accounting for Direct Loans and Loan Guarantees*, and Statement of Federal Financial Accounting Standards Number 6, *Accounting for Property, Plant, and Equipment*.

This Statement defines the recognition points for liabilities associated with different types of events and transactions.

- 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[2] 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

[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] 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.

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 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: contingencies, capital leases, Federal debt, pensions, other retirement benefits, and other postemployment benefits, and insurance and guarantee programs.

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Paragraphs 1 and 8-18 omitted.

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]

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

[9] Adapted from Statement of Federal Financial Accounting Standards (SFFAS) Number 1, *Accounting for Selected Assets and Liabilities* (March 30, 1993), par. 96.

[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*.

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 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).

Paragraphs 8-18 omitted.

[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.

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.

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

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[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.

[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.

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.

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:

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[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.

[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.

(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

(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 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

[22] See SFFAS No. 6, *Accounting for Property, Plant, and Equipment* for a detailed discussion of cleanup cost.

[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.

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. 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).

[24] See Statement of Federal Financial Accounting Standards Number 1, *Accounting for Selected Assets and Liabilities*, (March 30, 1993), app. A, par. 95.

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).[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:

- collectibility 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 more likely than not 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.

CRITERIA FOR DISCLOSURE OF
A CONTINGENT LIAB'LITY

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.

[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 transacuons 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.

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.

[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.*

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]

[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.

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[31]

49. Federal debt securities 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.

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

[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.

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

[34] These tables are intended to illustrate current practice only and are not to be considered authoritative.

FEDERAL DEBT INSTRUMENTS

DEBT CATEGORY	SUBCATEGORY	TERM	REDEEMABLE	ACCOUNTING METHOD
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)	Liability at face value net of unamortized discount Interest method of amortization of discount
			On demand (2 bonds)	Current value.

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]

58. Retirement benefits other than pensions (ORB) are all forms of benefits to retirees or their beneficiaries provided outside the pension plan. Examples include

[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.

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.

[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.

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 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

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[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.

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 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

[42] See SFFAS Number 1, *Accounting for Selected Assets and Liabilities*.

- 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

[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."

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 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:

DR.	Employer's Pension Expense	$100,000	
CR.	Appropriations Used		$60,000
CR.	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:

DR. Fund Balance with Treasury	$120,000	
CR. Retirement Program Revenue - Contribution Received from Employer Entity		$60,000
CR. 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:

DR. Fund Balance with Treasury	$XXX,XXX	
CR. 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 c[illegible]s employees--for the employees' pensions.

Entry # 4 -- Administrative entity's entry to record its pension expense:

DR. Pension Expense	$XXX,XXX	
CR. 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.

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

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[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.

[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).

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.

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.[30] 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 for the ORB Plan**--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,
- any gains/losses due to a change in the medical inflation rate assumption; and
- other actuarial gains or losses during the period, if any.

[30] See SFFAS No. 1, *Accounting for Selected Assets and Liabilities.*

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 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

[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".

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.)

- 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:

DR. Employer's ORB Expense	$10,000	
CR. Imputed Financing-Expenses Paid by Other Entities		$10,000

Table 5

<u>Employer Entity's Other Financing Sources as They Should Appear on the Statement of Changes in Net Position</u>

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.

<u>Employer Entity's Cost as It Should Appear on the Statement of Net Cost</u>

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.

[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.

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.

DR. ORB Expense $XX,XXX
CR. 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.

[54] Both the federal employee unemployment program and the federal workers' compensation program are financed by direct reimbursements from federal employers.

INSURANCE AND GUARANTEES

NATURE OF FEDERAL INSURANCE AND GUARANTEE PROGRAMS[35]

97. Insurance and guarantee programs are federal programs that provide protection to individuals or entities against specified risks. Many of 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

[35] 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.

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

[63] SFFAC No. 1, paragraph (16c).

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 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

[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.

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.

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.

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]

[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.

[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:

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

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

- 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.

[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]

federal support in the form of appropriations related to administrative cost or subsidies).

APPENDIX A: BASIS FOR CONCLUSIONS

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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

[63] SFFAC No. 1, paragraph (16c).

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 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.

[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.

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 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. <u>Hence, the discussion of social insurance has been withdrawn from the liability standard and consolidated in *Supplementary Stewardship Reporting*.</u>

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 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

[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.)

the federal entity to pay for benefits, goods, or services[44] 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.

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.

[44] 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.

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 allocatung 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 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

[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.

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.[illegible]

[illegible] 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

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. .

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.

treatment.

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 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.

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[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".

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 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

[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.

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.
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.

[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
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.

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 classifications of transactions involving asset transfers) SFFAS No. 8, *Supplementary Stewardship Reporting* (for reporting requirements on Stewardship PP&E)
Volume II References:	Capital Leases (C10), Cleanup Cost (C40), Deferred Maintenance (D20), Depreciation (D30), Federal Mission PP&E (F20), General PP&E (G20), Heritage Assets (H20), Internally-developed Software (I90), Land (L20), Property, Plant, and Equipment (P60), Multi-use Heritage Assets (M40), Transfers of Assets (T40)
Interpretations:	
Affects:	No other statements.
Affect by:	No other statements.

SUMMARY

This statement contains accounting standards for Federally owned property, plant, and equipment (PP&E); deferred maintenance on PP&E; and cleanup costs.

The diversity among Federal PP&E creates a need for meaningful categories of PP&E with different accounting standards for each category. Four categories of PP&E have been defined for accounting purposes. 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 and include weapons systems and space exploration equipment;
- heritage assets are those assets possessing significant educational, cultural, or natural characteristics; and
- stewardship land (i.e., land other than that included in general PP&E).

General PP&E shall be reported in the balance sheet and the statement of net cost. The acquisition cost of general PP&E shall be recognized as an asset. Subsequently, except for land which is a nondepreciable asset, that acquisition cost shall be charged to expense through depreciation. The depreciation shall be accumulated in a contra asset account--accumulated depreciation.

Annual expenditures to acquire, replace or improve Federal mission PP&E, heritage assets, and stewardship land shall be shown as a cost in the period incurred. Reporting on these three categories is addressed in SFFAS No. 8, *Supplementary Stewardship Reporting*.

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.

For cleanup cost associated with general PP&E, probable 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 cleanup cost associated with Federal mission PP&E, heritage assets, and stewardship land, probable and measurable liabilities shall be recognized when the PP&E is placed in service. Simultaneous with recognizing the liability, the related expense for cleanup cost shall be recognized.

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Paragraphs 1-16 omitted.

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
- 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,

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[17]Useful life is the normal operating life in terms of utility to the owner. (adapted from *Kohler's Dictionary for Accountants*)

[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

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.
- 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] 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),
- Federal mission 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

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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.

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). (adapted from Kohler's Dictionary for Accountants)

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.

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 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 include only land and land rights with an identifiable cost that was specifically acquired for or in connection with construction of general PP&E.

[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.

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. **Internally-developed**[31] **software** may be included in general PP&E (or other asset accounts[32]) if its cost is intended primarily to be recovered through charges to users.[33] Other internally-developed software costs shall be expensed when incurred.

28. If an entity elects to capitalize internally-developed software costs under the circumstances described in the preceding paragraph, costs that may be capitalized are limited to:

- those clearly identifiable with major new software projects and distinguishable from recurring maintenance-type activities;

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[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] "Internally-developed" means that employees of the entity are actively involved in developing the software. This is distinguished from contractor developed software and purchased software which are subject to the provisions of the PP&E standard.

[32] Currently, the US Standard General Ledger includes an account titled *Automated Data Processing Software*, number 1830, which is not part of the PP&E account series. These standards do not require that software be accounted for as a component of the PP&E accounts. It is permissible to maintain a separate account for software and the accumulated amortization on software.

[33] In this case, users may be internal or external to the entity.

- costs incurred after technological feasibility[34] has been established; and
- direct costs of developing the software, initial training material, and documentation manuals incurred after technological feasibility has been established (e.g., salaries of programmers, systems analysts, project management, and administrative personnel directly involved in the planning, designing, coding, or testing; associated employee benefits, outside consultants fees, and supplies).

The amortization or depreciation of these costs shall not exceed five years.

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 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.

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[34]Technological feasibility has been established when the entity has completed all planning, designing, coding, and testing activities that are necessary to establish that the software can meet its design specifications.

[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 the 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.

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]

- 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.

[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 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.

[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.

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 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:

[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.

[45] *Net remaining cost* is the original cost of the asset less any accumulated depreciation/amortization to date.

- 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 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.

Federal Mission Property, Plant, and Equipment

46. Federal mission PP&E includes certain items used to meet a Federal Government mission in which the specific PP&E used is an integral part of the output of the mission.[47] PP&E should be considered Federal mission PP&E if it possesses at least one of each of the two types of characteristics presented below. One type of characteristic relates to the use of Federal mission PP&E and the other relates to its useful life.

47. Characteristics related to the use of the 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

[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] The name "Federal Mission PP&E" may cause readers to erroneously assume that this category should include any PP&E supporting a Federal mission. Federal mission PP&E is limited to those items specifically identified herein as well as any other items exhibiting at least one characteristic from each of the two groups listed.

other program or entity (Federal or non-Federal) using similar PP&E with which to compare costs.

48. Characteristics related to the useful life are that it:

- has an indeterminate or unpredictable useful life[48] due to the unusual manner in which it is used, improved, retired, modified, or maintained; or
- is at a very high risk of being destroyed during use or premature obsolescence.

49. Federal mission PP&E specifically includes (1) weapons systems PP&E (e.g., fighter/attack aircraft, submarines, and tracked combat vehicles) and (2) space exploration equipment (e.g., space hardware and launch, tracking, and recovery facilities) which will be defined in paragraphs 50 and 52. Federal mission PP&E excludes land.

50. **"Weapons systems"** are a combination of one or more weapons[49] with all related equipment, materials, services, personnel and means of delivery and deployment required for self-sufficiency.[50] This standard addresses only the PP&E component of weapons systems. PP&E included in weapons systems are distinguished from general property, plant, and equipment held by defense agencies and defense support agencies in that they are intended to be used directly by the armed forces to carry out combat missions, when necessary, and to train in peacetime.

51. Weapons systems include only those assets owned by defense agencies and defense-support agencies that would otherwise meet the PP&E definition. Items meeting other than the PP&E asset category definitions (such as items of inventory or operating materials and supplies) are excluded from Federal mission PP&E.

52. **"Space exploration equipment"** includes items that are:

- intended to operate above the atmosphere for space exploration purposes, and
- any specially designed equipment to aid, service, or operate other equipment engaged in the exploration of space.

Recognition and Measurement

53. The periodic cost of acquiring, constructing, improving, reconstructing, or renovating Federal mission PP&E shall be recognized as a cost on the statement of net

[48]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.

[49]Weapons are instruments of combat used to destroy, injure, defeat or threaten an enemy. (adapted from *Dictionary of Weapons and Military Terms*)

[50]Joint Chiefs of Staff, *Department of Defense Dictionary of Military and Associated Terms*, Joint Publication 1-02, March 23, 1994.

cost when incurred. The cost shall be disclosed[51] as "cost of Federal mission 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).

54. Additional reporting requirements for stewardship reporting will be developed in a separate standard.

Implementation Guidance

55. Federal mission 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.

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.

59. Heritage assets may in some cases be used in general government operations (e.g., office buildings such as the main Treasury building). These assets are referred to as multi-use heritage assets. The costs to maintain these assets serve two purposes--they preserve the heritage features and permit continued use of the asset for government operations. 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 communications equipment/wiring) shall be treated as general PP&E and depreciated over the period of time they are expected to provide service or produce benefits.

60. Cost to renovate, restore, or reconstruct the heritage asset itself shall be excluded from general PP&E (i.e., not capitalized).

[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.

Recognition and Measurement

61. The cost of improving, reconstructing, or renovating heritage assets (excluding any costs designated as general PP&E) shall be recognized as a cost in the period incurred. Also, in the event that heritage assets are acquired or constructed, the cost shall be recognized as a cost of the period incurred. These costs shall be disclosed[52] as "Cost of Heritage Assets." 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).

- The cost of heritage assets transferred from other Federal entities shall be the book value of the asset recorded on the transferring entity's books. If the receiving entity does not know the book value, the fair value 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 transferred shall be disclosed.
- No amounts for heritage assets acquired through donation, or devise[53] shall be recognized in the cost of heritage assets.[54] The assets' fair value, if known and material, shall be disclosed in notes to the statement of net cost in the year received. If fair value is not known or reasonably estimable, information related to the type and quantity of assets received shall be disclosed.

62. Additional reporting requirements will be developed for stewardship report items in a separate standard.

Implementation Guidance

63. Heritage assets 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.

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).

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[52] 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.

[53] A will or clause of a will disposing of property.

[54] Theoretically, the amount of donated heritage assets should be included in the statement of net cost. However, the cost of providing this information is not warranted since heritage assets are more difficult to value than items that would typically be included in general PP&E.

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 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

[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.

[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.

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.

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

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.

RECOGNITION

79. A line item for "deferred maintenance amounts"[59] shall be presented on the statement of net cost with a note reference in lieu of a dollar amount.[60] No amounts shall be recognized for deferred maintenance.

DISCLOSURE REQUIREMENTS

Measurement

80. Amounts disclosed for deferred maintenance may be measured using:

- condition assessment surveys, or
- 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 deficiencies. It is desirable that condition assessment surveys be based on generally accepted methods and

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[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] This requirement applies to all four categories of PP&E.

[60] If management determines that there are no material amounts of deferred maintenance, this line item need not appear.

[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.

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:
  - 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

[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.

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 Disclosures

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 disclose critical and noncritical amounts, the disclosure shall include management's definition of these categories.

The provisions of this statement need not be applied to immaterial items.

[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.

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.

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.

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:

[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.

- 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:

- 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.

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[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.

[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 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.

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
- 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

[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.

[72]The term "stewardship PP&E" is used to refer collectively to federal mission PP&E, heritage assets, and stewardship land.

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 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 starting at paragraph 171, 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

[73] *Objectives*, paragraph 54.

Federal mission PP&E. The Board articulated 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.

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.

[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.

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

[75]Internally-developed software may be a component of general PP&E or stewardship PP&E.

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 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.

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[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.

147. The Board provided for the recognition of land .ights 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 22). 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.

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.

[77]FASAB Exposure Draft, *Accounting for Property, Plant, and Equipment*, February 28, 1995, page 19, paragraph 71, Item IC.

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.

[78] U.S. Advisory Commission on Intergovernmental Relations, High Performance Public Works: A New Federal Infrastructure Investment Strategy for America, November 1993.

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 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.

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.

[79]These agencies are the Department of Energy, the Department of the Navy, and the National Aeronautics and Space Administration.

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.

[80]FASAB, Recommended Accounting Standard No. 5, *Accounting for Liabilities*, September 1995.

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.

Cleanuop 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

ILLUSTRATION 1A: COAST GUARD PP&E

202. The Coast Guard has unique duties as both a peacetime operating agency and one of the military services. Its mission includes:

- public safety,
- law enforcement, and
- service in the event of conflict, national emergency, or natural and man-made disasters.

203. The Coast Guard uses vessels and aircraft in its operations. Vessels include buoy tenders, buoy boats, and lifeboats. This is general PP&E rather than Federal mission PP&E. The cost of PP&E used in providing general government services (e.g., law enforcement) is relevant for assessing operating performance on a period-by-period basis since PP&E is used routinely in providing these services. The Coast Guard's accomplishments are linked to the inputs available to it (e.g., PP&E) and associating the cost of inputs with accomplishments or outputs is useful for assessing operating performance.

ILLUSTRATION 1B: SPACE EXPLORATION EQUIPMENT

204. The application of the Federal mission PP&E characteristics to NASA's space shuttles is illustrated in this section. Of the three characteristics related to the use of the PP&E, the shuttle only meets the third--that is, it was specifically developed for use in a program for which there is no other program or entity using similar PP&E with which to compare costs.

205. Of the characteristics related to useful life, the shuttle meets the first--that is, it has an indeterminate or unpredictable useful life. A shuttle was first flown in 1981. Since that first flight, the fleet has completed 68 missions. Several factors would influence estimates of shuttles' useful lives:

- following the Challenger accident, the fleet was grounded for 32 months with some predicting that another similar accident could end the shuttle program,
- current schedules call for seven flights in 1996 but the space station project would require more frequent space shuttle flights in the future, and
- the possible development of a replacement vehicle which may be available by 2010.

206. Given the uncertainties and variables in estimating a useful life, it would be difficult, and not very meaningful, to assign the shuttle's acquisition cost to the shuttle's output--for example, flights. In the event that charges are made to users, NASA may wish to develop depreciation information for internal use only in setting prices. However, there is no broad need for depreciation information related to use of the shuttle.

207. Another example of space exploration equipment involves equipment that is used once and never recovered. The spacecraft *Magellan* was launched by a space shuttle in 1989 and is expected to burn up in the atmosphere around Venus. During the flight to Venus, the Magellan's signal was lost and recovered five times. In addition, many technical problems endangered the mission. However, in 1990, the Magellan reached Venus and began transmitting data back to NASA. Research based on this data is expected to continue for years following the life of the spacecraft. In contrast, the Mars Observer space probe disappeared during its approach to Mars and never reappeared.

208. Given the uncertainties involved in space exploration and the timing of any benefits, it is not useful to capitalize and depreciate space exploration equipment.

ILLUSTRATION 1C:
LAW ENFORCEMENT EQUIPMENT

209. A respondent to the ED *Accounting for Property, Plant, and Equipment*, questioned whether vehicles used in law enforcement activities qualified as Federal mission PP&E. It was noted that vehicles used for law enforcement purposes may have an abbreviated life expectancy. In addition, these vehicles may be modified for law enforcement uses.

210. However, in applying the two types of characteristics to these items of PP&E, one finds that they do not exhibit one characteristic from each category. The characteristics are repeated below for convenience.

211. Characteristics related to the use of the 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.

212. Characteristics related to the useful life are that it:

- has an indeterminate or unpredictable useful life[81] due to the unusual manner in which it is used, improved, retired, modified, or maintained, and
- is at a very high risk of being destroyed during use or premature obsolescence.

213. Vehicles used in law enforcement programs do not exhibit any of the three characteristics in the first group since (1) the basic vehicle can be used by other entities in other activities, (2) it is used routinely in operations rather than being held in anticipation of use, and (3) other entities, primarily state and local governments, have law enforcement activities and use similar vehicles. With regard to the second group of characteristics, the useful life may be abbreviated due to the manner in which it is used but it should nevertheless be predictable based on past experience with similar use. While it is possible that the vehicles are at somewhat greater risk of being destroyed than other vehicles, it is a matter of judgment whether this qualifies as very high risk. Overall, it is apparent that these items do not possess one characteristics from each group and do not qualify as Federal mission PP&E.

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 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.

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[81]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.

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 the footnote disclosures in 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

Note 4. 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 facilities
- 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	NONCRITICAL
Buildings	Condition Assessment Survey	4	$100,000-125,000	$75,000-	$25,000-50,000
Communication Eqp/Systems	Condition Assessment Survey	4.5	$10,000-15,000	$2,000	$8,000-13,000
Laboratory Eqp	Condition Assessment Survey	5	$500,000-550,000	$300,000	$200,000-250,000
Heating & Air Cond. Eqp.	Condition Assessment Survey	5	$40,000-42,000	$5,000	$35,000-37,000

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, 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

<u>Operating Assumptions</u>

239. The hazardous waste disposal site will begin accepting waste in 1995. The

[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.

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
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:

[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.

(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

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:

[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.

(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.

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:

[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.

$(a \times b/c) - d = e$
$(\$5,605 \times 35,000/100,000) - (\$1,110 + 759)$
$\$5,605 \times .35 - \$1,869 = e$
$\$1,962 - \$1,869 = e$
$\$\ \ 93 = e$

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:

$f = (a \times b_1/c) - d$
$f = (\$5,605 \times 25,000/100,000) - (\$1,110 + 759)$
$f = \$5,605 \times .25 - \$1,869$
$f = \$1,401 - \$1,869$
$f = \$(\ 468)$

where:
a = total cleanup cost estimated as of end of period
b_1 = cumulative capacity used at beginning of period[91]
c = total estimated capacity[92]

[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.

[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.

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.

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

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 begining after September 30, 1997.
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 fofeited 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 asssets, revaluations)
Volume II References:	Appropriations (A40), Dedicated Collections (D10), Donations (D50), Exchange Revenues (E60), Fines and Penalties (F30), Imputed Financing (I20), Nonexchange Revenue (N40), Prior Period Adjustments (P40), Reconciling Budgetary and Financial Accounting (R60), Revaluations(R30), Sale of Assets (S20), Seized and Forfeited Property (S40), Taxes and Duties (T20), Transfers of Assets (T40)
Interpretations:	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*

Affects: Paragraph 36(b) amends SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, by providing an exception to the general principles for losses on goods made to order or services produced to order.
Paragraph 53 amends SFFAS No. 1, *Accounting for Selected Assets and Liabilities*, Paragraph 41.
Designated material in Paragraphs 90 through 102 amend SFFAC No. 2, *Entity and Display*.
Paragraphs 264-269 amends SFFAS No. 3, *Accounting for Inventory and Related Property*, Paragraph 76.

Affected by: No other statements.

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]

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., "unexpended 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:

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[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.

- 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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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 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]

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[2]Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*.

[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.

19. Information about the net cost of exchange transactions serves other purposes as well. Net cost gives one indication of the extent to which 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), 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

[4] See discussion of social insurance programs in FASAB's Exposure Draft, *Supplementary Stewardship Reporting*.

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.

<u>RECOGNITION AND MEASUREMENT OF EXCHANGE REVENUE</u>

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]

(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 pay the established or negotiated price), an expense should be recognized and the allowance for bad debts

[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 46 (d) below.

[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.

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 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.

A. 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.

[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.

B. If the collecting entity transfers the exchange revenue to other entities, simila. 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.

c. 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 forgone. If a reasonable estimate is practicable to make, the entity should provide as other accompanying information the

[8]The pricing guidance in OMB Circular No. A-25 does not apply to prices set by law or executive order.

amount of revenue forgone 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 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 and 67) 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, 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

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[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.

[10]Customs refers to "compliance assessments" as protested assessment amounts.

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 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.

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[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 through 60.

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 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

[13] SFFAS No. 1, para. 44-51.

[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.

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 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 **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.

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.

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.

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]

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[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.

[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.

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 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]

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:

[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.

(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. 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.

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 84, 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.

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[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.

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 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. 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.

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 adjustments	(X)	
Donations not in the budget	X	
Financing imputed for cost subsidies	X	
Transfers-in (out)	X	
Exchange revenue not in the budget	(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 U.S. GOVT. GOVERNMENT	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 over- and under-funding of the trust funds (see para. 66, 67 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). As a result of further information from Customs following the exposure

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

draft, the Board added a supplementary information requirement for unasserted claims for refund (see para. 67. (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 (see para. 65 and 65).

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 and 69).

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]

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]

[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.

[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

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 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 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

attention on selected measures can have unintended--and sometimes undesired--consequences, etc.

[24]SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, para. 31-40.

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, 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

[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.

[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.

"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 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 debts may not always be needed, because full payment can often be assumed.

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[29] SFFAS No. 1, *Accounting for Selected Assets and Liabilities*, paragraphs 44-45 and 124-30.

[30] *Ibid.*, para. 44-51 and 131-133.

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 whole nor the other recipient entities recognize the natural resources as an asset and

[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.

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, compliance with these regulations is partial, and

[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

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 forgone 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 A-25 definition of full cost to be measured more accurately than has been

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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.

[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*.

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.

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

[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.

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

[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.

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 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 acccunts 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, 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

[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 in its disclosures required by para. 65.

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.[33]

189. Estimates of the tax gap by IRS have been made from time to time. Congress recently concluded not to authorize a current study[34] 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 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), other accompanying information is required or permitted under certain circumstances with respect to (a) the income tax burden (see para. 69), (b) tax expenditures (see para. 69), (c) directed flows of resources (see para. 69), and (d) revenue forgone 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.

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[33]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.

[34]The Tax Compliance Measurement Program (TCMP) planned for 1996.

Tax Expenditures

192. Tax expenditures are estimates of the revenue forgone 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 forgone 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.[35] 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.

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.

[35] Amounts appropriated to liquidate contract authority or repay debt are not available to incur new obligations and hence are not considered budget authority.

- 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.[36] The imputing process recognizes these costs in the net cost of operations of the responsible entity. 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.

[36] 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.

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.

TABLE OF TRANSACTIONS

TRANSACTIONS WITH THE PUBLIC

Nonexchange transactions with the public

242. Individual income taxes, corporation income taxes, social insurance taxes and contributions,[37] 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 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.[38] 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

[37] "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.

[38] See discussion of social insurance programs in FASAB, Exposure Draft, *Supplementary Stewardship Reporting* (August 1995).

compensation--they have virtually no legal option except to pay.

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.[39]--Federal employees may be covered by social insurance programs such as Social Security[40] 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 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

[39]"Social insurance" does not include programs established solely or primarily for Federal employees, such as pension and other retirement plans.

[40]Most Federal civilian employees hired before 1984 are not covered by Social Security.

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.[41] The collections are dedicated by 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.[42] 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.

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.[43] The Government does not give anything of value to the donor, and the donor receives only personal satisfaction. The donation

[41] 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.

[42] SFFAC No. 2, *Entity and Display*, para. 47.

[43] The term "donations" includes wills disposing of property and judicial proceedings other than forfeitures.

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.[44] 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 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

[44] SFFAS No.6, *Accounting for Property, Plant, and Equipment*, para. 61 and 71.

governments or is received in satisfaction of a previously recognized revenue (e.g., accrued tax receivables).[45]

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 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.[46]

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 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.

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[45]This amends SFFAS No. 3, *Accounting for Inventory and Related Property*, with respect to forfeitures related to satisfying tax liabilities.

[46]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.

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,[47] 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

[47] 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.

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 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[48] direct loans.[49]--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. 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.[50]

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 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).

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[48]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.

[49]For interest on pre-1992 direct loans, see the preceding section on "interest (unless classified elsewhere) . . ."

[50]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.

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.[51]--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 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.[52]

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[51]Federal employee retirement plans do not include social insurance, such as Social Security and Medicare.

[52]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.

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 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. <u>Sales of Government assets: other than property, plant, and equipment and forfeited and foreclosed property</u>.--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. <u>Sales of property, plant, and equipment</u>.-- The transaction is an exchange transaction, because each party receives and sacrifices something of value. If the sales price[53] 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.[54]

297. <u>Acquisition of property, plant, and equipment through exchange</u>.--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

[53]The sales price may include the fair value of items received in exchange.

[54]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.)

(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.[55] 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.[56]

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.[57]

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.

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.[58] Any difference between the book value loss (or gain) and the cost of modification is recognized as a gain or loss.[59]

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

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[55] See SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, para. 32.

[56] *Ibid.*, footnote 38.

[57] See SFFAS No. 3, *Accounting for Inventory and Related Property*, para. 79-91.

[58] 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.

[59] See SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees*, para. 53-55 and Appendix B, Part II(B).

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.[60]

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 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

[60]SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, para. 54.

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.[61]--Federal employees may be covered by social insurance programs such as Social Security[62] 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 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

[61]"Social insurance" does not include programs established solely or primarily for Federal employees, such as pension and other retirement plans.

[62]Most Federal civilian employees hired before 1984 are not covered by Social Security.

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.[63]

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.[64] 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.

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

[63]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.

[64]See SFFAS No. 6, *Accounting for Liabilities of the Federal Government*, para. 96 and para. 181, footnote 70.

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.[65]

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.[66] 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.[67] The imputed financing is necessary so that the imputed cost 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.[68]

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[65]See SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, para. 105-115.

[66]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.

[67]The employer entity's own contribution, if any, is generally financed by an appropriation but could be financed by earned revenue or other sources.

[68]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.

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.

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.[69]

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.[70]

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.

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

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[69]SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, para. 39.

[70]See SFFAS No. 3, *Accounting for Inventory and Related Property*, para. 29-30, 47-48, 54, 97, and 107.

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).[71]

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

[71] See SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, para. 32.

transferring entity.

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.[72]

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.[73] 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.[74]

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 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.[75]

365. Repayment of post-1991 direct loans.--The present value of estimated loan

[72]SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, para. 61 and 72.

[73]*Ibid*.

[74]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.

[75]The fee component of the subsidy cost is required to be disclosed separately.

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.[76]

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.[77]

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 cash inflow equal to book value is not recognized as a revenue, a gain, or an other financing source.[78]

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.[79] Any difference between the book value loss (or gain) and the cost of modification is recognized as a gain or loss.[80] 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.

[76]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.

[77]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.

[78]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.

[79]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.

[80]SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees*, para. 53-55 and Appendix B, Part II(B).

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 asset for another of equal recorded value and therefore is not recognized as a gain, a revenue, or an other financing source.[81]

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.

[81] 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.

INDEX OF TRANSACTIONS CLASSIFIED IN APPENDIX B

LIST OF ABBREVIATIONS

CFS--Consolidated Financial Statements
DL--Direct loan
FASAB--Federal Accounting Standards Advisory Board
FASB--Financial Accounting Standards Board
GAO--General Accounting Office
GASB--Governmental Accounting Standards Board
GL--Guaranteed loan
GPRA--Government Performance and Results Act
IRS--Internal Revenue Service
MMS--Minerals Management Service
OCS--Outer Continental Shelf
OMB--Office of Management and Budget
PP&E--Property, Plant, and Equipment
RSI--Required Supplementary Information
SEC--Securities and Exchange Commission
SFFAC--Statement of Federal Financial Accounting Concepts
SFFAS--Statement of Federal Financial Accounting Standards
SGL--Standard General Ledger

STATEMENT OF FEDERAL FINANCIAL ACCOUNTING STANDARDS NO. 8

Supplementary Stewardship Reporting

STATUS

Issued:	This statement was adopted by the principals on June 11, 1996 but has not yet been released due to a CFO Act requirement for Congressional review (see page 1 of the Preface).
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)
Volume II References:	Cleanup Cost (C40), Current Services Assessment (C80), Deferred Maintenance (D20), Federal Mission PP&E (F20), Heritage Assets (H20), Human Capital (H40), Land (L20), Nonfederal Physical Property (N60), Property, Plant, and Equipment (P60), Research and Development (R20)
Interpretations:	
Affects:	Paragraphs 116 and 117 defer consideration of social insurance until additional research is conducted which is a departure from the intent expressed in SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, paragraphs 6, 104, and 105.
Affected by:	No other statements.

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:

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.

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.

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.

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).

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Paragraphs 1-3 and 41-42 omitted.

CHAPTER 1: INTRODUCTION AND BACKGROUND

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) 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 Federal mission property, plant, and equipment (for example, space exploration and military weapons systems).

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.

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[4]Chapter 7 of the *Objectives of Federal Financial Reporting* provides a full discussion of financial position and financial condition.

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 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.

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;

[5] See SFFAC No. 1, pp. 41-42.

[6] Ibid., pp. 42-44.

- Property, plant, and equipment that are integral to meeting a unique Federal mission, referred to as Federal mission[7] property, plant, and equipment (PP&E), and

- 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

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[7]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 broadly labeled "Federal mission." The definition of this category, however, clarifies the characteristics of PP&E appropriately included in this category--a much narrower group than inferred by the category's title.

[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.

for the Government as a whole and will include both discretionary and mandatory programs and interest on debt.

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.

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.

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[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.

[11]See *Managerial Cost Accounting Concepts and Standards*, SFFAS No. 4, for a discussion of Federal cost accounting principles and standards.

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, 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.

APPLICABILITY

38. This standard requires that the consolidated financial reports[12] of the Federal Government and the financial reports[12] of its component units contain RSSI relating to:

- 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, and Federal mission 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

[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.

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.

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 cost shall include all costs incurred to bring the heritage asset to its current condition and location.

MULTI-USE HERITAGE ASSETS

48. 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. The cost of renovating, improving, or reconstructing operating components of heritage assets used in Government operations shall be included in general PP&E. The renovation, improvement, or reconstruction costs to facilitate Government operations (for example, installation of communication 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.

49. Costs of renovating or reconstructing the heritage asset that cannot be associated directly with operations shall be considered heritage asset costs and included as expense in calculating net costs.

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.

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[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.

- Condition[14] of the assets unless it is already reported in a note to the financial statements in which case a reference to the note will suffice.

- A reference to a note to the financial statements if deferred maintenance is reported for the assets.[15]

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.

[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.

CHAPTER 3: FEDERAL MISSION PP&E

Federal Mission Property, Plant, and Equipment

Federal mission property, plant, and equipment (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. Federal mission PP&E shall be valued and reported using either the total cost or the latest acquisition cost valuation method.

DEFINITION

52. Federal mission PP&E includes items used to meet a Federal Government mission in which the specific PP&E used is an integral part of the output of the mission.[16] PP&E should be considered Federal mission PP&E if it possesses at least one of each of the two types of characteristics presented below. One type of characteristic relates to the use of Federal mission PP&E, and the other relates to its useful life.

53. Characteristics related to the use of the 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 nonfederal) using similar PP&E with which to compare costs.

54. Characteristics related to the useful life are that it

- has an indeterminate or an unpredictable useful life[17] because of the unusual 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.

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[16] The name "Federal mission PP&E" may cause readers to erroneously assume that this category should include any PP&E supporting a Federal mission. Federal mission PP&E is limited to those items specifically identified herein as well as any other items exhibiting at least one characteristic from each of the two groups listed.

[17] 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.

55. Federal mission PP&E excludes land whether the land is general PP&E land or stewardship land.

56. Federal mission PP&E, however, specifically includes (1) weapons systems PP&E (for example, fighter or attack aircraft, submarines, and tracked combat vehicles) and (2) space exploration equipment (for example, space hardware and launch, tracking, and recovery facilities). Weapons systems and space exploration equipment are defined in the following paragraphs.

57. **Weapons Systems.** Weapons systems are a combination of one or more weapons[18] with all related equipment, materials, services, personnel, and means of delivery and deployment required for self-sufficiency.[19] This standard addresses only the PP&E component of weapons systems. PP&E included in weapons systems are distinguished from general property, plant, and equipment held by defense agencies and defense support agencies in that they are intended to be used directly by the armed forces to carry out combat missions, when necessary, and to train in peacetime.

58. Weapons systems include only those assets owned by defense agencies and defense support agencies that would otherwise meet the property, plant, and equipment definition. Items meeting other than the PP&E asset category definitions are excluded from Federal mission PP&E, such as items of inventory or operating materials and supplies.

59. **Space Exploration Equipment.** Space exploration equipment includes

- items that are intended to operate above the atmosphere for space exploration purposes, and

- any specially designed equipment to aid, service, or operate other equipment engaged in exploring space.

MEASUREMENT

60. Federal mission 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.

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[18] Weapons are instruments of combat used to destroy, injure, defeat or threaten an enemy. (adapted from *Dictionary of Weapons and Military Terms*)

[19] Joint Chiefs of Staff, *Department of Defense Dictionary of Military and Associated Terms*, Joint Publication 1-02, March 23, 1994.

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 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 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.

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[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.

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 program or category level; individual transactions, unless significant, need not be reported.
- Condition[21] of the assets unless it is already reported in a note to the financial statements in which case a reference to the note will suffice.
- A reference to the applicable note to the financial statements if deferred maintenance is reported for the assets.

IMPLEMENTATION GUIDANCE

69. For guidance on Federal mission 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.

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[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.

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.

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.

[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.

[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.

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.

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 byproduct 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.

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[25] A will or clause of a will disposing of property.

- Where parcels of stewardship land have more than one use, the predominant use of the land shall be considered the major use. 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.

- A reference to the note to the financial statements if deferred maintenance is reported for the assets.[27]

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.

[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.

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.

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.

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[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.

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 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.

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[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.

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

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[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.

outcomes for the programs for which the 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 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.

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[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.

- 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]

[35] See OMB Circular A-11, section 44.

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.

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 example, statistics on scientific and engineering personnel, graduate students and degree recipients by field and sector).[39]

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[36] See *Managerial Cost Accounting Concepts and Standards*, SFFAS No. 4, for a full discussion of Federal cost accounting principles and standards.

[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.

[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).

- "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 Research* - 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.

- 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

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[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.

MINIMUM REPORTING

Governmentwide Report of the Federal Government

105. The CSA shall present flow data as described in the two preceding paragraphs for inclusion in the consolidated financial report of the US Government.

106. Preparers of financial reports are encouraged to experiment with the presentation of the CSA data in order to make it more understandable.

107. In some cases, summary data will be more effective than detailed data. There may be situations, too, where graphic presentations will be more effective than tabular presentations.

Reporting Entities of the Federal Government

108. None.

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.

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

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 (in Millions of Dollars):

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 ANNUAL STEWARDSHIP INFORMATION

Federal mission property, plant, and equipment (PP&E) comprise certain PP&E that possess at least one of each of the two types of the following characteristics relating to the use of the property and its useful life. Characteristics related to use are that it: has no expected nongovernmental alternative use; is held for use in the event of an emergency, a war, or a natural disaster; or, is used in a program for which there is no other comparable program (Federal or nonfederal) using similar PP&E. Characteristics related to useful life are that it: has an indeterminate or an unpredictable useful life because of the unusual 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. Generally accepted government accounting standards specifically recognize weapons systems and space exploration facilities and equipment as Federal mission PP&E.

At this time, only weapons systems and space exploration equipment have been identified as Federal mission PP&E for this entity.

In the display that follows, items included under the caption "weapons systems" are valued at the most recent acquisition cost of a comparable item. Those under the caption "space exploration" are valued using the specific identification method, that is, the specific cost of each unit of PP&E is attributed to that unit. In each category, cost includes all costs to put the item in usable condition for its intended purpose including, among others, transportation, assembly, and inspection costs.

The value of land associated with the facilities included among Federal mission PP&E is not included in the display that follows. Land date are included in a separate section of this information entitled "Stewardship Land."

Virtually all items of Federal mission PP&E are useable for their intended purposes at September 30, 199Z. In some cases, however, scheduled maintenance has been deferred. On the basis of engineering estimates, the estimated cost of deferred maintenance ranges from $ 200 to $ 300 million in 199Z and $175 to $275 million in 199Y. Costs to complete critical maintenance, that is, maintenance that, if not performed, could lead to irreparable damage to the PP&E or to its unusability, range from $ 120 to $ 150 million.

On the following page is a summary of changes in Federal mission PP&E for the fiscal years ended September 30, 199Z.

FEDERAL MISSION PROPERTY, PLANT, AND EQUIPMENT SUMMARY[f]

Annual Stewardship Information[g]

For the Fiscal Year Ended September 30, 199Z

(in Billions of Dollars)

	Balance 9/30/9Y	Revaluation Adjustment	Deletions	Additions[h]	Balance 9/30/9Z
Weapons Systems (at latest invoice price)					
Aircraft:					
Fighters and Attack Aircraft	$ 67.7	1.5	4.5	9.4	$ 74.1
Bombers	47.7	1.0	3.0	4.7	50.4
Helicopters	22.2	.5	.5	3.3	25.5
Transport	14.6	0	0	0	14.6
Total	$152.2	3.0	8.0	17.4	$ 164.6
Vessels:					
Surface Combat Vessels	$ 138.0	4.2	2.0	4.5	$ 144.7
Submarines	108.2	2.2	2.0	2.5	110.9
Transport	50.3	0	0	0	50.3
Total	$ 296.5	6.4	4.0	7.0	$ 305.9
Ground Warfare Vehicles:					
Tanks and Combat Vehicles	$ 81.8	1.7	1.0	2.3	$ 84.8
Transport	$ 40.5	0	0	0	40.5
Total	$ 122.3	1.7	1.0	2.3	$ 125.3
Grand Total	$ 571.0	11.1	13.0	26.7	$ 595.8
Space Exploration (at cost, on a historical basis)					
Space Hardware	$ 8.7	N/A	.5	1.1	$ 9.3
Facilities[i]	$ 4.8	N/A	0	0	4.8
Tooling and Test Equipment	$ 7.8	N/A	.4	1.7	8.1
Total	$ 21.3	N/A	.9	1.8	$ 22.2

[f]See accompanying notes to the financial statements for the reporting of condition of these items.

[g]This display summarizes information from a variety of sources, including a prototype consolidated financial statement for the US and annual reports that contained information covering the categories of Federal mission PP&E (columns 1 and 5); and hypothetical amounts for revaluation adjustments (column 2); and deletions and additions (columns 3 and 4).

[h]Included as expense in calculating net cost.

[i]Facilities include tracking, launching, and training facilities.

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 useable 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

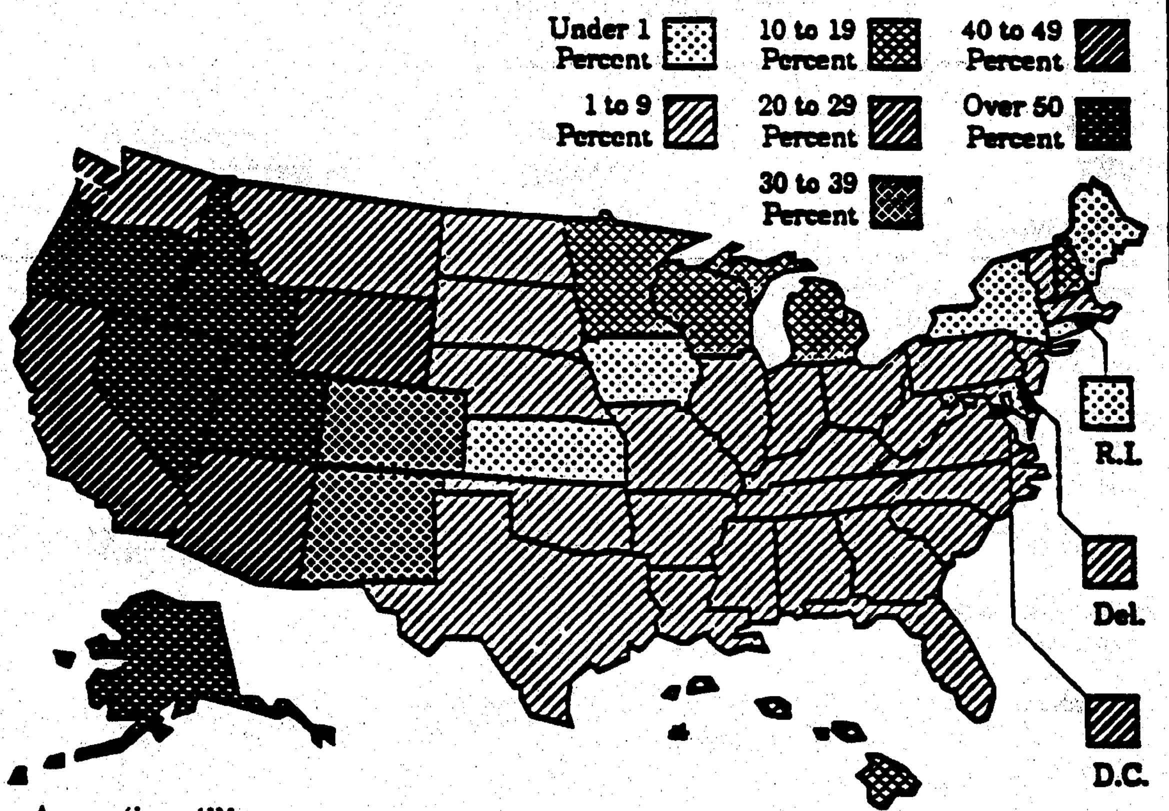
Major Uses of Land by Holding Agency[k]
(Within the 50 States)

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 millions)

Area/State	*Federally Owned*	*Area/State Acreage*	Percent Federally Owned
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:
(in billions of dollars)

	199V	199W	199X	199Y	199Z[a]
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[b]	2.2	2.3	2.4	2.5	2.7
Total	$ 29.8	$ 30.6	$ 30.8	$ 33.8	$ 36.2

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.

[a]Included as expenses in calculating net cost.

[b]Expenses of administration include an appropriate allocation of agency overhead costs.

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[e], for the 5 fiscal years ending September 30, 199V through 199Z:

Program: Transition Training for Former Navy Contractor Personnel

	199V	199W	199X	199Y	199Z[f]
Program Expenses($000s)[g]					
Counseling	$ 373	$ 508	$ 740	$ 980	1,053
Education	786	2,381	3,860	5,621	7,053
Administration[h]	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

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[e] This hypothetical program is for illustration only.

[f] Included as expenses in calculating net cost.

[g] Expenses are reported on an accrual basis, including contractual amounts due for counseling services delivered and educational costs incurred by participants.

[h] Expenses of administration include an appropriate allocation of agency overhead costs.

HUMAN CAPITAL SAMPLE REPORT (continued)

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[a] for the 5 fiscal years ending September 30, 199V through 199Z:

Program: Ceramic Materials Research Program

	199V	199W	199X	199Y	199Z[t]
Program Expenses($millions)[u]					
Basic Research	$ 106	$ 124	$ 136	$ 132	$ 143
Applied Research	93	101	107	118	121
Development[v]	46	62	73	68	82
Administration	14	16	17	19	21
Total	$ 259	$ 303	$ 333	$ 337	$ 367

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 from funded R&D	3	8	14	18	21
Rights to Inventions from funded R&D[w]	0	1	0	3	2

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[a]This hypothetical program is for illustration only.

[t]Included as expenses in calculating net cost.

[u]Expenses are reported on an accrual basis and include an allocation of overhead costs.

[v]Development grants are for a fixed amount, not to exceed 50 percent of the cost of the project.

[w]Indicates inventions financed with Federal funds to which the government has patent rights, in accordance with the Bayh-Dole Act.

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 A
INDEX

This index provides references to the topic in (1) this Volume, (2) the original statements, and (3) Volume 2. References to the original statements are organized as follows: The first character indicates that it is a Concepts Statement (C) or a Standards Statement (S). 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.

-B-

-C-

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-X-

-Y-

-Z-

APPENDIX B: EFFECTIVE DATES OF STATEMENTS

Statement:	Effective for Fiscal Periods Ending After:
1 - *Accounting for Selected Assets and Liabilities*	9/30/93
2 - *Accounting for Direct Loans and Loan Guarantees*	9/30/93
3 - *Accounting for Inventory and Related Property*	9/30/93
4 - *Managerial Cost Accounting Standards*	9/30/96
5 - *Accounting for Liabilities of the Federal Government*	9/30/96
6 - *Accounting for Property, Plant, and Equipment*	9/30/97
7 - *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*	9/30/97
8 - *Supplementary Stewardship Reporting*	9/30/97

APPENDIX C: LISTING OF INTERPRETATIONS ISSUED BY OMB

Number:	Title:	Related to Statements:
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	7
2	Accounting for Treasury Judgment Fund Transactions	4 and 5

APPENDIX D: LISTING OF TOPICS NOT YET ADDRESSED

This listing is intended to highlight for users those major topics that have not yet been addressed specifically in Statements of Federal Financial Accounting Standards (SFFAS). In addition, other resources within the hierarchy of accounting literature are identified to aid users in accounting for these items. This is not intended to imply that the Board will choose to address each of these topics or that these are the only topics that could be addressed.

The resource titles listed below are abbreviated. A list of abbreviations follows the resource list. References to "Title 2" are to the General Accounting Office's (GAO) Policy and Procedures Manual for Guidance of Federal Agencies, Title 2, Appendix I, *Accounting Principles and Standards* dated August 1987. While GAO has not yet updated Title 2 to incorporate SFFASs, However, it remains a useful resource in areas not yet addressed in SFFASs.

Topic:	**Other Resources:**
Accounting changes:	
Changes in estimate	
Changes in reporting entity	APB 20
Asset definition	FASAB Consolidated Glossary (Appendix E)
Capital leases (where government is the lessor)	Title 2, L10; FAS No. 13; OMB Form & Content
Capital leases, disclosure requirements	FAS No. 13; OMB Form & Content
Compensated absences	Title 2, C30; FAS No. 43
Consolidated Financial Statements	Title 2, C40; ARB 51
Deposit funds	Title 2, F40
Debt, disclosure requirements	OMB Form & Content
Excess or unused capacity cost	FAS 121
Fiduciary funds	Title 2, F40
Foreign currency translation	Title 2, F30; FAS 52
Grants & cooperative agreements	Title 2, G10
Imputed interest (cost of capital)	Title 2, I10; APB 21; NAA Statements on Management Accounting Nos. 4A & 4H; FASAB Invitation for Views (July 1996)
Internal controls (reporting on...)	Title 2, Appendix 2; OMB Circ A-123; COSO Report - "Internal Control - Integrated Framework"

Investments in marketable and market-based securities (other than (1) marketable and market-based securities issued by Treasury & expected to be held to maturity or (2) securities held as assets of a pension or other retirement benefits plan)	Title 2, I40; FAS 12 & 107
Investments in "partnerships" with private sector entities (joint ventures)	APB 18
Intangible assets & amortization	APB 17
Long-term Contracts for the Purchase of Property, Plant, & Equipment (Percentage of Completion Method)	Title 2, L40.04
Management discussion & analysis	OMB Form & Content (Overview Section); SEC Regulatioin S-K, Item 303
Natural resources	FAS 89 (Mineral Resources)
Operating leases (disclosure requirements)	Title 2, L10; FAS 13
Precious metals	ARB 43, Ch 4
Regulatory accounting	Title 2, R20; FAS 71, 90, 92, & 101
Research & development; accounting other than Supplementary Stewardship Reporting	Title 2, R40; FAS 2
Reversionary interests in property	Title 2, P40 & E20.05
Risk exposure (e.g., GSEs, derivatives)	AICPA SOP 94-6; FAS 52, 80, 105, 107, 115, 199
Social insurance	Title 2, E10
Software development costs *(other than internally developed)*	FAS 86; FIN 6
Specialized industry accounting (e.g., hospitals)	FASB Current Text
Unrecoverable costs (e.g., revolving funds with overvalued assets)	FAS 121
Unusual & infrequent items	Title 2, U30; APB 30

Abbreviations

AICPA	American Institute of Certified Public Accountants
APB	Accounting Principles Board
ARB	Accounting Research Bulletin
COSO	Committee of Sponsoring Organizations of the Treadway Commission
FAS	Financial Accounting Standard
FASB	Financial Accounting Standards Board
FASAB	Federal Accounting Standards Advisory Board
FIN	FASB Interpertation
Form & Content	OMB Bulletin 97-01, issued October 16, 1996
GAO	General Accounting Office
NAA	National Association of Accountants
OMB	Office of Management and Budget
SEC	Securities and Exchange Commission
SFFAC	Statement of Federal Financial Accounting Concepts
SFFAS	Statement of Federal Financial Accounting Standards
SOP	Statement of Position

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.

ABATEMENT - A reduction or cancellation of an assessed tax. (Cooper W, Ijiri Y, *Kohler's Dictionary for Accountants*, 6th ed., Englewood Cliffs, NJ: Prentice-Hall, 1983; hereinafter referred to as *Kohler's Dictionary for Accountants*)

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.

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.). (Adapted from *Webster's Ninth New Collegiate Dictionary* and *Kohler's Dictionary for Accountants*)

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)

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 - 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)

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. (*Kohler's Dictionary for Accountants*).

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 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*, and *Kohler's Dictionary for Accountants*.)

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*]

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.

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.

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 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*.)

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. (*Kohler's Dictionary for Accountants*)

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.

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. (*Kohler's Dictionary* *for Accountants*)

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.

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*)

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. (*Kohler's Dictionary for Accountants*)

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. (*Kohler's Dictionary for Accountants*)

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.

CREDIT PROGRAM - For the purpose of this Statement, 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 - An agency which takes possession of seized and/or forfeited property.

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. (*Kohler's Dictionary for Accountants*)

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.

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 MISSION PROPERTY, PLANT, & EQUIPMENT (PP&E) - Items used to meet a Federal Government mission in which the specific PP&E used is an integral part of the output of the mission. (See SFFAS 6 and 8 for more complete definition and discussion of Federal Mission PP&E.)

FEDERAL ENTITIES (UNITS, COMPONENTS) - See entity.

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*.)

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.

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.

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. (*Kohler's Dictionary for Accountants*)

HUMAN CAPITAL - Expenses incurred for education and training programs financed by the Federal Government for the benefit of th. public and designed to increase or maintain national economic productive capacity.

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.

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 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. (*Kohler's Dictionary for Accountants*)

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. (*Kohler's Dictionary for Accountants*)

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.

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. (*Kohler's Dictionary for Accountants*)

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. (*Kohler's Dictionary for Accountants*)

MAINTENANCE - The act of keeping fixed assets in useable 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.

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.

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 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. (*Kohler's Dictionary for Accountants*)

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. (Adapted from *Kohler's Dictionary for Accountants*)

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)

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.)

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 net cash outflows of loan guarantees estimated at the time of modification under the post-modification terms, discounted at the current discount rate. *[Special Term from SFFAS 2]*

POST-MODIFICATION VALUE - The present value of net cash inflows of direct loans estimated at the time of modification under the post-modification terms, discounted at the current discount rate. *[Special Term from SFFAS 2]*

PRE-MODIFICATION VALUE - The present value of net cash inflows of direct loans estimated at the time of modification under pre-modification terms, discounted at the current discount rate. *[Special Term from SFFAS 2]*

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]*

PRE-MODIFICATION LIABILITY - The present value of net cash outflows of loan guarantees estimated at the time of modification under the pre-modification terms, discounted at the current discount rate. *[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.)

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)

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.

REAPPROPRIATION - Enacted legislation that continues the availability of unexpended funds that expired or would otherwise expire. (JFMIP Standardization Project)

RECOGNITION (OR RECOGNIZE) - The term recognition, as used in this Statement, 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. (*Kohler's Dictionary for Accountants*)

RECORD - To give expression to a transaction on (or in) the books of account; to enter. (*Kohler's Dictionary for Accountants*)

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. (*Rosenberg's Dictionary*)

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 STEWARDSHIP INFORMATION (RSSI) - 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. (*Kohler's Dictionary for Accountants*)

SERVICE - An intangible product or task rendered directly to a customer.

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).

SPACE EXPLORATION EQUIPMENT - Items that are intended to operate above the atmosphere to explore space and any specially designed equipment to aid, service or operate other equipment engaged in exploring space.

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.

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. (*Kohler's* Dictionary) 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 forgone 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 non-compliance with existing laws and regulations.

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. (*Kohler's Dictionary for Accountants*)

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*)

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 (OMB, *Budget System and Concepts*).

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*)

UNCONTROLLABLE COST - The cost over which a responsible manager has no influence.

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. (*Kohler's Dictionary for Accountants*)

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. (*Kohler's Dictionary for Accountants*)

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. (*Kohler's Dictionary for Accountants*)

WEAPONS - Instruments of combat used to destroy, injure, defeat or threaten an enemy. (adapted from *Dictionary of Weapons and Military Terms*)

WEAPONS SYSTEMS - A combination of one or more weapons with all related equipment, materials, services, personnel and means of delivery and deployment required for self-sufficiency. (Joint Chiefs of Staff, *Department of Defense Dictionary of Military and Associated Terms*, Joint Publication 1-02, Mar. 23, 1994.)

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. [Special Term from SFFAS 3]

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*)

WRITE-OFF - An action to remove an amount from an entity's assets or financial resources. 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*)

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