



June 15, 2012

Memorandum

To: Members of the Board

From: Ross Simms, Assistant Director

Through: Wendy M. Payne, Executive Director

Subj: Presenting Fiscal Projections – **TAB E**¹

MEETING OBJECTIVE

The objectives of the meeting are to: (1) inform the Board that the Auditing Standards Board (ASB) has organized a task force to review the auditor's responsibility for prospective financial information like the Statement of Social Insurance (SOSI) and statement of long-term fiscal projections; and (2) discuss whether the Board would like to communicate any views that the task force should consider in its deliberations.

BRIEFING MATERIALS

Beginning on page 2, the transmittal memorandum includes a discussion of FASAB's conclusions regarding prospective financial statements and the briefing materials include the following Appendix to assist members in their consideration:

- Statement of Position (SOP) 04-01, *Auditing the Statement of Social Insurance*, presents current guidance regarding the application of generally accepted auditing standards to audits of the statement of social insurance.

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 ASB initiated the Prospective Information Task Force to develop guidance for certified public accountants engaged in auditing prospective financial information. The American Institute of Certified Public Accountants (AICPA) defines prospective financial statements as “either financial forecasts or financial projections including the summaries of significant assumptions and accounting policies.”² The task force was formed as a result of current and proposed accounting standards requiring prospective information, such as:

- Statement of Federal Financial Accounting Standards (SFFAS) 17, *Accounting for Social Insurance*, requires prospective measures for presentation in the SOSI.
- SFFAS 36, *Comprehensive Long-Term Fiscal Projections for the U.S. Government*, requires long-term fiscal projections be presented as required supplemental information in the consolidated financial report of the U.S. for fiscal years 2010, 2011, and 2012, after which time the fiscal projections will become a basic financial statement.
- Governmental Accounting Standards Board (GASB), *Preliminary Views of the Governmental Accounting Standards Board on major issues related to Economic Condition Reporting: Financial Projections*, was issued in November 2011. The document discusses requiring states and local governments to prepare 5-year projections as required supplementary information (RSI).

The task force plans to develop preliminary conclusions to discuss with the ASB in July 2012.

MEMBER FEEDBACK

If you require additional information or wish to discuss an 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) 512-2512 or by email at simmsr@fasab.gov with a cc to paynew@fasab.gov.

² AT Section 301, *Financial Forecasts and Projections*, paragraph .08a.

STAFF ANALYSIS

FASAB considers the information needs of various users and those users expect a broad range of information. For example, some users expect information on the cost of services and their outcomes while others may be concerned about whether future budgetary resources will be sufficient to sustain those services. Also, FASAB considers the unique nature of the federal government and its programs in developing accounting standards.³ To help provide a comprehensive financial picture of the federal government and help meet the range of users' needs, FASAB has developed a reporting model that includes:

- Background information about the entity
- Accrual basis financial information
- Budgetary basis financial information
- Summary level performance information
- Forward-looking or prospective information⁴
- Management's analysis of the financial and non-financial information, including key trends

Regarding the prospective information component of the model, FASAB's literature discusses many factors that the Board considered when determining whether to present this information in the principal financial statements. Some of those factors are presented below.

Users Expect Information Relevant to Measuring Financial Condition

The responsibilities of the federal government are broad and FASAB has noted that to evaluate how well the federal government has executed its stewardship responsibilities, measures of items other than its assets and liabilities or financial position should be assessed.⁵ Also, the federal government has an obligation to promote the general welfare of the nation in perpetuity and has established several significant social programs to achieve this responsibility. These programs are expected to continue for

³ For example, in Statement of Federal Financial Accounting Concepts (SFFAC) 1, *Objectives of Federal Financial Reporting*, FASAB noted that the federal Government is unique in that it has responsibilities for the nation's common defense and general welfare, and it has the power to tax, to borrow, and to create money. Also, in many cases, the government's financial condition is necessarily a secondary consideration. Moreover, there is not a constitutional requirement to provide sufficient revenues to fund its expenditures.

⁴ Note that support for addressing users' needs by advancing financial statements that include forward-looking information has existed for quite some time. For example, see Rimerman, Thomas. "The Changing Significance of Financial Statements," *Journal of Accountancy*, (April 1990): 79-83.

⁵ SFFAC 1, par 144.

several years, and some may be expected to continue indefinitely.⁶ Consequently, long-range projections are considered useful to informing citizens about the federal government's ongoing responsibilities and may be considered important for assessing the government's financial condition.

While the terms financial condition and financial position may sometimes be used interchangeably, the terms are distinguished in federal financial reporting. The Board explains that financial condition is a broader and more forward-looking concept than that of "financial position" as reported via the balance sheet. Additionally, indicators of financial position, measured on an accrual basis, are the starting point for reporting on financial condition. Financial condition may require, among other things, a current law budget projection under a range of alternative assumptions.⁷ Accordingly, FASAB has stated that

Federal financial reporting should provide accurate and transparent information to citizens so that they can make well-informed decisions for themselves and their government. In this regard, such reporting must include information on the government's long-term commitments for social insurance as well as all other government programs.⁸

Citizens and other users seek measures such as projections of receipts and outlays to help assess whether the government will have sufficient resources to continue providing a level of benefits and services. These measures help citizens to assess the government's financial condition and FASAB has noted that measures that are highly relevant to measuring financial condition are candidates for basic information.⁹ Particularly, with respect to the SOSI, the Board has noted that:

- The statement provides "a consistent and disciplined presentation" of certain critical financial projections related to financial condition.¹⁰
- The statement is "important to those who would understand the Government's financial condition and its impact on the financial condition of individual citizens, interesting to the public, and essential to fair presentation."¹¹

Regarding its requirement for long-term fiscal projections, the Board has stated that:

⁶ In SFFAS 17, *Accounting for Social Insurance*, par. 20, FASAB noted that "Social insurance programs normally have uniform sets of entitling events; and schedules of benefits are developed, announced, and applied to all participants. Administrators of such programs have little discretion in determining who should get benefits or how much they should get."

⁷ SFFAC 1, pars. 144-145.

⁸ SFFAS 37, *Social Insurance: Additional Requirements for Management's Discussion and Analysis and Basic Financial Statements*, par.1.

⁹ SFFAC 2, *Entity and Display*, Table 1: Table 1: Factors to Consider in Distinguishing Basic Information from RSI.

¹⁰ FASAB's Strategic Directions, Appendix III GAAP and Non-GAAP Reporting.

¹¹ SFFAS 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*, par.30.

- While federal financial reporting is not expected by itself to accomplish the stewardship reporting objective, it can contribute to meeting the objective. [footnote omitted] This Statement’s contribution relates primarily to the federal government’s operations and financial condition; it does not extend to an assessment of the nation’s financial condition.¹²
- The Board believes that comprehensive long-term fiscal projections [footnote omitted] make an essential contribution to meeting the stewardship objective and especially sub-objective 3B because it is concerned with the future and the resources needed in the future.¹³
- In this Statement, “Fiscal Sustainability Reporting” is the short term for the basic financial statement, disclosures, and Required Supplementary Information (RSI) required in the CFR. Fiscal Sustainability Reporting should provide information to assist readers of the CFR in assessing whether future budgetary resources of the U.S. Government will likely be sufficient to sustain public services and to meet obligations as they come due, [footnote omitted] assuming that current policy for federal government public services and taxation is continued without change (hereafter referred to as “current policy without change”).[footnote omitted]¹⁴

Such an assessment is important not only because of its financial implications but also because it has social and political implications. For example, users of financial reports should be provided with information that is helpful in assessing the likelihood that the government will continue to provide public services to constituent groups and to assess whether financial burdens without related benefits were passed on by current-year taxpayers to future-year taxpayers. [footnote omitted] Fiscal Sustainability Reporting should assist the reader in understanding these financial, social and political implications.¹⁵

Uncertainty inherent in Projections and Other Challenges in Developing Measures for Reporting on the Government’s Stewardship

FASAB has acknowledged that “great uncertainty” is inherent in the prospective information presented in the model.¹⁶ However, the Board believes that “if the uncertainty is suitably disclosed--as is required by SFFAS 17--it need not preclude designating the information as a basic financial statement...”¹⁷ Additionally, FASAB has stated that

Measuring the future effects of existing law and conditions for Social Insurance involves projections of economic and demographic trends, just as measuring the pension benefit obligation at a point in time involves assumptions about future

¹² SFFAS 36, par. 4.

¹³ SFFAS 36, par. 5.

¹⁴ SFFAS 36, par. 7.

¹⁵ SFFAS 36, par. 8.

¹⁶ SFFAS 25, par 27.

¹⁷ Ibid.

salary progression. It is true that SFFAS 5 specifies a different measurement method for pensions and retiree healthcare than the method SFFAS 17 specifies for Social Insurance. It is also true that Social Insurance measurements are more sensitive to assumptions about the most distant years of the projection period. Nevertheless, the Board believes that it is appropriate to report the SOSI as a basic financial statement, essential for fair presentation in conformity with GAAP.¹⁸

As a result, FASAB's guidance for fiscal projections includes requirements for disclosures regarding the assumptions used in the projections and requirements for presenting a sensitivity analyses. FASAB noted that a sensitivity analysis would "illustrate how an estimate or projection would change if assumptions, data, methodologies or other inputs change."¹⁹

Also, the Board has noted that because of the government's unique role, there are challenges in providing "bottom-line" metrics of success similar to the "earning per share" metric for publically-traded companies.²⁰ However, there are some fundamental metrics that could be provided. Thus, FASAB stated:

As noted in *Objectives*, because government services are not usually provided in exchange for voluntary payments or fees, expenses cannot be matched against revenue to measure "net income." Moreover, directly measuring the value added to society's welfare by government actions is difficult. Nonetheless, expenses can be matched against the provision of services year by year. The resulting cost can then be analyzed in relation to a variety of measures of the achievement of results. Information about social insurance that is relevant to this objective includes the cost of the program as well as long-range estimates (and ranges of estimates) of future costs and other obligations. Estimates of future costs highlight the cost impact of changes in benefit levels as well as economic and demographic changes (e.g., in the cost of health care and in life expectancies).²¹

Reporting on the stewardship objective requires projections to help measure financial condition²² and FASAB has noted that information that is highly relevant to measuring financial condition is fundamental to financial reporting.²³

The Potential for Concerns in Implementing Standards that Require Projections

FASAB acknowledged that there may be concerns with implementing requirements for reporting financial projections. For example, the Board noted that there may be difficulty in illustrating the level of uncertainty that may characterize projections. Accordingly, the Board noted that "the requirement in the standard would not preclude

¹⁸ SFFAS 25, par. 29.

¹⁹ SFFAS 17, par. 27 (4).

²⁰ SFFAC 1, par. 54.

²¹ SFFAS 17, par. 6.

²² SFFAC 1, par, 145.

²³ SFFAC 2, Table 1: Factors to Consider in Distinguishing Basic Information from RSI.

the entity from presenting additional discussions of uncertainty and the Board expects that agencies would do so voluntarily.”²⁴

In addition, regarding the requirement for long-term fiscal projections, the Board noted that significant judgment would be required. As a result, the Board established a three-year implementation schedule and noted that implementation guidance could be developed.²⁵

The Message to Send about the Importance of Prospective Information in Financial Reports

FASAB desires to minimize the risk of confusion regarding the significance of items of information and whether those items are essential for fair presentation in conformity with GAAP. For example, in the 90’s FASAB classified information as required supplementary stewardship information (RSSI) to help provide users with information about the federal government’s unique stewardship responsibilities. However, because the category was not fully understood, FASAB began to eliminate the category and require the reporting of information using categories that were more widely understood like basic and RSI.²⁶ Thus, the change led to changes in financial reporting practices.

FASAB acknowledges that some items of information may be audited while others may be subject to other procedures specified by generally accepted government auditing standards (GAGAS). SFFAC 2 explains the importance of distinguishing items of information as follows

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 Government Accountability Office. In developing accounting standards, the Board considers whether information should be categorized as basic information, required supplementary information (RSI), or other accompanying information (OAI). Distinguishing these categories is important because each category is subject to different procedures and reporting requirements under generally accepted government auditing standards (GAGAS). When an auditor is engaged to audit an entity’s financial statements, basic information as a whole is subject to testing for fair presentation in conformity with GAAP. However, RSI and OAI are unaudited, but subject to certain procedures specified by GAGAS for RSI and OAI, respectively. To assist users in analyzing the different types of information within financial reports, these differences must be conveyed and can be accomplished in a variety of ways. The traditional approach is to separate the categories of information. However, the categories may be commingled if the RSI and OAI are clearly labeled as “unaudited” or distinguished in a manner that informs the reader of the level of assurance provided. (par. 55a)

²⁴ SFFAS 17, par. 49.

²⁵ SFFAS 36, par. A40.

²⁶ SFFAS 25, pars. 8-11.

Accordingly, to determine whether an item of information should be basic or RSI, FASAB considers a range of factors. One factor the Board may consider is the relevance of the item to fair presentation. SFFAC 2 states

For example, members may consider the relevance of the information to fair presentation. If the information has a high relevance to fair presentation, it may be a candidate for basic information communicated by financial statements and notes to the financial statements. The financial statements and notes could not be considered fairly presented if the information is missing or materially misstated. (par. 73E)

With respect to the SOSI, the Board stated that the “SOSI should be treated as a basic financial statement because it is essential to fair presentation and is important to achieve the objectives of federal financial reporting.”²⁷ Also, the Board believed that significant assumptions related to the SOSI should be presented in disclosures rather than RSI because “the underlying significant assumptions are essential to fair presentation.”²⁸ Thus, the Board expects that if the SOSI was materially misstated, the auditor would modify the opinion on the financial statement. This would send a clear signal about the importance of the information to users.²⁹

Additionally, with respect to long-term fiscal projections, FASAB stated

The Board believes that comprehensive long-term fiscal projections [footnote omitted] make an essential contribution to meeting the stewardship objective and especially sub-objective 3B because it is concerned with the future and the resources needed in the future.³⁰

Information that is highly relevant to the reporting objectives may be considered basic information and the auditor’s opinion is expected to send a clear signal regarding the importance of the information.³¹

SOP 04-1, *Auditing the Statement of Social Insurance*, provides auditing and reporting guidance relative to FASAB’s existing prospective financial statement requirements or requirements for the SOSI. The guidance presents the following illustrative auditor’s report for the SOSI.

We have audited the accompanying consolidated balance sheets of XYZ Social Insurance Agency, as of September 30, 20X8 and 20X7, the related consolidated statements of net cost, of changes in net position and of financing; the combined statements of budgetary resources for the years then ended; and statements of social insurance as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4.¹⁷ These

²⁷ SFFAS 25, par. 26.

²⁸ SFFAS 26, *Presentation of Significant Assumptions for the Statement of Social Insurance: Amending SFFAS 25*, par. 8

²⁹ SFFAS 25, par. 30.

³⁰ SFFAS 36, par. 5.

³¹ SFFAC 2, Table 1: Table 1: Factors to Consider in Distinguishing Basic Information from RSI.

financial statements are the responsibility of XYZ Social Insurance Agency's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, Audit Requirements for Federal Financial Statements. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the financial position of XYZ Social Insurance Agency as of September 30, 20X8 and 20X7; its net cost of operations; changes in net position, budgetary resources, and financing for the year then ended; and the financial condition of its social insurance programs as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, the statements of social insurance present the actuarial present value of the Agency's estimated future income to be received from or on behalf of the participants and estimated future expenditures to be paid to or on behalf of participants during a projection period sufficient to illustrate long-term sustainability of the social insurance program. In preparing the statements of social insurance, management considers and selects assumptions and data that it believes provide a reasonable basis for the assertions in the statements. However, because of the large number of factors that affect the statement of social insurance and the fact that future events and circumstances cannot be known with certainty, there will be differences between the estimates in the statement of social insurance and the actual results, and those differences may be material.³²

The illustrative report appears to send a clear signal to readers regarding the importance of the information presented in the SOSI.

³² SOP 04-1, par. 41.

QUESTION FOR THE BOARD

1. What insights would you like to communicate to the Prospective Information Task Force to consider during their deliberations on guidance that would assist auditors in conducting their audits of prospective financial information?