



August 11, 2011

Memorandum

To: Members of the Board

From: Melissa L. Loughan, Assistant Director

Wendy M. Payne

Through: Wendy M. Payne, Executive Director

Subj: Federal Entity- **Tab B2-Federal Entity**-(2nd Distribution --Component Entity)¹

MEETING OBJECTIVES

- To approve an approach to the component entity phase of the federal entity project.

The primary objective for Tab B2 Federal Entity for the August Board meeting is to review options and approve the approach to the component entity phase of the federal entity project. Staff recommends the overall framework for the component entity standards should be the same and generally consistent with what has been established for the government-wide (principles for inclusion in the component entity and consolidation) and staff proposed questions are included on pages 8 and 9.

BRIEFING MATERIAL

- ***Staff Issue Paper (beginning at page 3 of this memo)***

You may electronically access all of the briefing material at <http://www.fasab.gov/board-activities/meeting/briefing-materials/> .

¹ The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

BACKGROUND

The Board has focused its deliberations on the government-wide entity. The next phase of the federal entity project is the component entity phase. In April 2010, the Board agreed that both the government-wide and component entity would be addressed in one standard because:

- Similar topics are addressed in one document.
- Issuing the government-wide entity without addressing component entities may result in continued questions.
- More timely to address both in one document--one due process to deal with the topic in its entirety (one public hearing)
- Risk of reversing or contradicting a conclusion reached during the government-wide deliberation when the Board deliberates the component entity document separately.

Certain members also noted that the readership on the government-wide document would not be as large as the component level document, so it was important to package them together since most interest is actually in the component reporting entity.

NEXT STEPS

After receiving the Board's feedback, staff will draft the component entity draft standards.

MEMBER FEEDBACK

If you require additional information or wish to suggest another alternative not considered in the staff proposal, please contact staff as soon as possible. In most cases, staff would be able to respond to your request for information and prepare to discuss your suggestions with the Board, as needed, in advance of the meeting. If you have any questions or comments prior to the meeting, please contact me by telephone at 202-512-5976 or by e-mail at loughanm@fasab.gov with a cc to paynew@fasab.gov.

Staff Issue Paper August 2011 Board Meeting Component Reporting Entity

This paper moves on to the next phase of the federal entity project-- component entity reporting. By determining key decisions, this will enable staff to establish the objective in setting boundaries for component entities and determine the level of detail and/or how the component entity standards may differ from the government-wide reporting entity standards.

The following definitions are in the Draft ED:

Government-wide Reporting Entity The government-wide reporting entity includes all organizations for which the Congress and the President are accountable based on principles established in this Statement.

Component Reporting Entity Component reporting entity is used broadly to refer to a reporting entity within a larger reporting entity² that issues GPFFR. Examples of component reporting entities include entities such as executive departments, legislative agencies, federal courts, independent agencies, and government corporations. Component reporting entities would also include sub-components (entities that are part of a larger component reporting entity) that prepare GPFFR. One example is a bureau of a larger department that prepares stand alone financial reports. Other examples include commercial functions, revolving funds, and/or other accounts for which GPFFR are prepared.

FASAB has often used the term “component entity” in documents to distinguish between the consolidated government-wide financial statements and financial statements of its components. The federal government as a whole is composed of organizations that manage resources and are responsible for operations, i.e., delivering services. These include major departments and independent agencies, which are generally divided into sub-organizations, or smaller organizational units with a wide variety of titles, including bureaus, administrations, agencies, and corporations.

Consideration of Existing Concepts and Standards

SFFAC 1, *Objectives of Federal Financial Reporting* and SFFAC 2, *Entity and Display* recognize that different users of financial reports may require data at different levels of aggregation. The Board contemplated if there should be a separate set of objectives of federal financial reporting for the component entity reports during deliberations of SFFAC 1. The Board determined that it might emphasize different sets of objectives depending upon the report and audience, but there wasn't a need for different objectives. As the Basis for Conclusions of SFFAC 1, states the following:

² The larger reporting entity could be the government-wide reporting entity or another component reporting entity.

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.

SFFAC 2, par. 56 discussed the different types of reporting entities, while pars. 75 – 76 built upon this notion and discussed the importance of component reporting entities:

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.

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.

The information for the individual components could be provided with separate columns in consolidating financial statements (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., tax collection activity; maintains large and complex fund flow activity; has earmarked tax activity; or its financial viability is of special concern to the Executive Branch or the Congress, e.g., deposit insurance funds. In those situations, it may be desirable for the sub-organization to prepare and issue a separate financial statement that is consistent with the concepts presented in this concepts statement. In doing so, it would need to identify the parent entity and describe the sub-organization's relationship to the parent.

Staff notes the Board also deliberated the Entity Concept and the notion of component entities in SFFAC 5, *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements*. Specifically, par. 10 - 16 (see Appendix 1 for excerpt containing par. 10-16 of SFFAC 5) describes that:

- An item that meets the definition of an element of the federal government is also an element of a component entity
- When determining which component entity should report an item, it should be the component entity responsible and accountable for receiving, controlling, managing, and utilizing government assets or incurring liabilities on behalf of the government because the component entity has such a comprehensive relationship, the assets and other elements involved should be reported by that component entity.
- When no component entity has a comprehensive relationship to a government program or activity, the assets and other elements involved should be reported by the component entity most responsible for managing them.
- Some items recognized in the financial statements of component entities are not recognized in the consolidated financial statements of the federal government because they do not meet definitions of elements from the perspective of the federal government.
- For a component entity, the terms “another entity” and “other entities” include other component entities of the government as well as entities external to the government.

Staff also notes a key notion was conveyed in the release of Technical Bulletin 2002-1: *Assigning to Component Entities Costs and Liabilities that Result from Legal Claims Against the Federal Government*. The Board explained the notion that all costs and liabilities included in the government-wide must first be attributed to a component entity. Specifically par. 9 stated:

9. All liabilities and costs must be attributed to the component entities responsible for the programs or activities that contributed to the claims or to their successor component entities. This attribution follows the general principle that all transactions or events reported on the consolidated statements should be attributed to some Federal component entity.

The Basis for Conclusions provided further explanation that the Board's position was that all costs and liabilities must be attributed to component entities; that is, entities other than the federal government as a whole-- all costs and liabilities must be reported at the component level before flowing into the consolidated statements. In general, the Board believed that the consolidated government-wide financial statement was a summation of component entity financial statements.

Another important consideration was the recent review by the Joint CFO Council-CIGIE examination of CFO Act of 1990 to identify lessons learned, or successes, implementing the CFO Act and reforms or improvements to the Federal financial management framework. While the final report is not yet available, several individuals who participated in the review have spoken publicly about the results. Based on their public remarks, staff has identified some relevant findings in the following paragraphs.

The review was required by the Improper Payments Elimination and Recovery Act of 2010. In performing the review, the council consulted with experts and stakeholders in government accounting and financial management and they are preparing a Report to Congress and GAO. The areas of consideration in the review included: Federal Financial Management, Financial Accountability and Reporting, Internal Controls, and Financial Systems.

The CFO Act of 1990 was one of the most significant, comprehensive pieces of Federal financial management legislation that brought many benefits and has served as one of the principal pieces of management reform legislation seeking to improve government accountability. As most are aware and the review confirmed, implementation over the years has increased transparency, fostered accountability, established a government-wide financial management leadership structure and agency CFOs, promoted new accounting and reporting standards, generated auditable financial statements, strengthened internal controls, improved financial management systems, and enhanced performance information. Various initiatives and efforts are ongoing and further progress is being made to fully realize the intent of the CFO Act.

There still appears to be a need for component level information that comes from the CFO Act. Participants in the review identified a continued focus on stakeholder needs and transparency reporting must be supported. Participants in the review found the public is taking a greater interest in the finances of the government and is increasingly concerned about how tax dollars are spent. Therefore, there is a greater interest and a need for increased transparency over spending data.

Staff Analysis

From FASAB's current pronouncements referenced above, previous Boards have concluded that the same objectives apply to both component reporting entities and that all costs and liabilities reported in the government-wide must be attributable to a component entity. In addition, there appeared to be a general notion and principle that

all costs and liabilities must be reported at the component level before flowing into the consolidated statements.

Component level reports serve multiple stakeholders-- including program managers; elected, appointed, and career officials in both the legislative and executive branches; the public; and other entities, such as the media, private companies, and public interest groups. Program managers require real-time data to make informed decision making; while elected officials require information that they can use to effect public policy and assist their constituents.

Providing standards at the component level would ensure consistent practice continues for component entities. Stakeholders have come to fully appreciate and rely on the statements. As the review by the Joint CFO Council-CIGIE found, this discipline has helped to ensure that the focus remains on improving the accounting and financial management systems.

Therefore, staff believes building upon this—stakeholders would benefit from FASAB providing detailed standards to ensure component entities' reports follow consistent standards for determining which organization should be included in the financial reports. This would allow the Congress and the President to hold management accountable for implementation of public policy decisions and show the risks inherent in agency operations and provide accountability. Stakeholders would want to understand the potential impact of these risks on future operations and programs.

When looking at the intent of the CFO act, it was directed at the agency and program level, or what one may consider a component entity. Today, with more robust financial management organization structures and complex entities that must be considered, an important question for the Board is how flexible the guidance can be for component entities (so long as the government-wide is complete).

The annual preparation and audit of agency (component) and government-wide financial statements have contributed to the evolution of reliable, timely, and useful financial information in the Federal government. Twenty-one of the 24 CFO Act agencies obtained unqualified or "clean" independent audit opinions on their fiscal year 2010 financial statements.

Therefore, preparers would benefit from FASAB providing detailed standards to ensure component entities' reports follow consistent standards for determining which organization should be included in the financial reports. Staff believes the overall framework for the component entity standards should be the same and generally consistent with what has been established for the government-wide.

The principles for defining what organizations should be included in the component entity reports should be consistent with those established for the government-wide. Principles and attributes established for core and non-core entities would generally be the same, but would have to be revised to fit the component entity *level* versus

government-wide. For example, the component entity core accountability would be with Top Level of Management or the Component Reporting Head (or equivalent) with a span or scope of accountability that includes organizations in the budget *instead of* “accountability that rests with President and Congress” as in the government-wide. In addition, non-core accountable entity disclosure requirements for presentation in component entity reports should be the same as those agreed upon as required in the government-wide. Naturally, based on materiality, the information presented in consolidated financial statements typically is aggregated and in less detail than in component entity financial statements. Therefore, when considering the entity reports it may mean that certain non-core accountable entities may meet materiality thresholds in component entity reports while not in the government-wide so that disclosures are more extensive in component entity reports.

An alternative to providing detailed standards would be to provide flexibility and allow component entities freedom to establish boundaries for organizations included in a report, as long as everything is included somewhere. This alternative would be used if the Board believes the boundaries of the components are not as critical as those for the government-wide. For example, the Board may believe that since core government entity components are not independent economic entities the designation of boundaries for components is an artificial construct. Taking that view, as long as you are clear what’s in the audited financial statements and the government-wide, one may not be concerned about where boundaries are drawn within the whole. This would be consistent with the view that the government-wide is the focus.

However, staff believes the proposed standard would be deficient if it didn’t clarify certain notions related to the boundary of the component entity reports such as-- is the report a complete accounting of organizations for which an appointed official is responsible. When considering it from a public policy perspective--stakeholders may want to view the financial information or monitor a program that was created to solve a public problem and there should be broad guidance on where the proper component would be to find that program or organization to review it.

Questions for the Board:

Does the Board agree the overall framework for the component entity standards should be the same and generally consistent with what has been established for the government-wide (that is, with necessary adaptations - principles for inclusion in the component entity would be budget, ownership or control, a means to identify core entities for consolidation and requirements to report related non-core entities through disclosures)?

Alternatively, does the Board believe there should be flexibility in boundaries of the components as long as all information is included in a component reporting entity at some point?

Options for the component entity standard: If the Board agrees with the staff recommendation above, there are potentially two options for accomplishing this, depending on the amount of detail the Board prefers.

- OPTION 1—Detailed standards for the component entity—would begin by rewriting and scrubbing the government-wide principles to make the necessary revisions or applicable changes so that it applied to the component entity level. This would result in making a much lengthier document; however staff believes it would be much clearer. As noted above, principles and attributes established for core and non-core entities would generally be the same, but would have to be revised to fit the component entity *level* versus government-wide scale. For example, the core entity accountability would be with Top Level of Management or the Component Reporting Head *instead of* “accountability that rests with President and Congress” as in the government-wide.
- OPTION 2—Provide a short statement indicating that the government-wide principles apply at the component level and focus on unique considerations at the component entity level. This section could note the differences that must be considered or applied at the component level and/or allow some flexibility in application. The principles established would be the same and not reworded to fit the component level. If necessary, additional guidance could come from the AAPC on application at the component level.

Staff believes Option 1 would provide the clearest principles for the component entities. Considering the component entities may have unique issues and circumstances, the preparer would benefit from clear standards that addressed the component level.

Question for the Board:

Does the Board agree with Option 1--providing detailed standards for the component entity level?

Appendix 1

SFFAC 5, Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements

10. All elements defined in this Statement are defined in relation to the U.S. Government (“federal government” or “government”). That is, an item that meets the relevant definition is an asset, liability, net position, revenue, or expense of the federal government. An item that meets the basic recognition criteria established in paragraph 5 and the additional considerations for recognition decisions referred to in paragraph 7 is recognized in the consolidated financial statements of the federal government, except when it is eliminated in the consolidation process, as discussed in paragraphs 14 and 15.

11. The federal government is composed of component entities that control, manage, or are otherwise accountable for the government’s assets and may be authorized to incur liabilities. Component entities include departments, independent agencies, and government corporations, as well as their agencies, bureaus, offices, administrations, corporations, and other organizational units. An item that meets the definition of an element of the federal government is also an element of a component entity. It is recognized in the component entity’s accrual-basis financial statements provided it meets the basic recognition criteria and the additional considerations for recognition decisions.

12. Sometimes a question may arise as to which component entity should report a particular item. Typically, a review of the authorizing legislation establishing a government program or activity, the appropriations act funding it, and related federal laws, regulations or other executive issuances clearly identifies one component entity as having a comprehensive relationship to the program or activity. That is, the component entity is responsible and accountable for receiving, controlling, managing, and utilizing government assets or incurring liabilities on behalf of the government in performing operations related to the program or activity. When a component entity has such a comprehensive relationship, the assets and other elements involved should be reported by that component entity.

13. When no component entity has a comprehensive relationship to a government program or activity, the assets and other elements involved should be reported by the component entity most responsible for managing them. For example, assume that two component entities support a single program to which neither has a comprehensive relationship. If one of the component entities has acquired and has some control over a government asset but the other component entity presently manages and utilizes the asset as part of its routine operations, the second component entity should report the asset. In other circumstances, a component entity’s management responsibilities may be limited to, for example, collecting monies owed to the federal government and depositing them in the U.S. Treasury. Although the component entity has no authority or responsibility to retain or use the monies collected, it should report the assets and other elements involved in the collection activity.

14. While items that meet the definition of an element from the perspective of the federal government are assigned to component entities, some items recognized in the accrual-basis financial statements of component entities are not recognized in the consolidated financial statements of the federal government because they do not meet definitions of elements from the perspective of the federal government. Instead, they are items that would meet element definitions from the component entity perspective and are treated as such by the component

entity. For example, component entities may exchange services for a fee and recognize the resulting intra-governmental assets, liabilities, and related elements in their financial statements. However, intra-governmental items offset each other when the government is viewed as a whole and are eliminated in preparing the government's consolidated financial statements.

15. Appropriations are another example of items reported in the accrual-basis financial statements of component entities but not in the consolidated financial statements of the federal government. For the component entities, appropriations are inflows of resources against which the component entity may incur obligations in support of authorized activities. Assuming an appropriation complies with the basic recognition criteria and additional considerations for recognition decisions, a component entity would recognize the appropriation as an increase in assets and revenues and would recognize the use of the appropriation as an increase in expenses and a decrease in fund balance with Treasury. However, from the perspective of the government as a whole, an appropriation is not a resource flow to the federal government or from the government to a component entity. Rather, it is a budgetary amount that constitutes legal authority for a component entity to incur obligations for specified purposes during specified time periods, and for the U.S. Treasury to liquidate the resulting obligations of the component entity. The actual liquidation will be from cash and other assets of the U.S. Treasury resulting from the inflow of resources from taxes and other financing sources. Therefore, appropriations recognized by component entities are eliminated in the process of consolidation and are not reported in the consolidated financial statements of the federal government.

16. The definitions of elements may refer to another entity or other entities. For the federal government, these terms describe entities external to the government, such as foreign, state, and local governments, business enterprises, not-for-profit organizations, and individuals. For a component entity, the terms another entity and other entities include other component entities of the government as well as entities external to the government.