

FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD
December 17-18, 2014
Room 7C13
441 G Street NW
Washington, DC 20548

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Wednesday, December 17, 2014

David Mader, Controller, OMB - Update on OMB Initiatives

Mr. Allen welcomed a very special guest; David Mader, Controller, Office of Federal Financial Management, Office of Management and Budget. He noted that Mr. Mader would provide an update on OMB activities and questions are encouraged.

Mr. Mader indicated that the six months since he returned to government service have been rewarding. His new position is exciting because of the challenges ahead of us. He noted that he has a great team and that OMB success hinges on relationships; those with FASAB, GAO and Treasury. OMB is a very small organization tasked with some

significant activity around implementation of the DATA Act. To be successful all must be working closely together.

Key points from Mr. Mader's presentation included:

1. OFFM's mission is to support the effective and transparent use of federal financial resources. To do so, they:
 - a. Improve the quality, utility, and transparency of financial information;
 - b. Protect against and reduce waste, fraud, and abuse; and
 - c. Help agencies maximize the impact of their limited financial resources
2. The CFO Act Audit results for FY2014 were:
 - a. 20 of the 24 CFO Act agencies received a clean audit opinion
 - b. approximate 50% decline in auditor-identified material weaknesses from Fiscal Year 2000
 - c. 25 FMFIA material weaknesses currently reported
 - d. 9 management assessed non-compliance with one or more of the three FFMA requirements
 - e. 10 auditors assessed non-compliance with one or more of the three FFMA requirements
3. There is a plan to get the Department of Defense to a position where they can be audited by 2017.
4. A series of initiatives is embedded in the President's Management Agenda seeking to improve the efficiency of government. One is a set of benchmarks. GSA and OMB now have in place a series of about 50 benchmarks that cover all of the traditional back office operations; human capital, technology, contracts, acquisition and financial management. Top management look at these benchmarks. An example of the result is Department of Commerce with 13 separate bureaus and variants between these bureaus on administrative costs. Key executives started to ask questions. Why is there such a variance? They launched an internal study of how to create administrative-shared services to support the entire Department of Commerce.
5. Regarding shared services government-wide, the significant progress made by OMB and Treasury is commendable. Four agencies, Department of Transportation, Interior, Treasury, and USDA, have been identified as core financial service providers across government. These four provide support for all of the software providers that are used across the entire civilian government. HUD, a major department, is in the early stages of migrating over to the Treasury-shared service provider. This is not only beneficial from a cost perspective but also from a security perspective. The fewer systems the better we can secure them. For implementation of the Data Act, the fewer systems the

easier implementation will be over time. (A general discussion of benefits and challenges of shared services followed.)

6. OMB Circular A-123, Management's Responsibility for Internal Control, is being updated for the first time in ten years. By introducing risk management in the financial community, we have done a pretty good job of managing financial risk. The question now is in managing the government enterprises. What are the other programmatic risks out there that need to be managed in a framework and in an approach to ensure that the proper attention at the right levels within a department or within a bureau are being paid attention to?

7. OMB's vision is to transform and evolve existing internal control compliance frameworks so that it creates a more value added, integrated, risk based, and less burdensome set of requirements for agencies. The revised guidance will:

- a. Clarify technical terminology to ensure that program managers can understand and use internal controls properly;
- b. Replace "check the box" compliance approaches with risk management based approaches to reduce compliance burdens and support program controls;
- c. Introduce Enterprise Risk Management (ERM); and
- d. Evolve internal controls beyond financial reporting.

8. The Data Act passed in May 2014 and charges both the Treasury Department and the OMB with implementation. Both have moved quickly. We have put in place the governance process and work streams. Regarding the goal of linking spending to program activity, the act requires taking the statutory definition of program activity that is in the budget and being able to display data in accordance with that definition. A member asked if there is a desire to go beyond the program activities to linking spending information to programs. Mr. Mader noted an interest by members of Congress to do that. Ms. Ho added that an ideal outcome is to eventually look at spending by program but an incremental approach to implement what is required on the act will move us a lot further ahead. Once there, next steps will be identified but we need to have a focused effort right now to do what is required under the act.

Members and Mr. Mader discussed the need to engage the budget community in the effort to integrate cost, budget and performance information by program. Mr. Reger added that the DATA Act team is very focused on defining program at least initially. At the same time, the team must try to link all the activity around that definition of program. A member asked if he sees that ever linking to the financial statements? Mr. Reger responded yes; the only value in doing all of this is to link budget information to financial statements to performance. This allows everything to link together. The key is to get the definitions and a place to start. Mr. Dacey noted that the FASAB's role is to identify what goes into the financial statements. Mr. Reger agreed and noted that the question is whether data coming out of the financials is used in the linkage or data is collected that

we then use to generate the financials. These are very different models. Presently, the focus is on getting the data back to the program managers, so they can manage their own activities.

Mr. Allen noted that while citizens and other users want to get where you are saying we are a long ways away. That is the level they care about government, not department by department.

Mr. Mader acknowledged the agreement that the financial management system is the authoritative source of that data. The current state across government is that grant systems and acquisitions systems stand alone. Data definitions vary and there are different financial data in those systems. Based on meetings across communities, Mr. Mader opined that people are approaching this with the right frame of mind and there will be changes made in developing common data definitions.

Ms. Ho indicated that Treasury plans to re-launch the USA spending website in the spring of 2015. In terms of its look and feel, it will look a lot like recovery.gov because it has been an award-winning site. She added that there has been initial outreach with the public, including Sunlight Foundation, the Data Transparency Coalition, and the NASACT. We have been trying to emphasize to people that this relaunch is not going to fix the data quality issues. The underlying data quality issue really needs to be addressed as part of the DATA Act implementation.

Mr. Mader continued his update by applauding the grant management reform work of OMB staff and others. The guidance will be published in the federal register this coming Friday. It dovetails nicely into the Data Act requirement of doing a pilot on streamlining administrative reporting.

Mr. Allen asked, from a taxpayer perspective, whether this is going to have an impact on the federal government. Is this going to yield the data that is needed to start approaching governing more effectively and improving service delivery?

Mr. Mader responded that the DATA Act is sort of a down payment. It begins the task of looking at data in a more comprehensive way, so that decision-makers, whether they are the Congress or the administration, can make better choices with regard to where the next dollar goes.

Mr. Reger noted that the government is facing large debts. For efficiency gains, you have to make those decisions on a program-by-program basis. You have to look at performance activity, budget activity and planning activity by individual programs, almost regardless of how we define program. With the DATA Act, you will be able to see granularity that you have not seen in a long time and that individual program managers have not seen in a long time. He noted this is about helping the people who are running major components and even down to individual programs to make the decisions they need to make. Then take the benchmarking initiatives and say, provide them the basic tools to not just look at how they are doing against budget, but look at how they stand out, either positively or negatively, and how they are running their own activity.

Mr. Mader added that another initiative is improving the real property program across government. If you look at what the government spends for maintaining excess and underutilized property, it is significant. The present program yielded some fairly significant reductions in the amount of space and we plan to expand that over the next couple of years. Data to support hard decisions, such as closing space in a particular district, will change the conversation with legislators.

In response to a question regarding a recent GAO report on the definition of “program,” Mr. Mader noted that the challenge of defining program will be coordinated with the Data Act implementation group. The performance staff and the financial staff will need to work together as performance and financial reporting need to be integrated. If you asked 12 departments for their definition of program, you are going to get 12 different interpretations of what that is.

Mr. Reger acknowledged the complexity and the importance of showing early progress. The underlying reorientation of data, away from a procurement-centric model to an accounting-centric model, has to come in the second step. It is just too fundamental to get done by the spring but it can be done. This is really something that is going to occur over a period of time. Maintaining the momentum is going to be the real challenge.

Members noted the Board’s interest in the definition of “program.” Mr. Granof asked what the role of the FASAB could be in all of this.

Mr. Mader indicated the FASAB could be a sounding board because of members’ experience and different perspectives.

Mr. Steinberg agreed that is a great role. The FASAB should be consulted regarding how this fits into our views of what financial reporting should look like. Once you do hear that, then consideration should be given to making the adjustment to have better financial reporting.

Mr. Mader noted that is actually what Mr. Reger has been talking about for the last couple of months. How do we leverage this Data Act into better financial management and better financial reporting? We do spend a lot of money on financial reporting, too. Is there a way to leverage what we are doing here that would make that process perhaps more efficient and more effective?

Mr. Reger noted that a lot of this progress is happening because people like Dave Mader and Dave Lebryk (Treasury, Fiscal Assistant Secretary) are very dedicated. The progress we make is because of the people who are involved.

Mr. Allen thanked Mr. Reger for the positive note on which to end. He thanked Mr. Mader for the excellent update and discussion.

Administrative Matters

- **Attendance**

The following members were present throughout the meeting: Mr. Allen, Messrs. Dacey, Granof, McCall, Reger, Showalter, Smith, Steinberg, and Ms. Ho. The executive director, Ms. Payne, and general counsel, Mr. Marchand, were present throughout the meeting.

- **Approval of Minutes**

The minutes of the October meeting were approved in advance of the meeting.

- **Discussion of Clippings and Updates**

Members noted that the Financial Accounting Foundation created an educational website and suggested considering ways to leverage the material.

Messrs. Dacey and Granof provided updates on activities of the International Public Sector Accounting Standards Board and the Governmental Accounting Standards Board, respectively.

Agenda Topics

- **Budget – Government as a Whole Panel**

FASAB discussed budgetary reporting in the consolidated financial report of the U.S. government (CFR) with a panel of experts. The panel discussed how information might be categorized in financial statements and provided insights on presentations that might be beneficial to users. The panel members are:

- Robert L. Bixby, Executive Director, Concord Coalition
- Paul L. Posner, Professor and Director of the Masters in Public Administration Program, George Mason University
- C. Eugene Steuerle, Richard B. Fisher Chair and Institute Fellow, The Urban Institute

Panel Member Perspectives

Mr. Bixby

Mr. Bixby discussed that the public should have a general understanding of the budget, but not necessarily details. His organization focuses on providing basic charts and broad categories, such as Social Security, Medicare, interest on the debt, and defense; and then shows the smaller domestic discretionary programs. The most useful

information for the public would not necessarily be functions or categories used by analysts. People tend to think of individually named programs and things that would not fit into a particular category, such as how much did we spend on farm subsidies, foreign aid, or programs that do not exist such as food stamps. It is hard to take such colloquialisms and incorporate them into reporting.

Also, the distinction between mandatory and discretionary is important because most of the budget is on “autopilot” or mandatory spending. It is not a matter of discussing what we spend it on but how we avoid making decisions on what we are going to spend.

Mr. Bixby likes the idea of an actual to budget comparison but it is not clear how that can be done because much of the budget is on autopilot or mandatory spending. The President’s Budget is not enacted and Congress has not been passing a budget resolution. Comparing what was spent this year to what was spent in prior years may be the most useful approach.

Mr. Posner

Mr. Posner noted that it is important that there be greater integration between budgeting and financial management. Currently there are issues about sustainability of programs and flexibility with being able to adapt to changing needs in our economy.

The government does things differently from businesses and its operations have changed over the years. Consider the following:

- The purpose of government budgets and financial statements is not only to focus on how government finances itself but also about how it achieves broader social goods. At times, the government’s bottom-line has to suffer to improve the broader economy. The government takes on risks to insulate parts of the economy from risks.
- Budgeting and financial reporting need to expand beyond traditional spending to cover emerging and less traditional government commitments. For instance, tax expenditures now exceed total federal discretionary spending and determining how these transactions should be captured and reported is a concern.
- The government’s interdependence. How can we track what our government does when we are interdependent on other sectors of the economy such as state and local governments? It tests our single bottom line focus.

Accordingly, we have to have a broader perspective with respect to the government’s finances. The public wants to know what they are getting for their money and they expect top-line performance.

The statement of budgetary resources (SBR) is a major advance. Obligations are being audited and there is an assessment of internal controls. Periodic reports on what we are learning from the audits would be helpful. However, the SBR could be disaggregated

from the current department-level presentation to show appropriations line items or other details.

A comparison of estimates to actuals is useful. The Government Accountability Office prepared this comparison several years ago and it helped show why the budget did not work out as expected.

Also, the system we have for determining tradeoffs could be improved. Currently, it is difficult to make comparisons because expenditures are classified in many different ways in government appropriations accounts, such as by program, object class, or organization. We need to have a uniform definition of programs to facilitate comparisons. Other nations have reformed their budget accounts to be more programmatic and consistent.

The CFR's Statement of Net Cost is too aggregated. We need to understand the accrual basis net cost of our programs because this would align with performance goals. The agency level may be the best level to report this information.

The major missions of the federal government have been standardized into budget functions. While the budget functions are too highly aggregated, the sub-functions do start to correspond to the standing commitments of the federal government.

Mr. Posner suggests that the federal government consider changing from a programmatic basis of budgeting to a portfolio basis. Discussions should start to focus on broader missions and goals and not only talk about the spending items but tax expenditures, loan guarantees, and regulations, and what part does the federal government contribute – what share is the federal government in total economic and governmental activity. The public, Congress, and others need to know this information organized by budget sub-functions.

Regarding macro and long-term goals, Statement of Federal Financial Accounting Standard (SFFAS) 36, Comprehensive Long-Term Projections for the U.S. Government provides important information for understanding the future. The Office of Management and Budget's (OMB) analytical perspectives shows the government owning 64% of the economy instead of showing a debt of 277% of GDP by 2088 as noted in the CFS. The OMB estimates include heroic assumptions such as discretionary spending shrinking to 1.5% of GDP. As we take long-term projections more seriously, the stakes grow and the opportunities for potential mischief grow. Some benchmarks and conventions should be established for these projections and FASAB might consider working with OMB, CBO and GAO to develop standard estimating criteria.

The line items of financial statements are important for understanding the stock of assets and liabilities but the bottom line is not particularly useful, as it is an incomplete number. It might be better to not total financial statement line items and focus on the components of the statement. Then, we could rely on the long-term projections to provide the broader perspective.

Mr. Steuerle

Mr. Steuerle noted that any set of financial statements cannot meet all users' needs or all reporting objectives. For instance, thirty years ago, we would have focused on the fiscal drag in the economy and reported on how much surpluses would be building in the future. Today, we focus on long-term deficits. Therefore, there is no single answer regarding what the focus should be.

Consider strongly what should be included in the very first table presented in the report because people do not read through the entire report. It may not be possible for individuals such as agency executives to read through every report that comes across their desk, but they are likely to review the first graph and the up-front summary. Mr. Steuerle offered the following:

- Present amounts in real dollars.
- Report on increments over time, similar to reporting a discretionary budget - reporting on the changes from past current levels. For instance, we could report that the President proposes ten years from now spending annually \$600 billion more in Social Security, Medicare and Medicaid, \$300 billion in interest on the debt, and nothing more on defense, and nothing more on domestic discretionary. This reporting could provide both what the President proposed and the changes allowed to occur in the economy.

The current budget debate is very much distorted by discussing how we adjust from a baseline. However, the public and most elected officials do not fully understand what the baseline is or how it is calculated technically. The baseline is called current law and current law for mandatory programs is different from current law for discretionary programs. Current law for mandatory programs is what the law requires over time and involves projections, while for discretionary programs it is current levels of total spending adjusted for matters such as sequesters. More and more of the budget involves mandatory spending, so when we report on changes in current law, most of the changes occur from what has already been built into the budget rather than legislative actions.

- Report on tax subsidies. Tax subsidies include mandatory and discretionary "spending." We need to determine how to combine tax subsidies with direct spending to answer questions such as how much are we spending on health or housing and how is the total allocated? In this example, most of the subsidies for housing are in the tax code rather than in the direct spending budget. Therefore, including tax subsidies either in a functional or portfolio approach would be extremely useful.

Mr. Steuerle expressed concern with present value accounting- not so much in doing it as in its interpretation. He noted that the public does not fully understand present value accounting. A primary problem arises when changes in interest rates greatly impact the amounts reported over time and cause confusion when trying to compare what has

been happening to programs over time. A simpler method (there are others) might simply show what is going to happen to a program's annual budget (at least for mandatory programs) 75 or 50 years from now.

Also, consider comparing the lifetime value of benefits and taxes in programs like Social Security and Medicare, keeping the same real discount rate over time. Policymakers tend to reform benefits in separate silos, such as the retirement age and the annual benefit. However, they then fail to see tradeoffs among the silos which becomes more apparent if looking at lifetime benefits. As another example, when looking at replacement rates in Social Security, they are often comparing an annual benefit to some annual wages while failing to see that lifetime values are going up faster than lifetime wages because the program fails to adjust for life expectancy.

General Discussion

Regarding whether FASAB should be concerned about budgetary reporting in the CFR, Mr. Posner noted that the Board should consider budgetary reporting in both the CFR and agency reports. While significant time is spent discussing the deficit, more time should be spent on organizing trade-offs across broader categories, where programs have related objectives. Other countries are seeking a whole of government framework that would facilitate discussions of trade-offs. Currently, sub-functions provide a useful way to think about broader trade-offs. Mr. Bixby added that it depends on the audience because different individuals have very definite views and consume information in different ways. However, broader categories might be the best approach.

Mr. Steuerle asked the Board to consider, as a matter of economy, undertaking occasional selective studies instead of trying to report on all topics, every year. The Board could say that it is going to report on a particular topic once every five years or report on selective topics on a one-time basis next year and then on another topic the following year. The Board would essentially be recognizing that the importance of topics might vary over time in ways that could not be anticipated in advance.

Mr. Reger noted that he would like to provide enough data with definitions so that if there was a concern about say, children's programs, someone could write an app and provide the information. This approach could be undertaken rather than trying to completely change the formulation systems, the financial statements, or the formulation pattern of budgetary systems.

- **Budget – Agency Level Reporting**

FASAB discussed agency budgetary reporting with a panel of experts. The panel discussed concerns with existing budgetary information and possibilities for improvement. The panel members are:

Carol S. Johnson, Program Examiner, OMB

S. Anthony (Tony) McCann, Adjunct Lecturer, University of Maryland

Denise Wu, Principal, CliftonLarsenAllen LLP

Panel Member Perspectives

Ms. Johnson

Ms. Johnson noted that the agency-level financial statements, the balance sheet and statement of net cost, provide useful information. Also, the notes to the financial statements are especially informative. However, the SBR is too aggregated and is not provided in time to be useful. In addition, is it necessary to present a statement, such as the SBR, which provides information that can be accessed from the (President's) budget? Ms. Johnson discussed possibilities for improving the reporting model:

- Present a statement of net cost that distinguishes costs that have already been appropriated (funded) by annual and permanent appropriations and amounts that will require an appropriation (unfunded).
- Include summary performance measures. It is important to state what is being accomplished. However, net position for agencies or programs is not particularly useful.

Mr. McCann

Mr. McCann noted that he was the first Chief Financial Officer for both the Departments of Health and Human Services and Veterans Affairs. He also served Congress, both on the Budget Committee and as staff director for the largest domestic Appropriations Subcommittee. Mr. McCann referenced his December 14, 2014 memorandum provided to the Board and emphasized that the Board should consider the level of aggregation that would be useful to most users and most users would be interested in program-level information. Also, the Board should be careful with the terms that are used in the statements.

For instance, the term spending is used in the schedule of spending (SOS) instead of obligations and outlays. Simply because money is obligated does not mean it is spent. Also, the federal government provides grants to cities, who give contracts to other organizations. Consequently, a "grants" category may be misleading because the final service provider may be a contractor.

Ms. Wu

Ms. Wu provided background information on the SOS and noted that the SBR is difficult for individuals to understand. Also, Ms. Wu discussed:

- The redundancy of information being provided. The SOS and SBR provide information on the budgetary basis and the public does not understand the budgetary basis. In addition, the OMB needs to determine how the data relationship among the SOS, statement of net cost, SBR, and the USAspending.gov website can be better defined. It is not clear what is being accomplished with the multiple presentations.
- Guidance is needed to clarify terms, such as spending, outlays, obligations, and cost. These terms are used interchangeably and can be confusing to the readers.
- The SOS provides some benefits such as facilitating transparency. Users can see where the money is spent or programs the government supports. The SOS also uses less technical jargon than the SBR. However, the SOS requires additional resources, such as contractor support, technology costs, and staff time. Its preparation competes with other priorities that the agencies face.
- Information presented in the statement of net cost needs to be disaggregated, similar to the SOS to be useful.

Regarding the role of FASAB, Ms. Wu noted that the Board should help ensure that the purpose of financial statements and the terms used are clear. Also, redundant information should be minimized. Ms. Johnson added that the SBR helps our government to be accountable and the fact the information is audited lends credibility to the prior year data presented in the budget. Mr. McCann noted that if sources other than financial statements provide the information, the Board should consider what value would be added by also presenting the information in financial statements.

The Board also discussed better presenting information in the SBR. Mr. Dacey noted that the SBR uses the same format as the SF-133, Report on Budget Execution and Budgetary Resources, and includes stocks and flows in a single statement rather than separate statements. Ms. Johnson noted that she would need more detailed information than the SBR provides and Ms. Wu noted that she would support a more user-friendly statement. Also, there are other ways to demonstrate that the budget information is reliable. Mr. McCann discussed that finance staff tend to look at what occurred in the past while budget staff look at what is occurring now and going forward. Also, the primary tool for budget formulation would be a modification of the congressional budget justification.

Regarding a budget to actual comparison, Ms. Johnson noted that agencies typically spend what they are appropriated. Also, the budget includes a presentation of estimates to actual to show how well they estimated mandatory spending. Mr. McCann noted that different programs have different statutory bases. Therefore, the budget amount would be different for different programs. For instance, if a program has an indefinite

appropriation or a no year appropriation, it should not be shown in the same way as a one year annual appropriation.

Mr. Allen thanked both of the panels and suggested that members may have additional questions to submit following the meeting. Responses from the panelists would be greatly appreciated.

- **Reporting Model**

Board members discussed their views on the earlier panel discussions regarding CFR and agency budgetary reporting. Also, the Board discussed a draft concepts statement.

Board Member Views on the Earlier Panel Discussions

Mr. Steinberg noted:

- The CFR report should indicate which spending is mandatory and which spending is discretionary.
- Functions is a way to classify expenditures.
- Performance information is important.
- If we move forward with the idea of a budget to actual comparison, the budget could be different amounts depending upon the legislation. Different programs have their budget legislated differently.

Ms. Ho noted that the Board should be clear about the role of financial statements.

Mr. Allen expressed concern about what should be the Board's role with respect to budgetary reporting and asked whether we are only looking at budgetary information to add credibility to the process. There may be a better way to accomplish that objective. Also, Mr. Allen sees a budget as a document used for planning the future, but a financial statement is a report on the past fiscal year, how much cost we incurred. He expressed concern about blending the two presentations.

Mr. Reger noted that budgetary information is being provided by other sources. Therefore, it is not clear why this would be an area for the Board. Also, the financial statements should be citizen centric. They should aim at the citizens, the people who do not have access to the robust information.

Mr. Dacey noted that he would have concerns about excluding budgetary information from the agency-level statements because that is the primary control mechanism. Also, the outlay and receipt data aggregates to the budget deficit number. The format of the SBR could be more user-friendly. In addition, citizens do not necessarily want to read financial statements. They want to review charts and graphs. Consequently, agency summary reports could be leveraged to provide the information of interest to citizens.

Mr. Smith noted that the statements are not serving the users because we are trying to make them do more than what is possible to do. Users can get the information from other sources. The Board should prepare standards for reports for users of the financial statements that are the public and people that do not have access to inside information. The Board could focus on a model that provides meaningful information for those users. Also, budgetary information could be supplementary information.

Mr. Showalter emphasized that the panel members believed that the financial statements were too aggregated. Also, the Board should think about budget as a performance measure. We thought we were going to spend X this year and we spent Y. This could be presented as supplementary information.

Mr. Granof noted that the budget means different things to different people and the lay public thinks that a budget is a plan, similar to that presented by states and local governments. Thus, any discussion has to clarify what the budget is. Also, a budget to actual comparison would probably not be of great interest because you are really talking about appropriations, which are equal to spending. In addition, performance information data is important and while the SBR is difficult to understand, it may not be necessary. The statements should be targeted to the public rather than internal users.

Mr. McCall noted that the definition of terms is important and the SOS uses terms that are not appropriate. For instance, the legal framework states that appropriations do not represent cash actually set aside in the Treasury. Rather, they represent legal authority granted by the Congress to incur obligations. The lay person thinks of spending as cash disbursements instead of obligations. Also, regarding a budget to actual comparison, we need to be able to tell the reader what the differences are and why they are important. Citizens are coming from a framework in which you have a balanced budget. That framework is different from the federal government's framework. Also, agency feedback on the statements should be considered.

Draft Concepts Statement

The Board discussed staff's proposal to include a summary of the Preamble to Statements of Federal Financial Accounting Concepts (Preamble) in the proposed concepts statement to provide background information for readers. Members agreed with the proposal and, for existing concepts statements, staff would add a link to the Preamble rather than revising each statement.

The Board discussed whether to include The Role of Financial Statements – Benefits and Limitations section in the proposed concepts statement. Members believed that there needs to be some discussion about the role of financial statements, given the statement concerns the reporting model. The focus should be on the value of financial statements, their use, and context should be provided given that there are other sources of financial information.

Regarding the presentation of budgetary information in the CFR, members did not express a need for more detail or additional information. With respect to the agency level, members expressed their views as follows:

Mr. McCall expressed interest in a budget versus actual presentation.

Mr. Granof noted that he would like to see information on programs and some link to performance data.

Mr. Showalter noted that the SBR should be a schedule. A budgetary statement would not be able to provide the level of detail needed to satisfy users. The cost statement could provide information by program.

Mr. Smith agreed with Mr. Showalter and noted that it is important to make sure that the agency does not overspend their appropriations. A schedule could show the budgetary resources that the agency has to spend and what they are obligated.

Mr. Dacey discussed that OMB should be consulted regarding whether the SBR needs to be in the same format as the SF133. There are ways to simplify the presentation of the SBR to make it more understandable. Also, the Board should consider a reconciliation of net cost to net outlay rather than then existing net cost to net obligations incurred. The reconciliation of net cost to net outlay would support the CFR.

Mr. Reger noted that OMB continues to need the SBR and indicated that it might be helpful to make the statement more understandable to external users.

Mr. Allen noted that he would like to see a simple presentation showing what budget resources the agency has. The presentation would be required supplemental information.

Ms. Ho noted that to the extent possible we would want to make the SBR more understandable, user friendly. However, we do not need to add more budgetary information into the financial statements.

Mr. Steinberg discussed that, at the CFR level, we need to have a reconciliation of the net cost to either the outlays or to the deficits because the deficits are often reported in the media. Also, we should report the expenditures at the CFR level by either programs or functions. At the agency level, we have to have some budget information, such as a budget to actual comparison, because budgetary integrity is one of the reporting objectives.

Conclusion: Staff will continue developing the concepts statement and provide a revised draft during the February 2015 meeting.

- **Department of Defense Update**

Ms. Loughan explained that the objective of this session is to provide the Board with the project plan for the Department of Defense (DoD) Implementation Guidance Request project and an update. The update includes a briefing from our contractor, Mr. Norwood Jackson of AOC Solutions. Ms. Loughan explained that she did not provide a bio for Mr. Jackson but page 11 of the project plan provided an overview of his career. Ms. Loughan also explained that there really were not any decision points for the Board and this is an informational update for the Board. The Board should feel free to ask questions.

Before turning time over to Mr. Jackson, Ms. Loughan asked if any members had questions on the project plan. Mr. Showalter asked for clarification on the status of the Research and Development area. Ms. Loughan explained that there has not been much progress in that area because we have not been able to get any contact information and have been unable to set up meetings in the branches. Ms. Loughan explained that there was a meeting this week with the deputy CFO and other parties and we were told that we should be able to move in this area at the beginning of January. We should have contact information as well as other information to proceed. Mr. Showalter confirmed with staff that it was a DoD imposed delay.

Mr. Allen asked if research and development may potentially be an issue beyond DoD. Ms. Loughan explained that staff had discussed this in the pre-brief with Mr. Allen. Once we receive more information from DoD, it is something staff would determine. Mr. Allen asked if so, then perhaps it would be considered as a separate project. Ms. Loughan explained that is correct but again, staff would need more information and that is why some of the dates in the project plan should be considered tentative. They will depend on progress as we move forward with DoD and others.

Mr. Jackson provided an update explaining that Attachment B identifies steps that he went through. However, Mr. Jackson explained that there are a couple of qualifications that he wanted to make abundantly clear.

One of the things that should be understood is we are dealing with the valuation assertion with regard to inventory. It is important to note that DoD, while they use the term operating materials and supplies in their internal work, when you look at the standards, inventory is all encompassing. What you are dealing with is the valuation of inventory, notwithstanding what it is called. The term operating materials and supplies was a DoD insert into SFFAS 3 many years ago, but when you get right down to it, the valuation of inventory encompasses everything.

But the real point is that we are dealing with the valuation assertion and we are not dealing with the completeness assertion. In our discussions with the various military departments at DoD, it came up that certain subsets of inventory are not in their new Enterprise Resource Planning Solution (ERPs.) While that may be of concern, it is not of concern to us because what we come forward with in terms of a recommendation for the Board will be a broad-based recommendation with regard to inventory valuation. If

they have chosen for whatever reason to keep certain inventory out of their basic systems, that is an operational issue. A member asked why they would keep it out other than it would be classified or sensitive.

Mr. Jackson explained his understanding was that the Navy ERP is maintaining inventory for their working capital funds. When they sell or move that inventory to a general fund activity, in some cases, that inventory may no longer be maintained in their official accounting records; it is treated as if it is in the hand of the end user. He explained that there is some discussion as to whether or not when they move inventory to a base; does that movement represent a transfer to the end user? However, one could argue that could be a significant amount of inventory held by user organizations that is not in their official records since it was expensed at that the time of transfer from the working capital fund. Mr. Jackson explained he did not know the dollar amount at this time but the issue has been discussed in a meeting with one of the military departments and some expressed concern about the amount of this inventory and it not being accounted for in the ERP system.

Mr. Steinberg explained that if he remembered correctly, when the Board worked on SFFAS 3, there was not a definition for end user, so it could be the actual seller; ship, or any type of a unit.

Mr. Jackson explained that he envisioned that would be a policy issue. The problem is you could as a matter of policy expense a large amount of inventory that is still sitting in warehouses. He provided the example of when supplies are moved from a working capital fund operation to a ship and there is massive storehouse on a ship. Does the ship constitute the end user? He explained that in certain cases, the answer is no. On an aircraft carrier, they would not treat that as an end user because it is like a depot and it is an extension of the working capital fund. However, if you moved it to another type of vessel, that would be the end user.

Ms. Payne explained she would like to interject and state a new staff member will be coming on in January. Ms. Payne explained that she expects her to revitalize the Accounting and Auditing Policy Committee, and this (end user) is an issue that we will put on the table for the AAPC to address.

Mr. Smith asked if this is an issue that the AAPC would address without our assistance or is this still going to be an unresolved issue when this project is complete?

Mr. Jackson explained it would be unresolved when he completes his task because it is not part of the scope of this particular project. This particular project is about finding a way for the Department of Defense to be able to value their inventory given their complexities and their valuation history. He explained that it may be a good AAPC issue because they could deal with the completeness issue.

Mr. Smith asked if this should be a part of the scope of the project now. Mr. Reger agreed that is what he would like to explore further. He would like to know whether these inventories are uniforms or supplies or food, but if they are weapon systems as an

example, each individual component of that inventory would be in and of itself a significant value.

Mr. Jackson explained that he does not know right now and needs to clarify the information received. He explained that he will know some time in January what this inventory comprises.

In considering whether the expensed items can be material in total, Mr. Jackson explained that inventory would not include aircraft but could include the engines to the aircraft which may meet the definition of principal items.

Some members were concerned that it could be possible to define term 'end user' so that they basically have no inventory because everything is in the hands of the end user. Some thought the Board may wish to better define 'end user' – so that classification would be consistent. Others thought it may be a policy issue.

Mr. Jackson explained that with respect to an aircraft carrier, these vessels operate depots. The depot is a working capital fund, not the end user of the engine. The engine is on the aircraft carrier for obvious reasons, as replacement parts for aircraft stationed on the carrier. Some of that inventory on a carrier is in the hands of the end user; other items are held in the depot (working capital fund) and issued as needed. With respect to engines and replacement parts (many of which are referred to as reparable), these items are removed and replaced and may be repaired on the ship for reuse or sent to a land based depot for repair. Mr. Jackson explained that it is not a one size fits all type thing. There are major operations that occur on a carrier similar to land based repair activities, whereas items placed on other ships are to be consumed on those ships and accordingly are properly considered as being in the hands of the end user. Similarly, items issued to units in a war zone might properly be considered in the hands of the end user.

Mr. Steinberg explained that there could be a problem. It goes to the aircraft carrier, which is the depot and they may have two squadrons on there and each squadron could be the end user. The question is if the Air Force base is an end user.

Ms. Payne suggested that this is not an issue for today because the Board has not been provided issues and options or analysis on the end user issue. Mr. Jackson agreed and stated that at some point we will be able to drill down. Right now, one of the things that we are trying to do is solidify the data we have.

Mr. Jackson explained that with regard to deployed PP&E, he wanted to make a comment that from the first meeting with DoD representatives up until the most recent meeting, we have received no support from any DoD entity for expensing deployed PP&E. In fact, in the first kickoff meeting, every single military department in the meeting took issue with the notion of expensing PP&E when it is deployed. The military departments in follow up meetings and responses to questionnaires provided detail in which they went through their capitalization process and process for accounting for destroyed PP&E and they explained it would cause accounting problems to make the

change. In some cases, the Army noted that they change the location of the PP&E. For example, if a tank is sent into a zone of conflict, then the location of that tank is changed. If something happens to the tank, for example, it is destroyed, then there is a process by which they report upstream to have that taken out of the accounting records. The DoD representatives made the point that if the Board came forward with a standard or other guidance that indicated that it is appropriate to expense deployed PP&E, it would create a serious accounting problem for them.

Mr. Jackson explained the difficulty comes because they still have to capitalize the PP&E when it is bought if it is above the capitalization threshold. If you have to capitalize it when you buy it and you are going to expense it when you send it to a zone of conflict, then you have to go through a process of identifying everything that is sent into the zone of conflict to expense it. Furthermore, if the property is brought back from the zone of conflict, then they would have to bring the gross book value back on the accounting records. In addition, they would have to run depreciation on it while it was in the zone of conflict and record the accumulated depreciation for it.

Mr. Steinberg asked why they brought it up. Mr. Jackson explained that it was his understanding that one component of the military raised the point and it was included in the DCFO letter. He explained that while it was incorporated in the letter to FASAB, after hearing the discussion, there was a suggestion that it not be considered further once the interviewees and respondents determined that you would have to capitalize PP&E at the time of acquisition, expensed when deployed, and accounted for upon return from deployment through recapitalization with a corresponding recordation of accumulated depreciation.

Mr. Steinberg asked if he believed we should drop the deployed issue based on that. Mr. Jackson explained that he put a note in meeting notes earlier in the week that he is awaiting direction from the executive director with regard to how to proceed.

Ms. Payne explained that her view on the deployed PP&E issue is that it has been brought up on many occasions because it sounds good and leads one to believe it could be a cost-saving approach. However, clearly it is more complicated than most people think and she wants to document the analysis and the conclusion in the minutes. While it would not be in an official standard, she believes it should be documented that these were the findings and the Board is not planning to take further action based on the results.

Mr. Steinberg explained that he believed DoD may be telling their auditors they cannot get a clean opinion because there is no standard on deployed assets. However, based on the Board's discussion there did not appear to be support for this statement.

Mr. Allen explained the whole notion befuddles him because it seems like they are arguing that accounting drives the responsibility to manage assets and that is not the case at all. They have the same management responsibility for those assets regardless of the accounting. Mr. Allen thought that the consideration of expensing deployed assets had the possibility of reducing the valuation efforts of accounting for these assets

but would not reduce the responsibility for managing these assets. He recalled board discussions several years ago about how carcasses (military assets needing to be refurbished) should be valued. He believed this could be an opportunity for DOD management to be able to say that when certain military equipment is deployed, it often ends up being destroyed or coming back in a condition that needs to be refurbished and therefore certain assets could be expensed when deployed. .

Mr. Jackson explained that military departments have to account for the PP&E at the time of acquisition. He explained an example where DoD buys a tank that costs millions of dollars. It is a capitalizable asset and is used in training and so forth. The deployment question pertains to when the tank is sent into a zone of conflict.

Mr. Allen explained that a standard would not say you have to expense it at that point in time. The standard would say that if circumstances are such that the deployment of this asset will likely result in it not coming back in a realizable condition, go ahead and expense it.

Mr. Jackson elaborated that when he wrote the response to the statement of work, there was no definition of the word deployed in the statement of work. The definition of deployed would have to be developed if one continued down that path. For example, are we strictly talking about going into a zone of conflict? If it goes into a zone of conflict, then it may be deployed--but the likelihood of it returning must then be considered and that may be high. Mr. Jackson explained the likelihood may be high if it is a very sensitive asset and even if it is destroyed, because it was some sort of drone or whatever, it will be returned. Mr. Jackson added that certain equipment is always returned because of its nature, putting aside destruction, the fact that it was deployed means is not necessarily as basis for expensing. He explained the exercise to define a deployed PP&E would be a decision tree type process used to determine whether the PP&E would be expensed.

Mr. Allen explained he was looking at it as a permissive standard, not a mandatory standard to help them easier manage their assets. However, if they no longer want us to consider it, that is okay.

Mr. Jackson reiterated that he can say to you now without further ado that it was made clear in the kickoff meeting that they did not want this because it would create a significant accounting burden.

Mr. Allen said that he agrees with Ms. Payne, and considering FASAB has taken the time to consider the matter, we should document it was considered and the results of the meetings and discussions. He does not want one of the problems that they were not able to get audit ready is because they had deployed assets that they could not account for.

Members discussed deployed assets further noting:

- Some brought up that auditors may argue that they could not audit stuff in a war zone but there are alternative procedures to prove the existence of the assets in a war zone.
- Ships and planes would not even be an issue because they generally come home.
- An outline of criteria for expensing deployed PP&E was provided for discussion with DoD since one cannot leave “deployed” undefined if it impacts accounting. For example, the Navy might argue that a deployed asset is when an aircraft carrier leaves Norfolk, Virginia no matter where it goes – examples of responses to natural disasters were offered by members. At the kickoff meeting with representatives from all branches, they say they do not want to change this because they account for the PP&E when it goes into a zone of conflict.

Mr. Jackson explained he will have follow-up meetings with the branches and meet with the Marines. This issue will resurface just to make sure we have not misinterpreted the responses we have gotten so far. Mr. Jackson explained that he will meet with FASAB staff to develop an action plan the Board thinks is appropriate with regard to deployed assets.

Mr. Allen explained that he does not believe the Board will take action on the deployed asset topic based on what has been presented. Mr. Allen suggested that the Board move from this topic to an area that we may be able to provide assistance.

Mr. Jackson agreed and moved on to the topic of inventory. He explained that he did not access any of the military department systems for arriving at the total amount of inventory as detailed in the chart provided in the board materials. He explained the chart was trying to summarize the volume of inventory that has been reported to the DoD Supply Chain Integration Office for FY2013. He explained there is approximately \$180 billion worth of inventory that is reported upstream and is comprised of secondary items, consumables, reparables and principal items.

Mr. Jackson explained there are several areas that we still need to research further and gain more information. It deals with reparables and we plan gain a better understanding and determine how they account for value reparables. Thus far, the Air Force has shown with some degree of specificity how they value reparables and it seems to be in accordance with the standards. However, we are not in a position to validate this, but we are trying to drill down so that we are getting clear explanations and a fair representation of the process.

The second inventory category requiring further research is principal items. Principal items are about half the inventory value. Mr. Jackson explained attachment in the briefing paper provides details on the composition of principal items. It includes things such as weapons themselves. It includes items such as shoulder fired missiles. He explained that gaining an understanding of principal items involves determining who manages these items. For example, principal items by definition are centrally managed-

-such as munitions are all managed by the Army. We need to determine what systems manage munitions and the valuation method. Mr. Jackson explained that we are in the process of trying to gather this type of information and in fact, we sent a chart to the DoD folks about 30 days ago actually asking questions with regard to the military department with management/accounting responsibility for each category of principal items, the system in which each category is managed, and the valuation basis for each category. He explained that we have been told that the military departments maintain a record of the principal items inventory (for example, the munitions) they own but that they do not manage since they are centrally managed.

Mr. Jackson explained another area that we want to delve into is confirming our understanding of inventory accounting and valuation processes at each branch. He elaborated that while the Air Force has given us a very clear explanation of their whole inventory accounting and valuation process, the Army has been using many different systems. Therefore, it is not clear how the data was valued in these multiple Army systems, and how that data was in turn transferred to their ERP. The situation at the Navy pertains to non-working capital fund inventories that we previously discussed. We need to confirm our understanding of the valuation process in the coming months. As detailed in the paper, we have been told that the Navy and the Army have adopted new ERPs. The Navy stated that they moved all inventory from the legacy systems to the ERP, and they moved it at latest acquisition cost. However, no effort was undertaken to attempt to revalue the inventory at historical cost or estimated historical cost. The effort would have all but impossible given the absence of a historical record.

Mr. Jackson explained that this is the type of lengthy process that the Defense Logistics Agency performed. When the Defense Logistics Agency moved inventory from their legacy systems to their new ERP, they went through a process to try to approximate historical cost using the best information available. It took them several years to do this and there were hundreds of thousands of national stock numbers involved.

With regard to the Air Force, the Air Force does not have an ERP currently to account for their inventory. They are using some legacy systems and they go through a process annually to use data to value their inventory at moving average cost. While we cannot say that they are doing it right since we did not validate the process, the Air Force provided us with a very thoughtful explanation of process it uses to arrive at moving average cost.

Mr. Jackson explained that what he sees as a big hurdle as he gets to a recommendation to the board is the question if the board is willing to accept latest acquisition cost at the time of transition from a legacy to a new system that will calculate value at moving average cost. He explained that all the ERPs that are currently in place are designed to calculate inventory value at moving average cost. They are all SAP systems. As noted the Air Force has not migrated its inventory to an ERP.

Mr. Allen suggested that he did not think the board should be the primary audience for that question and that should be posed to their auditors. He asked if their auditors have been involved in these discussions?

Mr. Jackson stated they have not been involved because the standard says historical cost. It gives you various ways of dealing with historical cost. The standard also says you can use latest acquisition cost if you can go through a valuation adjustment for financial reporting. The DoD does not have a methodology for computing it. In 2003, DoD decided to move to moving average cost, but you cannot go to moving average cost on these legacy systems because they are not designed to use this methodology. As they move forward to new systems, they can use the moving average cost.

Mr. Jackson explained that right now DoD cannot comply with the standard as written and that is one of the reasons they came to the Board. The question is can a modification to SFFAS 3 or some other authoritative route be taken to accept something other than what is currently in the standard. If a modification accepts Latest Acquisition Cost (LAC) at transition, then from that point on, moving average cost is to be used. Mr. Jackson explained the modified standard would have dealt with what currently would be an auditor issue with DoD's current valuation methodology.

Mr. Smith asked if DoD can identify when the items were purchased? Mr. Jackson explained he cannot say for certain right now. We have been told that the system will not give you a historical record of the value of their current inventory. When they buy something today, everything in the system is changed to Latest Acquisition Cost; LAC. Mr. Smith asked if at the transition date if they would know how old those things were that they put in the system in the beginning. Mr. Jackson stated he did not know for certain.

Mr. Jackson explained that we had one other thing in our work plan, which we have not tried to execute yet. He elaborated that one of the steps was to look at turnover rates. For cohorts of assets that have high turnover rates, then it would appear for that cohort, Moving Average Cost (MAC) would be the equivalent of LAC. The only question is do you want to go through that for all their assets, hundreds of thousands of national stock numbers. Instead, they could be put in dollar value cohorts and review the big classes. There is probably a way to figure out whether a large percentage of their assets have a high turnover rate. Mr. Jackson explained a good example would be medical equipment--the Air Force medical equipment, has a turnover rate of 200 and is measured using the latest acquisition cost.

Mr. Showalter asked why we care. He explained that after a couple of cycles, it does not matter. He suggested reviewing the International Financial Reporting Standard 1, First-time Adoption of International Financial Reporting Standards, and stated that IFRS 1 may help with the modified moving average question. He explained they have some very practical answers to sticky questions on initial implementation. However, Mr. Showalter explained that he had trouble understanding the problem because it seems once it works through a couple of cycles, the issues will resolve itself.

Ms. Payne explained that there are some cohorts that do not turn over as quickly. Mr. Jackson agreed.

Mr. Smith asked if there was a way to determine how old items were at the date they were put in the system and take a deflation rate and deflate it back based on when acquired.

Mr. Jackson explained that one must consider DoD is dealing with millions of items. He has considered many ways to estimate this, including deflation rates and SFFAS 35. However, do they want to try to go through a deflation process with regard to those when they may not know when they were acquired? Further, what benefit is this to the Department of Defense managing \$180 billion worth of inventory? What decision is going to be affected? They are fine going forward.

Ms. Payne explained that one concern with even saying LAC is they have to document it. Further, some of them are not at LAC anymore because they already transitioned, so they have a mix of LAC and MAC. She asked could we accept on a date what is in your system and that is your starting point. Don't worry about the documentation other than here is what is in my system and that is where I started and move forward.

Mr. Allen asked for thoughts from the auditors.

Mr. Dacey stated that some of systems have already been converted, but have they been converted over to MAC at this point?

Mr. Jackson said it would be fair to say we are not certain at this point. Mr. Dacey explained that we are now in FY2014 and we are looking at best-case first audits in FY2018. He explained there would need to be slow-moving inventory in material amounts to have an impact. He believes if the numbers are manageable and if they do the complete transition soon, it could be reviewed.

Mr. Dacey explained the challenge in addressing at the standard level--and he planned to look back at IFRS—there is certainly a breadth of acceptability. But saying that a whole basis of accounting was developed and is now accepted, which may in fact not even be LAC. Even if it is purported to be LAC, it may or may not be LAC. It would be difficult to suggest you just take whatever values are recorded as acceptable. Mr. Dacey explained the Corps of Engineers went through that whole process. They had values in the system, but they did not know if they were right or wrong. Ultimately, they had some professional engineers on their staff that made some judgments about whether it was a reasonable cost as opposed to the exact cost.

Mr. Jackson explained another issue is documentation. DoD will tell you that one of the big problems they have is providing documentation to support transition values.

Mr. Steinberg stated he agreed with what Mr. Showalter said and he believes they will audit all of these conversions. He explained if the Board is trying to make things easy for them, he would say for a short period of conversion time they can value their inventories based upon the quantity and the moving average cost.

Mr. Smith explained that if we know the quantity we can get there. We should figure out what items they have and what is the best way that we can get to a value and say that this is acceptable in transition.

Mr. Allen suggested there may be wording in GASB Statement 34 that may be helpful; it relates to documenting your method of estimation. If you have a cost, implement it. If you do not, document the method of valuation and then going forward consistently applying that.

Mr. Jackson asked the Board how much effort should DoD be expected to put into something like this when in fact we should be looking forward and not backwards. He explained that they have moved to the adoption of valuation and accounting methods in compliance with the standards. Mr. Allen explained that six or seven years ago, a DoD representative talked about audit readiness and this issue was discussed. Mr. Allen explained that he suggested that DoD make an estimation and from that point going forward you will have accurate information so that over time it will get more accurate. The response back was they do not have the ability to capture new asset cost information so it will not necessarily get more accurate as they go forward.

Mr. Jackson suggested that in the case of inventory, that is not true and they do have a system. There are ways to look at the information, such as turnover rates. He explained that turnover rates can be looked at so you can start seeing how fast this will cleanse itself.

Mr. Allen explained that may be consistent with Mr. Dacey's point about there may be a manageable number if you look at materiality and turnover rates. Mr. Jackson agreed but explained that what he is struggling with right now is to what extent within the context of this project that we want to start drilling down and looking at turnover rates. He noted that high turnover rates means then LAC is equivalent to MAC. Then the only issue remaining is do you have documentation to support LAC because you had a beginning number. But if you have a high turnover rate, that beginning number has already purified itself.

Mr. Jackson acknowledged there are a lot of ifs at this point and right now, we were just trying to gather information. Up to this point, we have spent time gaining an understanding of where they are with regard to transition and understanding valuation methods that they used in existing systems. There are things that we need to better understand where they stand, and then the next question is do we want to engage in a turnover rate analysis or do we want to move to a recommendation without that level of analysis.

Mr. Allen explained that his point of involving the auditors was that perhaps the Board may not need to do anything. He explained if DoD can do whatever they have done and keep accurate records going forward from this point on that could be a route for moving forward.

Mr. Reger explained that he thought the point was that if there was somewhere in a standard the ability of an adoption of a permissible method, it would be incredibly helpful. Mr. Jackson agreed, with the caveat that the adoption clause cannot have an unending life.

Mr. Smith suggested that Mr. Jackson come back to the Board once he has a better understanding of what is there and what needs to occur. He added at that point he can put something on the table to say this would be very helpful and would support DoD with their auditors. Mr. Smith explained that it may be a lot there is not anything that needs to be done in the standards.

Mr. Jackson agreed and stated what he views as an objective of the task is to come to a meaningful recommendation, he would like to make certain that we do not do anything that causes DoD to spend millions of dollars on contractors for the sole purpose of arriving at an amount that is necessary to comply with existing standards that provides no operational benefit to them whatsoever.

Mr. Steinberg asked if there has been discussion with their auditors. Mr. Jackson responded no and that we want to make certain that we have all of our facts. Further, the inspector general is who we would have to have the conversation with.

Mr. Dacey explained that he did not know if there was any way to validate that, when they adopted moving average cost, the LAC was appropriate and free from material errors. Hopefully they can substantiate that basis as there was an issue noted with documentation.

Mr. Jackson explained that documentation is an issue for them and they are concerned. They have expressed concern with the need to be able to get documents to support valuation at transition. However, why would that be of concern because if something is recorded at latest acquisition cost, they should have the last invoice that they paid by national stock number.

Mr. Jackson explained that DLA moved to MAC and apparently based on what they said, they have a fairly smooth running system. They may be some valuation data in the DLA system that could act as a surrogate for valuing information that is in the service systems. He explained there is the possibility of some data matching.

Mr. Allen noted the complexities in the area and thanked Mr. Jackson and FASAB staff for the work in the area.

Conclusion: The Board did not make any decisions at the December 2014 meeting on this agenda item as this was an update. Important items discussed that are detailed in the minutes include the following:

- Staff anticipates making progress in the Research and Development area in the coming months, contingent upon DoD providing contact information and more information about the request.

- The issue of “end user” will be researched further to determine how best to address it.
- Follow-up with the branches (as well with the Marines) will be held to confirm all results to date on the deployed assets issue. A final recommendation will be presented to the board for approval, vote and record in the minutes.
- FASAB staff (with contractor assistance) plans to continue research and gain more information in various areas as it relates to inventory—including reparables, principal items, and confirming our understanding of inventory accounting and valuation processes at each branch.
- FASAB staff (with contractor assistance) plans to research various areas discussed by Board members at the meeting such as IFRS 1, GASB 34, further analysis and consideration of turnover rates, etc. The members also suggested meeting with the DoD IG at a time deemed appropriate.

- **Steering Committee Meeting**

The Steering Committee briefly discussed the FY2016 budget and indicated that the 2016 amounts remain uncertain.

Adjournment

The Board meeting adjourned for the day at 5:00 PM.

Thursday, December 18, 2014

Agenda Topics

- **Insurance Program – Educational Session**

Mr. Allen thanked Ms. Gilliam for getting such a distinguished group of people together to help educate the Board. He assured the panel that the Board works hard to issue standards that consider cost benefits of applying them. Therefore, he requested that they address challenges that they may have and any broad thoughts in regard to federal insurance program. He then turned the education session over to Ms. Gilliam.

Ms. Gilliam referred the Board to Tab F and introduced the panel:

Department of Agriculture (USDA), Risk Management Agency (RMA), Federal Crop Insurance Corp (FCIC)

- Michael Drewel, Accounting Officer
- Margo E. Erny, Chief Financial Officer (CFO)
- Shanda Sander, Special Assistant to CFO
- Tom Worth, Senior Actuary

Department of Homeland Security (DHS), Federal Emergency Management Agency (FEMA), National Flood Insurance Program (NFIP)

- Jennifer Raab, Accountant , Financial Statements and Reporting Branch-OCFO
- Thomas Hayes, Chief Actuary

Department of Transportation, Federal Aviation Administration (FAA), Aviation Insurance Program

- Tom Brown, Insurance Examiner

Ms. Gilliam explained that this education session was in response to the open questions the Board had about the premium deficiency discussion at the October Board meeting. We want to get answers about how losses are estimated in order for the Board to make a decision about adding a premium deficiency liability. She turned it over to Ms. Erny with NCIP.

RISK MANAGEMENT AGENCY (RMA)

FEDERAL CROP INSURANCE CORPORATION (FCIC) PRESENTATION:

Ms. Erny began by explaining the operating structure of RMA. RMA is the agency that has the people resources and where the salary and expense (S&E) is captured. The FCIC is structured to manage program cost but no S&E cost. RMA has the following Board Members:

- Under Secretary of Farm and Foreign Agriculture Services (FFAS), [Michael Scuse](#);
- USDA Chief Economist, [Dr. Joseph Glauber](#);
- FCIC Manager (non-voting), [Brandon Willis](#);
- Four farmers, one of whom grows specialty crops:
 - [Margaret Goode](#)
 - [Ellen Linderman](#)
 - [James Bardenhagen](#)
 - [Kenneth Ray Sneed](#)
- An individual involved in insurance (often an agent), [Iris Sáenz](#);
- An individual knowledgeable about reinsurance or regulation, [John F. Finston](#)

The program (RMA) establishes rates, policies, standards, regulations, and the subsidies for our growers. While FCIC provides a subsidy, it is not a payout. The subsidy does not leave RMA/ FCIC. It is an accounting entry that is made. FCIC also pays approved insurance providers (AIPs) to market and service the policies.

Mr. Allen asked if it is appropriated funds that FCIC uses for the subsidy. Ms. Erny said yes, and explained that there are two funds, 1) the annual Salaries and Expenses (S&E), and 2) the FCIC fund which provides such sums as necessary and is part of the Farm Bill.

Mr. Granof asked why there is a subsidy, and how does the subsidy work? Mr. Drewel of FCIC said that a premium subsidy is a benefit to the producer. The subsidy reduces

their premium which we use to pay some of the losses along with the producer premiums.

Mr. Allen asked if you have any discretion over how you pay it out. Or, has Congress set how much blueberry growers get versus cattle ranchers? Ms. Erny explained that FCIC is not a disaster program. It establishes the confines of the insurance up front through the contracts it issues with producers, like you would have for your car insurance. FCIC sets parameters as to what gets paid under what circumstances and how much it costs. Rates are set to have a 1.0 loss ratio with no loaded premium. The formula is:

producer premium

+ premium subsidy

total premium

(total losses)

-0-

Ms. Erny turned to RMA's relationship with the Approved Insurance Providers (AIPs) stating that RMA does not just pay the AIPs to sell and service the policies, that AIPs also has some skin in the game. To explain, she referred to the term "moral hazard," which is part of capitalism. If you leave people to their own devices potentially - abuses could happen. So the AIP share in the gains and losses to keep the cost down in the program.

The AIPs responsibilities are to market and service the policies, collect and guarantee the producer payment to FCIC and do the accounts receivable for the insurance contracts. FCIC does have some very small accounts receivable for collecting fees.

Ms. Erny moved to discuss the crop statistics slide, to give the Board a framework for the magnitude of the program.

Crop Statistics

Program Information Comparison	Crop Year 2014 (Estimated)	Crop Year 2013 (Actual)
Policies	1.20 million	1.22 million
Farmer Paid Premium	\$3.88 billion	\$4.51 billion
Premium Subsidies	\$6.24 billion	\$7.30 billion
Total Premium	\$10.12 billion	\$11.81 billion
Indemnities	\$7.49 billion	\$12.06 billion
Loss Ratio	74%	102%
Insurance Protection	\$109.46 billion	\$123.77 billion

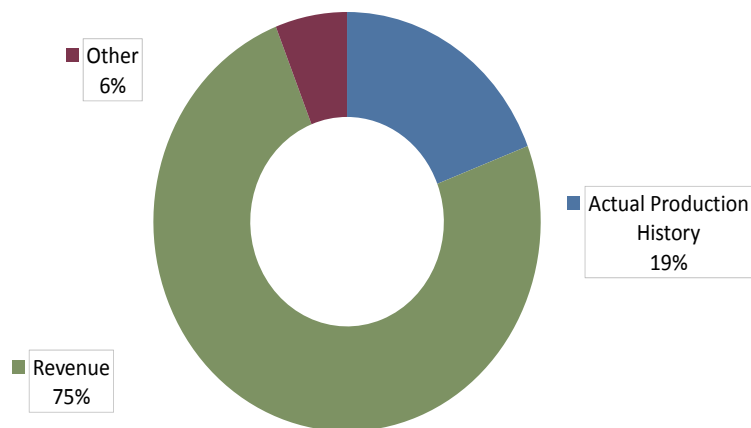
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The insurance protection is the value if we would lose everything.

Mr. Showalter asked if “insurance protection” is the amount under contract. Ms. Erny said that, yes, that is the amount under contract. She noted from working with FEMA the day before, that there are different terminologies across insurance programs, so she encouraged the Board to ask for specifics.

She turned to the Insurance in Force slide to further explain.

Percentage of Insurance in Force
by Type of Insurance Plan



5

The big part of the donut--(green section) is insurance on revenue and is much more common now than it used to be as it has been growing over the last 15 years. Revenue insurance is yield times price. RMA smoothes out both the yield and the revenue, therefore, if the price of corn goes down but the yield goes up, producers may or may not get a payout.

Mr. Reger asked if that takes away the incentive to produce more even if you are selling it for less. Is RMA/FCIP protecting producers against both fluctuations in the quality of the crop and against price fluctuations and the quality of the crop and against pricing?

Ms. Erny said yes and explained the different types of insurance:

- Revenue policies protect the producers against the loss of revenue, pricing fluctuations, and yield loss to natural causes.
- Actual Production History & Yield Protection Policies (APH) protects against just yield losses.
- Other Policies include policies based on county results rather than individual farms, Adjusted Gross Revenue, and Fixed Dollar Amount of Insurance.

All the major crops are now covered, but we do have an avenue for people that are not part of RMA to propose types of policies. We get grower associations and different insurance companies come up with different types of policies to cover organics and clams and other small types of agriculture.

Mr. Worth, Senior Actuary, of FCIC took over to discuss premium rates:

Premium Rates

- Determined by RMA on behalf of FCIC
- Federal Crop Insurance Act:
 - “the amount of the premium shall be sufficient to cover anticipated losses and a reasonable reserve.”
 - “the Corporation shall periodically review the methodologies employed for rating plans of insurance”
 - “The Corporation shall take such actions. . . to achieve an overall projected loss ratio of not greater than 1.0.”

The above slide quotes from the Federal Crop Insurance Act that guides RMA's establishment of premium rates. The first quote instructs us to charge a pure premium not loaded for expenses, and the other two quotes state that we should be actively engaged in reviewing our methodology, and improvements or potential for improvements should be pursued, to assure that the expected loss ratio going forward is at or below 1.0.

He explained that losses for the program have to do with water, either not enough or too much. He walked through the four map slides to show the patterns between because of excess moisture and drought and higher liability and exposure.

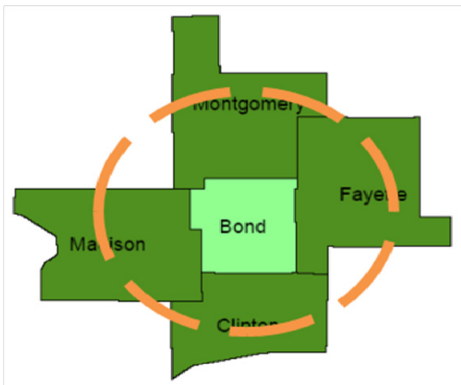
He explained that the **premium rating** is a pure premium rate with no expense load for expected indemnities individualized.

The method used is the loss cost method which uses the average rate of loss, $\text{Loss} = \text{Liability}$, for a rolling 20 year window.

For example, if the insured value is \$100 and on average through time we pay \$10 of loss, 10 percent loss rate or loss cost, then we charge 10 percent. And the average that we look at in terms of average loss cost is a rolling 20 year window.

There are other complicated adjustments to smooth the premium rate, for example:

- Credibility smoothing with adjacent counties as shown in the below slide:



- Catastrophic loading process based on the most extreme loss events observed in the historical data for a particular area back to 1975, and
- Weather weighting looking back 20 years at the weather window out of 100 years of history to determine if that is a better or worse than average time and doing an adjustment based on that to achieve a straight up lost cost average.

Mr. Showalter asked if there is an inflation factor in the cost. Mr. Worth said that yes, the inflation factor is actually captured with the commodity price. Every year we

look at the expected price on the futures market for the major products. For example, our program has grown tremendously due to the fact that when we first came to the program corn was around \$2 a bushel, and then it got to \$6 a bushel. So everything we charge is a percent of the value.

He went on to explain that RMA individualizes their insurance by allowing producers to purchase:

- 1) Varying levels of coverage; the higher the level of coverage the more we charge;
- 2) A “unit choice” product where they can combine and insure all their fields together, which means the excess in one field can offset the shortfall in another. Unit Choice provides more stability and a lower rate; or
- 3) A “yield ratio” product where they can purchase a field by field insurance contract. The premium is higher. [Research has shown that if a producer’s yield is higher than average for the county, they tend to be a lower risk, and vice versa]

And then finally there’s **Revenue Coverage**.

RMA looks at that 20 year rolling average loss cost to establish yield rate, but we have a forward looking establishment of revenue risk based upon options prices in the commodity market. We look at the options market and try to lock in a price for corn and then use that to shape how much we charge for the insurance.

Mr. Allen asked what happens when yields tend to be higher, does that lower the risk. Mr. Worth said that the loss cost will automatically adjust if the rate of loss has been 10% for the last 20 years. But if in the next five years it is 15% that will pull up the average loss cost.

Mr. Allen asked if that is adjusted for the county-wide basis and not the individual farmer. Mr. Worth said that the individual farmer is pulled up with the county-wide base, and then those adjustments move from the base.

Mr. Allen asked that if he were an individual farmer that had a significant loss and others around him did not, how does that affect the average? Mr. Worth said that is a good question and that is addressed through the yield adjustment. For example, if an individual farmer had a big loss as compared to others in the county then his position relative to the average in the county will fall and his premium rate will go up. That is RMA’s risk classification mechanism.

Mr. Reger asked if it all focuses around maintaining a consistency of income. Mr. Worth clarified that yes, the insurance is there to stabilize income. For example, producers can purchase a maximum of 85% revenue coverage. If the crop value is \$100 and the producer purchases 75% coverage he is guaranteed \$75 of revenue in hand.

Mr. Reger asked if it is actually designed not to encourage producers to adopt

better farming practices, because if I produce more on an acre than my neighbors then actually I'm penalized. Mr. Worth clarified that if you produce more than your neighbors you are not penalized. Two things happen: 1) you make more money because you can sell more of the crop, and 2) your average yield will be higher than your neighbors, and your rate will go down.

Mr. Worth further explained that the risk is managed by how much RMA guarantees. RMA looks at the producer's average yield. If the average yield has been 150 bushels per acre, then that establishes your yield. If you then start doing 180 then you get a higher guarantee to match that. That provides a disincentive. On the other hand, if you have been doing 150 bushels and then you have a couple years of 10 bushels, then that pulls down the average and your insurance guarantee for the next year is much lower which results in not only a higher rate, but less coverage.

Mr. Allen asked that in relation to the hundreds of thousands of acres that are not farmed in Washington State, if RMA pays them not to plant wheat. Mr. Worth said that is a conservation reserve program which is not a part of RMA's mission.

RMA tries not to affect market signals, and that's why we turn to the markets. If the futures market is saying that corn for December delivery is \$4, then that is the price we use to guide how much we guarantee. We do not want to create an incentive to plant for the insurance, so we follow the market.

Ms. Erny said that FCIC does offer insurance in relation to a weather problem, for example, there is too much rain and the producer cannot get into the field to plant. But this is not to be confused with being paid not to plant.

Mr. Worth continued with the Loss Ratio History slide to present a snapshot of the program performance for the period from 1975 to 1994 and from 1994 to the present. For the period from 1975–1994, there was an average loss ratio of 1.93 during that period there were a couple catastrophic events: 1) the most significant drought we faced was in 1988 and 2) the 1993 floods.

In the last 20 years the program performance has been much better due to:

- congressional reforms in terms of program integrity,
- how premium rating is approached,
- risk sharing with the companies,
- cleaning up the policies, and
- producer tracking and compliance.

Therefore, the loss ratio performance in the last 20 years is now below 1.0.

Mr. Steinberg asked that if the loss average is 0.89 would RMA/FCIC build up a surplus year after year. Mr. Worth clarified that the program operates with the

expectation of a loss ratio at or below 1.0. The program does not have a reserve. Rather, if premium collected from growers exceeds indemnity, then that is returned to the Treasury. If indemnity is greater than the premiums, then there is a withdrawal from the Treasury.

Mr. Showalter asked if there is a dividend on the insurance policy for a lower loss ratio. Mr. Worth stated not for the individual producer. However, there is a risk sharing agreement with the AIPs. In years when there is an underwriting gain some of it is shared with the AIPs and some is retained by the government.

Mr. Showalter asked if the loss ratio was more than 1.0 in a certain period of time would the RMA try to adjust immediately in the next year. Mr. Worth said that RMA adjusts premium rates regularly with loss cost. The advantage of the loss cost methodology and the rolling 20 year average is that it adapts to where the program is headed. But it is a balance. We do not want to overreact since each year is a single observation and 20 are actually not that many years. And so that is where we trust our methodology and go through regular reviews.

Mr. Showalter asked if RMA tries to protect farmers from too much swing in their costs. Ms. Erny explained that every year producers have an annual rate review plan that they generate and provide the rate strategy memo to decide what if anything needs to be reviewed as far as rates are concerned and come up with a risk plan.

Ms. Gilliam asked if RMA/FCIC could explain the term indemnity and how they use that in relation to the losses since all the programs use that term a little differently. Mr. Worth explained that “indemnity” means losses paid to the growers.

Ms. Gilliam asked for further clarification in relation to how their subsidies work since they stay in-house and it is just an accounting entry. That instead of them paying the missing premium, if there is a loss and the premium has not covered that loss then RMA indemnifies (pays) the producer with the subsidy. Mr. Worth gave the following example: As a producer you receive a premium bill for \$100 from an AIP, telling you that the government is going to pay \$60 of that \$100 and you owe \$40. The AIP collects the \$40 and forwards it to RMA. Then at the end of the year, the producer has a loss of \$100 which the AIP pays. RMA then refunds the companies that entire amount [the \$40 collected from the premium and the \$60 withdrawn from the Treasury].

Ms. Erny clarified that RMA asks for appropriations different than RMA spends them. RMA ask for an appropriation for subsidy, but spends on indemnities. See the above formula on page 4.

Mr. Granof asked if the subsidy is the difference between what an individual pays and what it would cost. And, Mr. Steinberg asked how RMA decides what the overall appropriation is for the subsidy versus what the farmer pays. Mr. Erny explained that Mr. Worth generates an estimate of the total premium for the crop year using a model—basically a giant spreadsheet—that adds and subtracts factors,

including any changes from an updated farm bill.

A number of members wanted clarity on how and what bill sets the subsidy rate. RMA/FCIC panelists explained that the subsidy rate, the percent of premium that is covered by the government, is set in the Farm Bill which is a mandatory bill and not an appropriation bill.

Every year, RMA does an initial apportionment based on the estimate in the model; we receive money from the Treasury and then do cash management throughout the year. RMA does not give back the money early. But if more money is needed, like in 2012, we do an additional apportionment to cover “such sums as necessary,” and we receive additional money from the Treasury.

Mr. Reger clarified that at the end of the year if you have not spent all the money then it is remitted to Treasury, but what happens if there is a debt crisis at the end of the year.

Ms. Erny explained RMA works closely with OMB and Treasury to manage their daily/weekly spending when responding to an end-of-year debt crisis. Mr. Drewel added that RMA retains a \$500 million reserve for capital stock which is approximately a one or two week reserve in heavy loss seasons or a four to six week reserve in the light loss season.

Ms. Sander continued by addressing the first set of questions that Ms. Gilliam asked:

- ***How are the pricing policies determined for premiums?***
- ***Who sets the pricing policy for the premiums?***

The actuarial branch identifies specific issues and addresses them internally, and can contract with external parties to review the rates. The actuarial branch also prepares an Annual Premium Rating Strategy Memo that provides an implementation plan, which is then reviewed and approved by management.

- **When does your program bill for premiums and recognize revenue/unearned revenue?**

Ms. Sander stated that there are two pieces to the revenue, the producer premium and the premium subsidy. Both are recorded in the general ledger at the time the acreage reports are accepted by RMA--the producer submits the acreage report to the AIPs which is then transmitted and accepted by RMA. The acreage report provides the following information that determines the amount of revenue:

- What crops have been planted,
- Which crops have been prevented from planting due to excessive moisture,
- Where the crops are located,
- The number of acres planted, and
- The dates planted.

The accounting entry for the premium subsidy appropriation received is unique. RMA records the appropriations used to recognize the benefit of the premium subsidy.

Unexpended Appropriations – Used (SGL 3107)

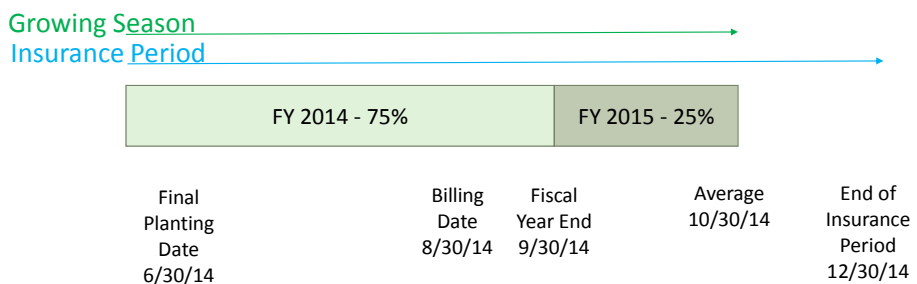
Expended Appropriations (SGL 5700)

RMA does not pay out the appropriation as premium therefore, they do not record any entry of cash transmitted. It will be used later to pay losses generally that occur into the next fiscal year.

The premium revenue is recorded earlier in the year, and then at fiscal year-end RMA establishes liabilities to record the amount of revenue that is deferred into the next fiscal year. RMA looks at this on a crop by crop basis. We take an average in our system of when the billing date for that crop is, and the average at the end of the insurance period.

Unearned Revenue/ Premium Deficiency Reserve

At fiscal year end, liabilities are established for a portion of revenue deferred into the next fiscal year to pay the losses incurred in the next year. The amount is based on the average number of days between planting date to billing and planting date to end of insurance period compared to the days after the end of fiscal year.



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For example: The final planting date where the producers have to plant by is June 30th. The AIPs will bill them on August 30, and the end of the insurance period is December 30. RMA takes the average of the billing date and the end of insurance period to determine that crop is harvested on average around October 30.

So in this case the growing season is four months, from June 30th to October 30th. 75% of those four months [July, August, and September] fall in the current fiscal year. The remaining 25% fall into the next fiscal year which is the amount RMA will defer and establish a liability on the financial statements.

Ms. Gilliam asked them to clarify the growing season, which is from July to June,

in relation to the four month example provided.

RMA/FCIC panelists explained that annual growing season is the reinsurance year for all crops. Each crop is only planted one time during the reinsurance year. The slide shows one specific crop for example, corn in the Midwest. Revenue is analyzed by individual crop and state to get the percentages in order to determine the deferred revenue.

Mr. Dacey asked if the un-earned premium is on the total premium, including the subsidy. Ms. Sander confirmed that the unearned premium is only the portion of producer premium.

She stated that they also record a “Premium Deficiency Reserve” for the percentage of the premium subsidy that we create a liability for the next year.

Mr. Allen asked when are the losses paid out, are they known at the end of the year. Are you recognizing revenue in one year and the payment for that in another fiscal year? Ms. Sander said that loss payments come at the end in the next fiscal year. And, we record a liability for the incurred but not reported (IBNR) claims which are estimated and not known. Mr. Drewel added that IBNR losses would be a future funded cost in the current year obligated in the next year.

Mr. Allen asked why RMA does not defer the whole revenue recognition year. Ms. Erny explained their challenge in relation to other insurance programs and matching the losses and the revenues—which is a basic accounting principle—is defined **when a drought actually occurs**. If it is three days after planting when the ground is dusty and dry, but it rains next week then the crop will be fine.

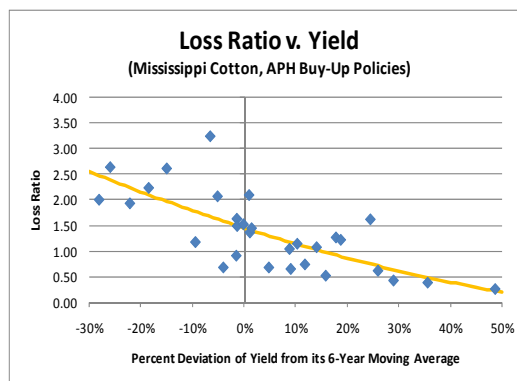
The main challenge and difference is that crop loss is not related to a single defined event – like a flood or a plane wreck. Drought is a long-term activity that has be averaged over the time of the crop year, for that crop’s activity. The challenge in knowing the actual amount of the loss also relates to the fluctuation in prices.

Mr. Worth continued using the below slide to emphasize that it is difficult if not impossible to forecast or predict loss.

Estimating Claims

- *Does your program estimate claims for the remaining open policy period following the end of the reporting period? If yes, how?*

- Limited data – major crops
- NASS yield projections
- Commodity Market Prices



In relation to the slide, the graph on the right chart shows a relationship of deviation of the state average yield from its six year moving average because typically growers have around six years in their average yield that establishes their insurance guarantee. You can see that the general relationship shows that the lower the yield is below its six year average the higher the loss. However, there is a lot of uncertainty as you can see from the dots.

For example, note to the left of the zero%, there are more than 3 to left of 0% different dots. One at almost a loss ratio of 3.5, and one all the way down to a dot near a 0.5 loss ratio. In other words it may look dry, but then the rain comes and the crop is fine, or vice versa.

In addition, we do not know the distribution of losses. If the average deductible in the state is 25%, and the state is down 25% and it is evenly distributed, then there is no payment. Or one part of the state can be doing well and the other has a severe loss. This shows that there are so many things that we do not know.

Another element of uncertainty is the **commodity price** which is depicted in the left chart. That is the futures price for the December corn contract which we use to guide what we establish as the insured value of corn and to determine during the month of October what we will be paying for in terms of price decrease. And there was a significant price decrease.

The corn price started off really high, and then partway through the summer it was declared a bumper crop and the price dropped like a rock. The corn price hit its lowest point in late September right when we are supposed to close our books, and at that point it looks like we are going to pay a lot of revenue losses. But then during the month of October, which is our reference month for establishing our harvest price to determine

payments, the price bounced back up, which showed a very different picture by the end of October.

[*Challenge with audit*] Which demonstrates how utterly unpredictable this is, yet this is the source of tension that I have in dealing with actuaries from the financial audit groups since they insist that we should know.

Ms. Sander mentioned that because the growing season for 93% of premium extends past September 30th we do not know the yield at September 30th.

Mr. Smith asked for those 93% of the premiums, how many months do they extend past September 30th. Mr. Drewel said that the insurance period for those crops is usually December 15th or 31st.

Mr. Granof asked if they close their books in November. Ms. Sander said that we are generally finished by the first week of November.

[*Challenge with audit*] However, even though we have an estimate as of September 30th, the external auditors do not come in until the last week of October, and we have new data, at which time they want us to restate the entire estimate. Then we only have one week to turn it around.

Ms. Erny noted that this happens repeatedly and expressed how frustrating it is to redo all the financial statements, notes, et cetera, every year because auditors send in a new person who asks Mr. Worth why they do not know their losses on September 30th.

A number of members asked if RMA/FCIC is a part of Agriculture and were they audited as a separate component. Ms. Erny said that the audit is stand alone and required by law because the federal crop insurance corporation is a corporation; they are six or seven other corporations in Agriculture. She thinks that if they were not audited separately, they would still have a significant amount of scrutiny because the amount of their liabilities is material.

Mr. Reger recognized the amount of work and asked if they use the audit report for anything. Ms. Erny said that the audit report is used to maintain their funding with OMB. Mr. Worth said that in relation to the actual program administration, the audit report does not help at all. Ms. Erny added that it does not help because it takes too long to provide the program managers with enough data to influence program decisions.

Mr. Reger said that it is a challenge to match the government's September 30th deadline and as a regular business the year would not end on September 30th.

Mr. Allen noted that there are some entities within the federal government that have different fiscal years. Ms. Erny pointed out that they would still have to be audited as of September 30th, because it has to go into the USDA report and the government report.

Mr. Reger noted that there are agencies that have different year ends and we take

the most recent audited year for the statements. But he did note that FCIC does have a huge budgetary impact for which we would need to know the numbers.

He asked if there are accounting transactions that you do at the close of the fiscal year that you do not do during the course of the year. He also asked if the accruals and actuarial estimates are done just for closing.

Ms. Erny said yes, 85% percent of the balance sheet liabilities are estimated. RMA/FCIC Panelists: FCIS is on a cash basis which would not have a budgetary impact. FCIC does not receive extra money to pay the liabilities accrued for the financial statements. We do not have \$10 billion available in cash. The accruals we are booking are for unfunded liabilities and unfunded expenses.

Mr. Reger asked at what point in the year do you know the actuals. FCIC Panelist stated around March-April.

Mr. Reger asked that if you had a March 30 year end would you just do them only once, at March 30th. Ms. Erny said that there is a second season for winter wheat and other spring crops, which are not nearly the volume we have of the fall, would be much easier to handle, and probably not even material.

Mr. Reger and Ms. Erny agreed that they needed to revisit that concept at a future date.

Ms. Sander continued with how they record the incurred but not reported claims at fiscal year-end:

Incurred But Not Reported Claims

- FCIC uses model to estimate Total Losses for all policies in force.
- Incurred Losses in current fiscal year = Total Losses - Unearned Premium and PDR
- IBNR = Incurred Losses less Recorded Losses

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Using the estimate of total losses for the year, RMA assumes that losses are incurred at the same rate as premium is earned. They take their total losses less an equal portion

of unearned premium and the premium deficiency reserve for the incurred. To IBNR they take the incurred losses, less what has already been recorded in the fiscal year, and record that liability.

The following slide was used as an example:

Example of Accounting Impact

Assumptions:

- 1 policy with total premium of \$100
- Producer Premium = \$40
- Premium Subsidy = \$60
- 75% of growing season from crop is in FY 14 and 25% in FY 15
- Expected Loss ratio at September 30 is 1.0
- Indemnity payment is \$100

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In a perfect world there is one policy with an expected loss ratio of 1.0, and the indemnity magically equals to the total premium which is \$100, producer premium is \$40, and premium subsidy is \$60. Again, 75% of growing season from crop is in FY14 and 25% in FY15. For the accounting entries:

Scenario Example: FY 2014

Event	Accounting Transaction	Amount	Debit	Credit
Apportionment	Receive Appropriation for Premium Subsidy	\$60	Cash (1010)	Unexpended Appropriation - Received (3101)
Acreage Report	Producer Premium recognized	\$40	Accounts Receivable (1310)	Premium Revenue (5500)
Acreage Report	Premium Subsidy recognized	\$60	Unexpended Appropriations - Used (3107)	Expended Appropriations (5700)
Billing	Producer Premium Collected	\$40	Cash (1010)	Accounts Receivable (1310)
Year-End	Record Unearned Producer Premium	\$10	Premium Revenue (5500)	Deferred Revenue (2320)
Year-End	Record Premium Deficiency Reserve (PDR)	\$15	Future Funded Expense (6800)	Estimated Losses for Insurance (2660)
Year-End	Record Incurred But Not Reported (IBNR)	\$75	Future Funded Expense (6800)	Estimated Losses for Insurance (2660)

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When we receive the \$60 apportionment, they debit cash in and credit appropriations received. To record the \$40 producer premium revenue, we debit accounts receivable and credit premium revenue. To record the \$60 premium subsidy, we debit unexpended appropriations used and credit expended appropriations. When we collect the \$40 cash for producer premium, we debit cash and credit accounts receivable. At year-end to record the \$15 unearned premium, which is 25% of the \$40 producer premium, we debit premium revenue and credit deferred revenue.

Mr. Smith asked the following question in theory: With your current accounting practice, the loss starts when the producer starts planting. Could you provide insurance for just the yield and price during harvest. Thus this is all you are insuring and the rest of it does not matter? Then you would recognize revenue during the harvest period, and that is when you would have a liability? It seems like we could simplify this accounting.

Mr. Reger said that is because the year ends September 30th, and they need to record financial transactions for the outstanding harvest.

Mr. Smith continued saying that at September 30th, 100% of the premiums would be deferred revenue. They would have no liability at all and then you would not have to go through a lot of this complicated accounting.

Ms. Erny noted that they do record the entire revenue as soon as they get the acreage report and back out the premium deficiency reserve and the unearned revenue from the producer.

Mr. Steinberg noted that he only sees the premium revenue received from the producer as revenue. For the amount that is subsidy, the credit is to unexpended appropriations—an equity account, it is not revenue.

Ms. Erny stated that there is no entry because the entire premium is not revenue.

Mr. Reger clarified that would imply a transfer from Treasury to RMA creates revenue when revenue is not created until you either receive money or disburse it—that is when the transaction occurs.

Mr. Steinberg confirmed what Mr. Reger was saying, but still found it confusing because the earlier slide showed that \$100 is total revenue which we get it from two sources 1) the producers and 2) Treasury. But when they account for the portion from Treasury they account for it differently.

Mr. Reger explained that is due to the warrant to get an apportionment. To get a warrant they have to go to Treasury and the money has to be in the bank.

Ms. Erny said that it is not exactly revenue; it is a use of funds from Treasury.

Mr. Reger explained that we are talking about general fund and how RMA/FCIC is a perfect example of how they deposit money to the general fund and then take credit for it, playing it against their receipts. But also how they get an allocation of funds that do not exist in the general fund, which is your apportionment, which is the money that you are going to be appropriated, and then you only take the piece of that that you actually need at year-end.

[Challenge with audit] Ms. Erny agreed, saying that we give back what we do not need. Another thing that complicates it at year-end, is that we collect on the last day of the year and then turnaround the next day and pay, so that the revenue is in the year-end. The 2008 Farm Bill accelerated collections and they delayed payments. So we accelerated our collections, get the cash late on September 30th around 4:00pm, which makes it very challenging to estimate cash. Mr. Drewel said that historically they started doing these entries back in the late '80s before FASAB existed, based on FASB 5 and FASB 60 on insurance accounting entries. He was around then if we need him as a reference.

Ms. Erny noted that this year's audit was very difficult. They tried to simplify it unsuccessfully. They still had a clean audit but it was very hard to get there because the auditors' did not have enough comfort with it and therefore rejected the change and they had to redo everything the other way.

Mr. Reger confirmed that this is the reason that Agriculture's financial statements are late this year. Agriculture asked and was granted the approval because they had started early, did a lot of new estimating and modeling. 30 days ago the auditors came along and said we cannot get a level of comfort around the new actuarial estimates, and they had to go back and redo them in the old models in

order to get the auditors comfortable.

Mr. Steinberg said that it seems there are two challenges probably, 1) the difficulty of making the estimates, and 2) the way the entries are done because we are doing budgetary and financial accounting. He then asked if the change was in estimating the losses. Ms. Erny said yes.

Mr. Reger said that as he understands it, the new estimates did not give you materially different numbers than the old estimates, but they could not get comfort around the estimating process. Ms. Erny felt, that as a taxpayer, the volatility of the program - \$1 or \$2 billion - is material.

Mr. Worth said that the new strategy in predicting is basically unpredictable. It was to base the estimates upon historical norms and bring that forward. He emphasized that whether they use the original or new way of estimating that both numbers will be wrong and the government can either spend a lot of money using the complicated estimating model to produce an unpredictable number, or spend less time and money on a simpler model to also produce an unpredictable number.

Mr. Smith said that their presentation was very valuable and helpful for the Board members to understand that auditors still must comply with the available standards. Are you following a commercial model that is really driven off of FASB and causes you to go through a lot of exercises for estimating? FASAB is in a completely different situation and by understanding this we have an opportunity to change the principle and deliver a pronouncement that makes sense, is practical, and fits our situation in order to deliver financial statements that are materially right and properly present what a reader needs.

Mr. Showalter also noted his appreciation and directed their attention back to the slide to discuss how they calculated the \$15 premium deficiency. Ms. Sander said the \$15 is 25% of the \$60 premium subsidy.

Mr. Showalter asked if that is really a premium deficiency reserve since the Treasury is going to reimburse and is really an appropriation in waiting.

Ms. Sander and Mr. Drewel explained that the financial auditors require a premium deficiency and say that we cannot book an appropriation receivable.

Mr. Showalter said that economically it is an appropriation receivable and Ms. Erny agreed.

Mr. Reger said that as individual corporation, it is a receivable, but when you sum it up on the consolidated financial report it is not. So actually we ought to eliminate it in consolidation.

Ms. Sander moved to the next slide [Scenario Example: FY 2015] and noted that for the following fiscal year, we reverse each of the accruals, the unearned premium, the

premium deficiency reserve, and the IBNR. Then we pay out the loss of \$100.

She then referred the Board to the next slide to illustrate what the balance sheet and the statement of net cost would look like.

Scenario Example: Financial Statement Impact

Balance Sheet Liabilities	FY 2014	FY 2015
Estimated Losses on Insurance Claims:		
IBNR	\$75	-
PDR	\$15	-
Total Estimates Losses	\$90	-
Unearned Revenue	\$10	-
Total Liabilities	\$100	-
Statement of Net Cost	FY 2014	FY 2015
Claims Incurred	\$75	\$25
PDR	\$15	(\$15)
Total Cost	\$90	\$10
Less Revenue	\$90	\$10
Net Cost	\$0	\$0

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Again, this is the perfect world where total premium equals total losses, and therefore, net cost is zero, and therefore, no income was created or expenses reduced in the following year. However, in actuality we do have variances that occur in the following fiscal year because of differences between actual and estimated.

Ms. Erny explained that for this past year, they spent a great deal of time explaining over and under estimates. For example, in 2012 we overestimated losses because we thought it was a bad year, but turned out not to be as bad as we estimated. Therefore, when the estimate is reversed, we ended up with a positive amount. Last year we under-estimated, because at the end of the year it looked like a 0.74 loss ratio was appropriate and we ended up with a 1.02. So that disparity shows up quite clearly on the comparative balance sheet.

To smooth those over and under estimates we use a 1.0 loss ratio. In addition, we used 20 years of losses instead of one year of losses, to give us a more accurate picture of the program. In order to better accomplish that we should have back tested it. There were just a lot of things that the auditors recommended at the end that we should have done and that we will endeavor to accomplish this year.

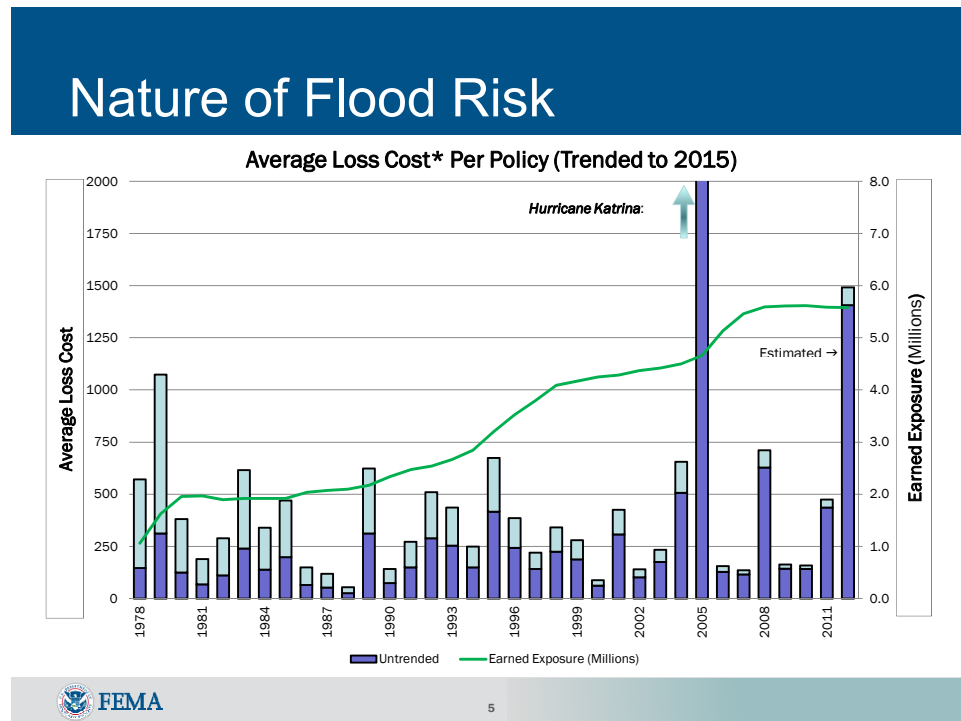
Ms. Sander referred the Board to the next slide to answer the question on what reports, outside of the financial reports, are available. The Premium Prices and Actuarial Methodology documents are available on RMA's public website under publications. Ms. Sander thanked the Board and concluded RMA/FCIC's presentation.

NATIONAL FLOOD INSURANCE PROGRAM (NFIP) PRESENTATION:

Mr. Hayes introduced himself and Ms. Raab. He referred the Board to the slide “Nature of Flood Risk” that depicted the 40 year history of hurricane and tropical storm activity in Florida from 1920-1959 and the next 40 years from 1960-1999, pointing out that there is a vast difference in the hurricane activity between these two time periods.

Which creates the following challenge—as an actuary who is responsible to price this insurance product, which time period should he use? Because he is going to get vastly different results and actual data is too unreliable, the answer is they do not use actual loss history for either 40 block time period. We use our knowledge from the hydrologists who study flooding and the flood patterns who tell us what the probabilities are.

In the following slide about hurricanes, Mr. Hayes demonstrated more variability in severity and frequency that can affect how premiums are priced. He then moved to the next slide on our actual program data.



The green line depicts our policy counts over time. The dark blue in the bottom half of each of those bar graphs is what we actually paid on an average policy basis spread over all our policies. For example, in 1988, our lightest loss year, we paid out very little per policy.

And then in other years, such as 2005, we paid out significantly more. The light blue on top of each bar is trending at the future dollar levels. The early years have a lot of light blue on top; more recent years do not have much; that is what you would expect with

trending.

In response to the members' and staff question about what "trending" is, Mr. Hayes explained, that it is based on Consumer Price Indexes (CPI) factors. The dark blue is what we paid in 1978 dollars and the light blue is what it would cost in 2015.

The next slide ranks the policies from lightest to heaviest. To demonstrate unpredictability, Mr. Hayes explained, that if you throw out the four lightest years and the four heaviest years, that leaves the 80 percent middle ground which shows that policies vary from \$150 per policy to \$650 per policy. That is a 4:1 ratio.

Therefore, the law of large numbers does not work for the flood insurance program because there is no predictability. It would be very difficult to privatize this program because it would be hard for companies to figure out what a good price is to charge when variations can be that large. If over a five year period where four of the five years are in the upper half of the probability, you can wipe out your surplus very quickly, and the odds of having four out of five years above average are significant.

Mr. Hayes continued to show the full size of Katrina as compared to every other loss year. You can see it dwarfs the smaller half and in fact NFIP paid more out for that one single event than they had in our previous history of the program combined.

How NFIP prices premiums. Since we are not using our actual data, we use a complicated formula for the probability of water reaching certain elevations, and the resulting damage.

Mr. Showalter asked if this is done by geography.

Mr. Hayes replied it is done on a national basis and then applied, appropriately, geographically. But when people hear we have national rates they are concerned that NFIP is charging the same high rate to Michigan as to the risky gulf coast. NFIP applies premium prices to the local community based on that community's flood risk in relation to where a structure is built including the base flood elevation (BFE).

The heart of the model is the probability of water that is the frequency of flooding times the damage—the severity. In reference to *Expected Damages*, Slide #9, we start with the severity on this model with coverage on a \$295,000 structure 8 feet below BFE. We look at water depth in the structure at one foot intervals to see when flood damage has actually happened to the structure even before the water reaches the structure, due to some wicking in the soil that affected the foundation. For this particular example, one foot of water caused just under \$49,000 in damage. Then we adjust it for the claims handling and the deductible on claims handling expenses and we expect to pay out a little over \$50,000.

For each amount of water depth there is an amount of damage there.

In addition to elevation of the structure relative to the flood risk, pricing differences also

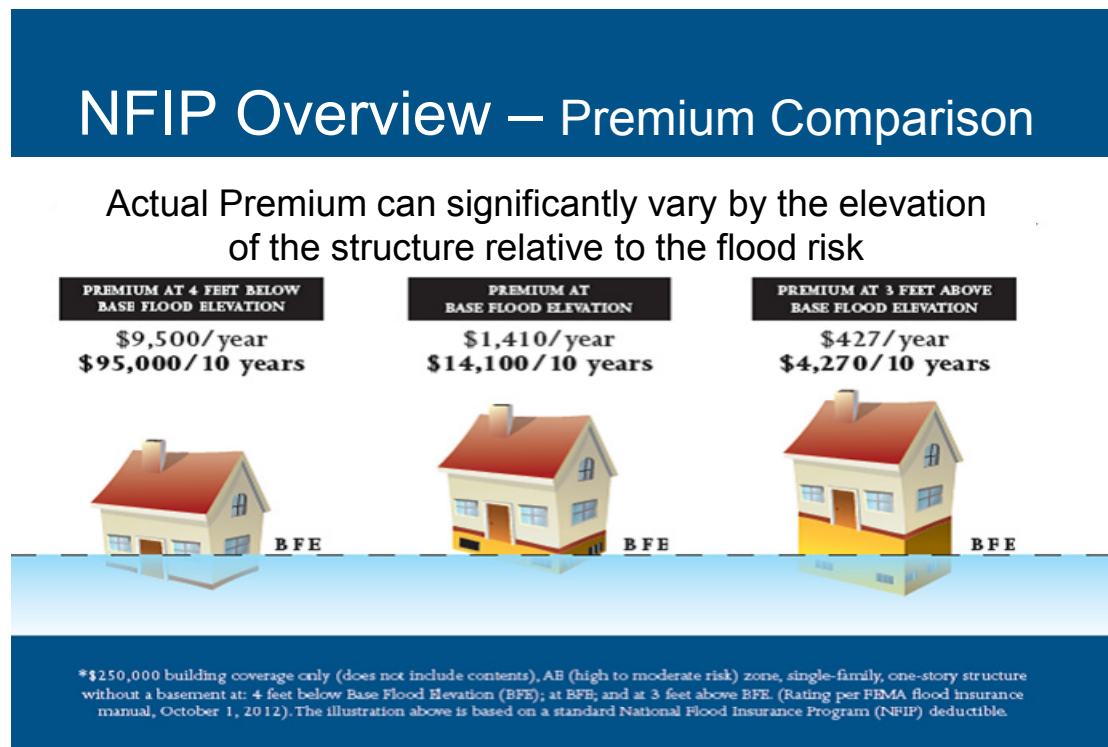
depends upon how many floors make up the structure. For example, if there is only a single floor, four feet of water sitting in that structure is damaging a higher percentage of the total structure than if it is a two story structure.

After we look at the expected payout we look at the probability of the water reaching that depth in the structure. Since this is a structure eight feet below the one percent annual change, it has a pretty high probability of flooding.

This information was presented to Congress who indicated that they want us to move very aggressively to full risk premiums for our older structures that are currently subsidized. The information showed very high premiums for some of these old structures.

For example, this shows a \$10,000 premium for \$250,000 of coverage. And for some of our structures the answer was even higher than that, and that caused a lot of consternation, especially among realtors who tried to sell the property. A lot of buyers ended up walking away when you tell them you will have a \$40,000 premium every year after this. So Congress passed subsequent legislation to slow the movement to full risk premiums. They did not stop it, but they did slow it.

Below is a slide that shows three homes, one built at an elevation below that one percent annual chance of flooding, one built right at it, and the last one built three feet above the BFE:



The information is from 2012 and does not show current premiums but the magnitude of premium pricing in relation to where the structure is built is evident.

Ms. Gilliam asked how risk is managed and if there are regulations that require structures to be built up on platforms and get above the BFE.

Mr. Hayes noted that the subsidy is only applied to older structures built before FEMA had issued a flood map for that community. Therefore, if someone wants to build unwisely they should not because the local ordinances are supposed to prohibit it, but it still happens occasionally. If they build that structure four feet below BFE, they will not get a subsidy, and will have to pay that full premium.

Mr. Allen asked how NFIP deals with whole communities such as New Orleans that is 15 feet below the water level. Mr. Hayes stated that since that is now in flood plain management area developers will have to elevate the structures.

Mr. Reger said that as he understands when the federal government created this program we employed the Army Corps of Engineers to map these floodplains around the country, and then turn it over to local government who issues building permits to try to keep people from building in those flood plains. Therefore, is this program insuring based on local government following through on the Army's recommendations?

Mr. Hayes said that if the individual wants to insure a newer structure they will pay a commensurate premium. A ten year patterns shows, that generally if you get charged a full premium you find a way to get out of it for example, by paying off your mortgage or elevating the structure.

By the early 1970s most communities were mapped and entering the program. It took a few years before flood plain management became effective at the local community level. Once local communities learned that yes, NFIP did expect them to enforce the ordinances, then we did get much better compliance.

One of the metrics we measure every year is how much our building codes have reduced annual flood damage in the country, on a long-term expected annual basis. NFIP estimates up to \$1.4 billion in reduced damage per year because communities have not only followed our minimum ordinances but have gone beyond that. NFIP also has an additional program called Community Rating System which encourages and recognizes communities for going beyond our minimum. There are a number of activities communities can take to further reduce the flood risk, such as storm water retention.

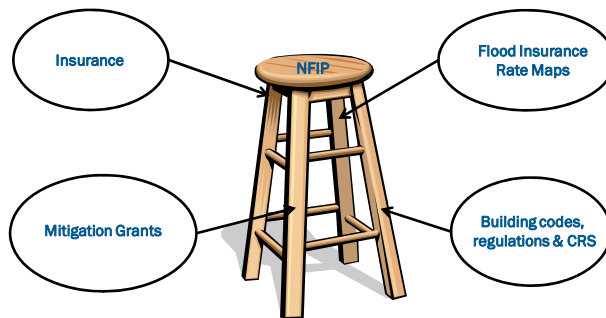
Mr. Reger asked whether flood insurance pays for damage despite the location, value of the structure, and related revenue.

Mr. Hayes clarified that Congress has limited coverage to \$250,000 per structure. In the case of a flood, these most expensive homes are going to have to pay for a lot of the loss themselves. Mr. Hayes moved to the NFIP Overview slide to discuss the NFIP approach; which does not just provide insurance.

NFIP Overview

The NFIP – more than insurance

The NFIP is a voluntary Federal program enabling property owners in participating communities to purchase insurance against flood losses in exchange for adopting and enforcing regulations that reduce future flood damages. A participating community's floodplain management regulations, must meet or exceed the NFIP minimum requirements.



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Mr. Hayes moved to discussing NFIP subsidized policies. He noted that unlike FCIC, NFIP does not get any general revenue dollar in the form of appropriations from Congress. Premiums being lower than full risk premiums are simply “revenue foregone” by the program. These are policyholders with structures built before the flood map was issued around 1974 that are paying less than their full risk premium.

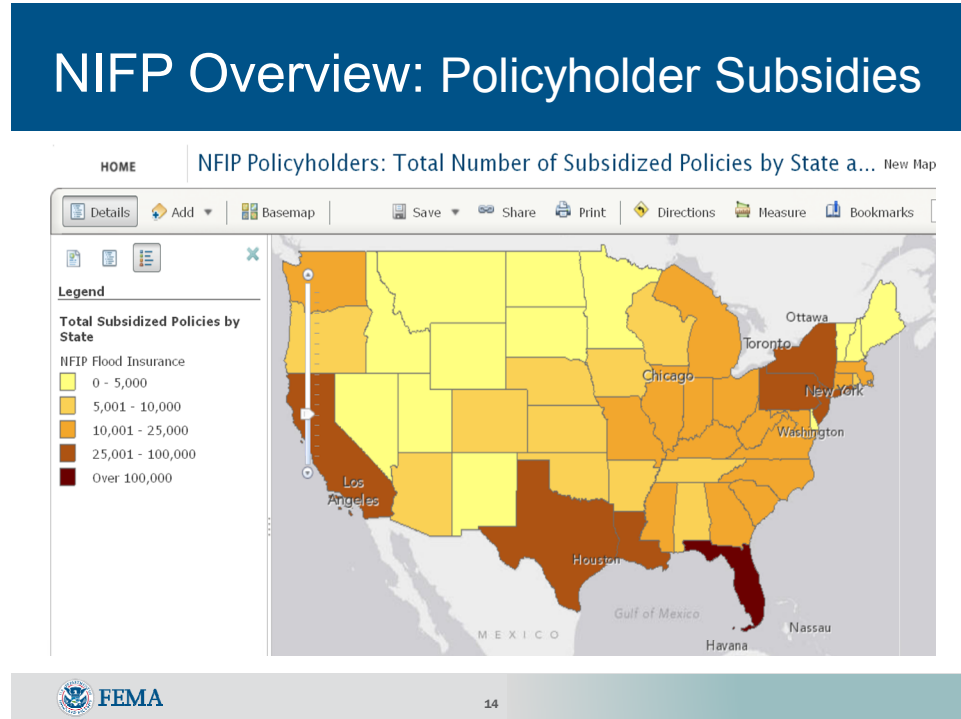
Mr. Allen asked if Congress determines the subsidies. Mr. Hayes said not in statute. Congress gave NFIP the authority to offer discounted premiums which they strongly monitor. In the very early days of the program Congress took our very low cost subsidized premiums and had NFIP cut them in half. Despite this in a low loss year we incurred a \$1 billion loss, which back then given our exposure was a lot of money.

Congress forgave that debt through a five year series of appropriations. NFIP informed Congress that unless they raised the subsidized premium we will be incurring debt over and over again. Therefore, Congress did allow some adjustment, and NFIP was successful in pushing back on the pressure to lower the rates. Until Katrina and suddenly the pressure to lower the rates disappeared. Now Congress is interested in full

risk premiums.

So we do have subsidized policies on pre-FIRM older structures.

The following slide shows how the subsidized policies are concentrated around the country:



Next Mr. Hayes addressed the following **questions sent by Ms. Gilliam.**

➤ **How are the pricing policies determined?**

FEMA’s actuaries and underwriters annually review the pricing and classification structure of the NFIP and recommend changes for management approval.

The annual review process incorporates any recent legislative changes such as the Biggert-Waters Flood Insurance Reform Act of 2012 (BW-12) and the recent Homeowner Flood Insurance Affordability Act (HFIAA) of 2014.

➤ **Who sets the pricing policy for the premiums?**

There are two types of premiums for NFIP policyholders, 1) actuarial--full-risk—premiums, and 2) subsidized—less than full-risk or “discounted” premiums.

FEMA’s actuaries, in accordance with Actuarial Standards of Practice (ASOPs) and in compliance with the National Flood Insurance Act of 1968, as amended, make recommended revisions to FEMA management.

Premium rates for actuarial premiums are made using an accepted actuarial “frequency and severity” approach as described earlier in this presentation.

- **When does your program bill for premiums and recognize revenue in the unearned revenue?**

The NFIP sells policies on individual structures (i.e., buildings) with terms and conditions in the contract. The policyholder pays the entire annual premium on or before the effective date of the policy to the insurance company or agent who then remits it to NFIP. Revenue is recognized as the Program receives the premium. An unearned premium reserve is established for each individual policy and earned in a uniform basis over the life of the policy.

Mr. Showalter asked about paying the insurance company for that processing fee. Mr. Hayes explained that they analyze annually the operating cost for the industry as a whole to determine the processing fee.

Mr. Allen asked if the policy period is the same for all policies and how do you account for policy periods that cross over the fiscal period to report on your financial statements, and how do you deal with the different start dates. Mr. Hayes said that 99.9% of our policy holders have a twelve month policy. There’s a small group where we work with a grant program to provide a three year policy to low income people following a disaster. Most of our policy sales occur when you buy a house. We have an unearned premium reserve liability to reflect the fact that we have not earned the entire premium that individual paid. We have about 4.4 million contracts, and we earn each one of those contracts over their policy life.

- **Does your program estimate claims for the remaining open policy period following the end of the reporting period?**
- **If yes, how.**

Mr. Hayes said they use assumptions based on losses from future flood events that happen after the end of the reporting period. Therefore, they focus on events that might happen for those policies that are in force on the statement date and are still in force when the future flooding event occurs, for example, in October, November, March, or June.

Mr. Allen noted that we are discussing future events, but there is also incurred but not reported losses. Mr. Hayes also includes a paragraph on IBNR, which is included in their liability for unpaid claims, for flood events that have happened on or prior to the accounting statement date, because claims are still being reported, investigated, and have not yet been paid. For example, we are still paying claims on Katrina because there is always a handful from a big event that are more contentious and take longer.

Ms. Gilliam asked if NFIP recognizes a premium deficiency reserve.

Mr. Hayes explained that in relation to his background in the insurance industry he is used to the term “premium deficiency reserve” which means if you have a substantial deficiency in the premiums you charge your policy holders, you have the expectation of a future loss that losses will exceed the premium you generated.

And in the industry, it is not just for policies in force, it is for future policies you expect to write until you can get that premium deficiency corrected through a rate change. And it is usually corrected by the financial statements. Sometimes it can take a while for the state to approve the rate change. NFIP chooses to do it just for those policies in force at the end of the reporting period.

NFIP estimates an unearned premium reserve on how much the losses exceed that unearned premium liability. Please refer to the handout for the risk assumed September 30, 2014; RSSI note that includes background calculation and a list of assumptions.

Mr. Dacey asked if they have had a premium deficiency.

Mr. Hayes said that every year they report a premium deficiency, but whether or not it actually materializes is to be determined. Due to the extreme variability of flooding, there is not much certainty with it, but most years the unearned premium will be sufficient to pay such future losses. Personally, not speaking for FEMA’s official position, he would not include it as a line item in the financial statement because they cannot predict a catastrophic year; therefore, the premium deficiency is a long long-term average.

Mr. Dacey asked if you are more likely to have a premium deficiency when the event actually occurs before you issue your audited statements. Mr. Hayes explained that they have a consulting actuary who estimates losses that have actually occurred for all the funding events that happened up to September 30. There was one year where we held up the audit because of a subsequent development that caused us to revise our statements.

Mr. Reger wanted to confirm that premiums are not set after a catastrophic event to repay the catastrophic event. And that NFIP is challenged in getting Congress to raise the premiums enough to pay for what is anticipated. For example, will a Katrina event be paid by future policyholders? Mr. Hayes said that their administration has repeatedly said there is not a realistic chance that NFIP can pay for a Katrina on their own. We collected about \$3.5 billion and due to the rate increases our collections are growing to \$4 billion. But due to the rate increases we have also lost four percent of our policies in this last year and are projecting additional losses in policies in force in future years which we cannot quantify at this time. Therefore, how are we expected to pay back debt with this shrinking policy holder base?

Mr. Granof asked that for a subsidized policy 1) who makes up the subsidy, and 2) where do you get the money for the subsidy. The losses on those policies seem to exceed your revenue.

Mr. Hayes said that is “revenue foregone” by NFIP. Losses will only be realized—subsidized— when losses exceed our revenue through borrowing authority. We historically had a \$1.5 billion borrowing authority, after Katrina it was raised to a little over \$20 billion.

Due to the huge randomness of loss years, losses do not always exceed the premium we get in. If we have a light loss year, like this past year where we went from virtually no cash on hand at the beginning of this last fiscal year to about \$1.5 billion at the end of the fiscal year. Therefore, even with our subsidized policies, we can still generate a positive cash flow.

Mr. Steinberg asked what the liability to Treasury is right now.

Mr. Hayes said they are \$24 billion in debt, with \$30.425 billion total borrowing authority. So we have \$6 billion remaining that we can borrow.

Mr. Reger said that the real issue is what is going to happen if they have another catastrophic storm.

To clarify, Ms. Gilliam said this sounds similar to crop where NFIP does not pay the premium. That the subsidy is when the loss is greater than the premium and then NFIP needs to borrow to pay the remaining loss. She asked if that is the way NFIP works, where they do not get a subsidy to pay the other part of the premium, but the additional loss above premiums collected.

Mr. Hayes said that following Katrina, we quickly paid out \$1.5 billion then that increased to \$3.5 billion. However, we got to about a three week period where we had used that up, and while the companies continued to investigate claims, and to write the checks, they were not mailing anything, because they did not want to be on the hook for the payment. However, once Congress finally approved the additional approximately \$15 billion we were prepared to use our line of credit to draw down the money. However, we received a call from Treasury saying they did not have that much cash. Now we have a memorandum of understanding with Treasury to handle large events.

Mr. Dacey asked whether the acquisition cost for these policies are significant and if they are expensed when they are paid as would be commissions. Mr. Hayes said that the insurance companies receive about 30% on the policy sale side and that is expensed when NFIP collects the premium.

Mr. Dacey asked crop insurance if they have significant acquisition costs and when are they recorded as costs.

Ms. Erny said that the AIPs—Approved Insurance Providers—are paid approximately 14-16% to sell and service the policies. So it is between \$1.3 and \$1.4 billion a year. We accrue it as the policies come in, and then we pay it out on October 1st because the receipts are split. So if the crop year starts in June, we wait until the following October to pay out the servicing fees.

Mr. Hayes clarified that for NFIP, although the insurance companies are paid up front, if a policy holder wants the balance of the premium back, NFIP in turn requires the company to give NFIP that share of the expense loading back.

Mr. Dacey noted that essentially the programs do not have any deferred acquisition cost on your statements.

FEDERAL AVIATION ADMINISTRATION (FAA) AVIATION INSURANCE PROGRAM PRESENTATION:

Ms. Gilliam introduced Tom Brown from FAA stating that his agency is in a little different position where they are actually moving policy holders into commercial insurance companies and therefore will not answer questions she sent out, but tell us about sun setting the program.

Mr. Brown introduced himself and explained that the Aviation Insurance Program Office offers two programs: 1) the premium program and 2) non-premium which provides contracts with US TRANSCOM of DoD where FAA gets reimbursed for any loss expenses paid.

The premium side is where we have made our money over the years. After 9/11 the premium program started providing what we call third-party only coverage. We did not cover the aircraft, or the people in the aircraft, just any damages on the ground. It started at \$50 million in ground damages. In 2002, the Homeland Security Act required us to go to no deductible, so we started at dollar one and we increased our coverage from just third-party to the hull, the passengers and crew, and then the third-party—damages on the ground. But we could only charge twice the third party limit.

For example, for a big aircraft carrier like American, they would have a three-part policy where they would pay a rate on the hull, a rate for the passengers and crew, and then a rate for the third party. However, their total premium could not exceed twice the third-party. So if they had a \$10 million premium, but only \$1 million of it was for third party, we could only charge them \$2 million.

Over the years CBO was scoring us showing that we were paying over \$200 million a year in losses, which in fact we were not. Over the years we have collected approximately \$2 billion in premiums into the revolving fund, but only paid about \$15 million out in total claims. If losses were to exceed the balance in the revolving fund then we would go to Congress for a supplemental appropriation. Therefore, we have been working over the past couple of years to move it out to the commercial market, which was completed as of December 11, 2014.

A number of Board members asked for clarification on when/how this insurance was moved into the commercial industry. Mr. Brown explained that after 9/11 the insurance providers started to exclude wartime, hijacking, bombings, etc., from their policy, and then they would offer it at approximately 10 times what the rate should be, so that is why we intervened.

About two years ago we went out to the commercial market, mostly in London, to reengage and provide proposals on how to transition the program to them.

In May and June of 2014, most of our big carriers left the program and went back to the commercial market even though they lost the nuclear and biochemical coverage, which the commercial policies do not cover. By the end of the fiscal year 95% of our premiums had already exited the program, so it was more incentive for them to put the end date in the bill. When the President signed the new omnibus bill instead of continuing the provisions of the Homeland Security Act, it put an end date of December 11, 2014. Therefore, our last day for providing this insurance was December 11, 2014.

Mr. Steinberg asked if they ever paid out a loss. Mr. Brown answered that since 2001 the premium program, FAA has paid out three losses and named the events.

Board members asked what happens to the surplus. Mr. Brown explained that the program still pays up front for non-premium (reimbursable) insurance that covers US TRANSCOM of DoD. Although we do collect a \$575 fee when the DoD air carrier registers another aircraft or adds another aircraft to their fleet and we receive other forms of revenue through interest on securities—we invest in Treasury notes and make \$40-\$50 million a year—we still need the surplus from the premium insurance in case of a major occurrence. If another 9/11 happened, we would deplete all of our funds and have to go to Congress. At the current time, we are funded until 2018.

Ms. Gilliam and Mr. Allen thanked the panel again.

- **Risk Assumed**

The following was discussed in relation to Question I—does the Board approve including claim adjustment expenses (CAE) in the liability for unpaid claims.

Ms. Gilliam presented the following definition for claim adjustment expenses, which Ms. Payne noted is very close to the existing industry definition.

Claim adjustment expenses —expenses incurred in the course of investigating and settling claims. Claim adjustment expenses include any direct expenses incurred such as legal and adjusters' fees, and the costs of paying claims and all related expenses.

Ms. Gilliam noted the following regarding current practice:

- PBGC does not have CAE because they are not technically an insurance program.
- Flood includes CAE in their liability. CAE includes three pieces calculated specifically on claims (see the staff memo for details). The cost of CAE fluctuates depending on flood claims. The proposal would not be an additional burden for Flood as they have been historically capturing CAE.

- Crop pays CAE as part of their program delivery costs which also includes the sales and servicing of the policies. Program delivery costs are calculated using a set percentage against their premiums and expensed. Therefore, CAE does not increase with the incurrence of claims. The proposal is not an additional burden for Crop as they have been historically capturing program delivery costs.
- OPIC information is not available yet. Staff has asked OPIC if they capture CAE and if their claims adjustors are employed in-house or as outside contractors.

Mr. Dacey asked for staff to clarify what costs should be included in loss (claim) adjustment expenses in relation to internal and third-party costs to settle claims.

Mr. Smith recommended that for the definition, the Board should include in-house claim adjustor expense and/or contracted claim adjustor expenses, but not to include the daily administrative expenses to process claims. Mr. Granof agreed. Mr. Reger stated that staff should present defining words around what costs to include. Ms. Gilliam stated that staff will clarify the definition.

Mr. Allen took a vote of the members and noted that the Board is agreeable to the concept to include claim adjustment expense in the liability for unpaid claims.

The following was discussed in relation to Question II—does the Board approve distinguishing between a liability for unpaid claims and a liability for premium deficiency/net future losses:

Ms. Gilliam thanked Mr. Dacey for helping with the visual depicting premium deficiency/net future losses. She then turned the discussion over to Mr. Showalter who contacted her with a question about the slide.

Mr. Showalter noted that the slide and accompanying chart appear to frontload the expenses in the first three months, and it looks like the last nine months we priced it right. He asked if that is the picture that the Board wants to present.

Mr. Dacey said that we do not want to defer that cost if we know we are going to incur it under concepts in SFFAC 5 (elements).

Mr. Smith noted that if the government is providing a subsidy and we are not charging the insured 100% of the premiums, he would not book a premium deficiency reserve because you did not match it and will eventually break even—with the government eventually picking up the shortfall.

Mr. Reger said that makes sense on the consolidated statements, but how would you book a liability on the individual incorporated entity?

Mr. Smith said that the premium deficiency reserve is not for a loss you have recognized as of the balance sheet date, it is recognizing that income to be

received is not sufficient for the future cost—future losses—associated with those premiums.

Mr. Dacey asked when we would recognize cost in an extreme situation, where there is no premium, for example terrorism risk, and it then becomes a non-exchange transaction. Do we recognize it when it happens, or sometime during the policy period before it has even happened? Mr. Smith said that you recognize it when it happens.

Mr. Dacey said that for non-exchange programs, we generally record the costs when it is due and payable. Now insurance programs may differ because there are contracts. Mr. Allen said it is an exchange-like transaction. Mr. Dacey agreed that these programs are somewhere in the middle between exchange and non-exchange. There is a timing issue. To be consistent with other non-exchange programs, the accounting should be more like a non-exchange than an exchange transaction. However, he noted a challenge is that NFIP looks closer to an exchange transaction.

Mr. Dacey noted for Crop, the government provides around 60% in subsidy. The insured (producer) pays the remaining premium necessary to cover the estimated cost. Regarding consistent timing of loss recognition, he would be most concerned if the contracts are greater than a year.

Mr. Smith asked what we accomplish by recording that liability and recognizing the loss. We want to record it on the commercial side because we know we are going to have a loss, and you recognize that loss at the time that you can estimate it. We do not have a future loss associated with that claim because the government is going to fund the deficiency. Therefore, at the entity-wide level it will be eliminated, so it does not matter.

Ms. Payne noted that the bottom line for the statement of net cost, is supposed to be the net cost to the tax payer of events and transactions during the period. The key event, or transaction, is signing the contract on July 1st, knowing (in the case of Crop) that the taxpayer is going to pay 60% of the losses if they have a perfect one to one estimate.

Mr. Reger asked if she is suggesting that we book the entire loss on July 1st when you sign the contract. Ms. Payne said that in concept, yes, because signing the contract is what triggered the cost to the taxpayer and therefore, we should get it on the books then. It just happens that we close the books on September 30th.

Mr. Smith stated that if the federal government pays 100% for a program, , and as of the balance sheet date there will be a loss in the future for that program we do not recognize that contingent future loss of the balance sheet date. What is the difference between that contingency that we disclose in the footnote compared to

this contingency that you want to put on the balance sheet for these insurance programs where premiums do not cover all of the cost.

Ms. Payne noted that the focus should be on measurability, probability, and the date the event happened. That it is similar to a loan guarantee or a loan subsidy for which losses are estimated and recorded upon signing contracts.

Mr. Dacey noted that another option, particularly in Crops' case, is to defer the revenue until the end of the year, which becomes a liability and may be a sufficient liability. Mr. Granof asked if you would defer all the revenue until the end of the fiscal year. Mr. Smith said the deferral would be until the end of the harvest. Mr. Showalter noted that is assuming the revenue is sufficient, but that still does not get you an additional liability for the loss expected to exceed the revenue.

Mr. Dacey said that while his example does not recognize an additional liability, it does get us closer to a non-exchange transaction by recognizing the cost when you incur the cost.

Ms. Payne suggested that the term "premium deficiency" does not work very well in the federal environment particularly in the case of Crop where they consider the entire premium inclusive of the government subsidy. Therefore, staff wants to shift the focus to net future losses and the taxpayer. Appropriations should never show up in the statement of net cost as an offset of cost. Staff suggests that the Board think of net future losses as cash flows; inflows and outflows to the government as a whole. Mr. Showalter agreed.

Ms. Gilliam asked the Board if "net future losses" provides more clarity. She also reminded the Board that this project is to measure risk assumed for insurance programs. Not being able to cover losses with premiums from those insured is a risk that these programs do assume as of the balance sheet date. A "net future losses" liability will provide clarity to the agencies who are struggling with so much uncertainty.

Ms. Ho asked if these are estimable future losses based on an event that has already occurred. Ms. Gilliam answered that net future losses is on future losses that have not occurred yet (focusing on the date of the insured event rather than the date of the assumption of risk by signing a contract).

Ms. Payne noted that the primary focus is on getting better disclosure. Most likely we would not have these federal insurance programs if they were highly measurable, because the private sector would be covering such risks. In addition to the importance of improving the disclosure is how and when to recognize and measure the loss event. Clarifying that will give us a complete set of insurance standards.

Mr. Allen said signing the policy creates the obligation and estimates. However, there are normal loss years that have transactions with exchange characteristics, and then an unusual horrendous event occurs [like Katrina or Sandy] causing non-exchange transactions because not enough premiums are collected and then the program needs to borrow from the Treasury or request an additional appropriation.

Mr. Steinberg agreed and noted that they are insuring against floods. If they have enough money over the years they will still have estimated net future losses. But unfortunately when a Katrina happens and they have to pay out a significant amount more, then there is a liability to the Treasury department because they cannot collect through premiums.

Mr. Steinberg stated that when you report for the federal government, the amount that FEMA owes the Treasury Department would not be in the financial statements. Mr. Allen agreed. Mr. Reger said that if we are trying to reflect the material risk that the federal government has assumed then that becomes non-exchange transactions. If we cannot reasonably estimate them during the consistent loss periods to book a liability, then it will all fall to disclosure.

Mr. Steinberg said that if they are collecting premiums that they have not yet received claims for, but they base those premiums on things that they expect are going to happen, then that should be shown that on the financial statements as a probable contingent liability. Mr. Allen agreed as long as it is material.

Many Board members discussed how NFIP and Crop estimate their losses and premiums.

Ms. Ho stated that for both programs, they know the full price premiums through their risk estimation models but no one would be able to afford or pay these premiums, which would affect the bigger economy through housing and commodity prices.

Mr. Smith said that for both of those programs, policy holders pay a set premium and the government pays a subsidy for any losses that are not covered. For the years where losses are less than or equal to collected premiums, there is no subsidy (appropriation or borrowing). However, for an extraordinary event the government will subsidize those losses for that year and we put a liability on the balance sheet.

Mr. Showalter pointed out that what we are talking about is “measurement uncertainty” which is a term we use when we deal with estimates. Therefore, the risk assumed should be disclosed around the uncertainty about that measurement. We should get programs to record what number they are comfortable with using in their actuarial report so that readers understand there is this topside risk that is not covered in the number they have. But both of those

are the same thing. The insurance will cover a part of it, and then the federal government is assuming the risk for another portion.

Mr. Allen noted that he does not see Crop as being a risk assumed because it is an ongoing appropriation each year that flows through Agriculture based on a previous decision by Congress. However, he does see NFIP as risk assumed because in most years the program will pay for itself except when there is an event like Katrina where the program cannot cover the extraordinary loss. The risk assumed component is the horrific event.

Mr. Smith said that both programs are the same even though the probability of a major catastrophe is less for Crop insurance because production is spread more around the country than NFIP flood risks. What if all the crops were located in the same location and were wiped out from a Katrina like catastrophe? The only thing that is different is that historically we have not had such a large claim in Crop. However, both are the same in that the insured is paying for a portion of the risk and the federal government assumes the risk for the other portion either in an annual appropriation or an occasional loan. Probability and materiality are the only differences. With crop insurance, if they do not need their annual appropriation, they adjust their estimate and return the unused appropriation. It is the same thing with the NFIP shortfall, except they are funding the shortfall through a loan instead of an appropriation.

Mr. Reger agreed with Mr. Smith's point that the programs are not materially different and programmatically look exactly the same

Ms. Gilliam asked if the risk assumed is the shortfall that the government has to pay because the programs do not charge full base risk premiums.

Mr. Showalter said that to him risk assumed is the amount over the appropriation, because the program has already anticipated risk to include the appropriated amount. Mr. Steinberg agreed that it is the amount over the premiums; the losses the program may incur over the premium. Mr. Reger said Crop is assuming a certain amount of appropriation funding in the premium itself therefore if you are estimating the risk, it includes both pieces of the premium. Mr. Steinberg noted that the programs are only budgeted for differently.

Mr. Reger asked how the Board should deal with the \$24 billion loan from the general fund to NFIP that will get eliminated and then not recorded anywhere. Mr. Allen said he sees that as a disclosure. If the program cannot estimate a reasonably probable event, then he does not recommend booking a liability, but instead providing a disclosure under SFFAS 5.

Mr. Reger asked when then do we record the potential loss. Ms Payne said that this is the basic question about whether a loss is recognized when we have an explicit insurance arrangement that is probable and measurable. Is there anybody who objects to applying the contingency model to this? Mr. Reger said

that is accepted accounting practice to estimate a loss, if you can at the end of a reporting period.

Mr. Smith does not agree that we should recognize a liability at the time we collect premiums because we do not know at that time if we have sufficient funds for a future loss? Ms. Payne pointed out that because the programs entered into a contract—a losing contract—these are not simply social welfare programs offering safety nets.

Mr. Smith said that he thinks they are because by entering into a losing contract for the program—a commercial one—would re-price it as soon as possible to sufficiently cover costs. He would not book the liability because we have intentionally made a decision to recover some cash from policy holders but the government is who is really insuring these programs.

Ms. Payne said that she would book it, because the cost of not booking is not including it in the accrual basis statement. She also noted that it does not show up in the deficit until the cash goes out.

Mr. Granof asked Mr. Smith if he could make the same argument with regard to subsidized or guaranteed loans where we estimate at the signing of the loan a future number of people who will not pay. In this case, we estimate that in the future some number of crops will fail.

Mr. Smith said that he agrees 100% with the accounting theory Ms. Payne presented even though it seems driven by commercial industry—whereas these government insurance programs are non-exchange transactions. From a practical standpoint, he does not agree because of the cost benefit of estimating a future liability for something that has not occurred and which the government will fund because they are not trying to recover all cost from the policy holders.

He could also argue that if we booked more of the appropriations we would not have a premium deficiency because cumulatively we still have appropriation capacity to pay for losses. And this makes the statements a lot more difficult for a theoretical item. Therefore, he is not interested in an additional liability. Instead, he recommends a disclosure in relation to the exposure.

Mr. Showalter said that he is most concerned about that position because it could lead to budget based accounting—cash basis statements. If we start chopping off one liability after another in GAAP statements, then the statement of net cost will not recognize all program costs.

Mr. Showalter also argues that the programs should be accruing in order to measure and manage the demands of the business more than once a year to prepare the financial statements. Mr. Reger noted that Crop would not normally do it on September 30th because that is not the end of the crop year—not a relevant date for them. Mr. Showalter agreed.

Mr. Granof countered Mr. Showalter's argument saying that it could be a slippery slope of recording every entitlement program as a liability. Mr. Showalter pointed out that those programs are non-exchange where-as insurance programs have exchange elements in them. Mr. Granof said that exchange or not exchange is the whole issue here. Mr. Showalter said that it seems more of an exchange than not.

Mr. Dacey said that if a reasonable estimate can be measured—as we have seen through confirmation by actuaries and audits—then the question is, when do you record the expense in a program that has a subsidy component. He cited two examples: (1) for credit reform, we book estimated subsidies for the entire life of the loan on the day the loan is signed , and (2) for entitlement programs that subsidize, such as unemployment and others, we record it when it becomes due and payable.

And then there are the insurance programs which fit somewhere in the middle, and how do we best represent that in the financials? If a Katrina happened on October 3rd, would you book that all in the current year because it happened three days after the end of your year? Under the premium deficiency argument you would book it as a future loss.

Ms. Payne said that in relation to the exchange or non-exchange classification for the Crop program (NFIP is a little more complex) when we enter into a partnership with the producers, they are exchanging their willingness to be in the farming industry in addition to their cash premium. Therefore, it is not as straight forward as the cash exchange.

Mr. Showalter said that aside from the unusual events, NFIP is covering their cost. This goes back to Mr. Allen's point about whether the programs are exchange or non-exchange. Mr. Allen said that if the insurance programs are exchange-like, then we recognize the liability.

Mr. Allen said that in relation to the history of risk assumed, the project started with the herculean event where the federal government stood behind entities such as Fanny and Freddie, the banks, and the automobile companies that they previously said they would not support. Therefore, this project's original goal was to develop disclosures in our financial statement on risk assumed.

With that Mr. Allen called a vote of the other Board members on whether to include a liability for premium deficiency/net future losses in addition to the already existing liability for unpaid claims.

- Mr. Showalter voted yes to record net future losses.
- Mr. Smith agreed as long as the intent of this was for an exchange transaction.

- Mr. Dacey said yes, noting that his major concern is for non-exchange-like transactions, what is the appropriate recognition for long duration contracts.

Ms. Gilliam explained that most of the long duration contracts are booking their premiums in short duration time periods. They are either booking them quarterly or annually. For example, FDIC, bills annually for their assessments. Therefore, you could actually break all these down to short-term contracts. Mr. Dacey acknowledged that and noted that he wanted to understand the difference with subsidizing long-term contracts and if there is a more material effect on the outcome. He also noted that if we record non-exchange-like contracts, he wants to be clear that the Board's reason is because it is a contract as opposed to a non-exchange program where we provide benefits even if there is some money received. Ms. Gilliam agreed that staff will address that in the standards.

- Mr. Reger voted yes but also noted we will need to properly define long-term and short term. He also said that he agreed with helping to unburden Crop's financial statement preparation.
- Mr. Allen voted yes and noted his concern about how to appropriately account for programs that have borrowing authority to pay losses in excess of premiums.
- Mr. Reger agreed.
- Ms. Ho voted yes, agreeing with Mr. Allen that there is a difference between these two. Even though they are both subsidizing, one is more explicit than the other, where the American public had the opportunity to say yes, and it is easier for a politician to say we are going to appropriate for Crop insurance and encourage farming. However, no one would appropriate to subsidize people buying waterfront properties, just like the Fannie/Freddy issue.
- Mr. Steinberg voted yes to account for a liability for net future losses, because he sees these as exchange transactions. Both programs told the Board that they set premiums at a level to cover losses. Yes, there could be a catastrophic event like Katrina, but basically they are doing it to cover the losses. As far as the long-term contracts to the insurance programs, he agrees that there is a difference, but recognizes that the Board will define and account for them differently.
- Mr. McCall agreed that we should have a liability for net future losses. He noted that he audited the Department of Insurance for many years, but never had this issue come up with the state of Florida. We regulate it, but we did not go out and audit the insurance companies. He thought that Mr. Smith made a lot of great points and agreed that disclosures should explain the liability to the reader.
- Mr. Granof said yes.

Mr. Dacey said that he did not like the term “future losses,” because the liability recognizes is a current contingent loss or an expectant loss. Mr. Granof agreed that it is a contingent loss. Mr. Dacey requested staff to present additional titles at the next Board meeting

Mr. Allen thanked Ms. Gilliam and broke the meeting for lunch.

- **Leases**

Ms. Valentine opened the lease discussion by stating that the objective for the current session is to review proposed accounting guidance for intragovernmental lease arrangements and to provide direction regarding the first three chapters of the GASB Preliminary Views (PV) on Leases. The GASB PV on Leases will be used as a foundation for the development of the FASAB lease standards on non-intragovernmental lease agreements. She also mentioned that she received some comments from Chairman Allen, Mr. Steinberg, Mr. Showalter, and Mr. Granof.

Intragovernmental Lease Arrangements

Ms. Valentine presented to the Board minor revisions to the below seven lease-related definitions that were previously discussed by the Board.

- Lease
- Intragovernmental
- Intragovernmental Lease Agreement
- Intragovernmental Lease Inception
- Intragovernmental Lease Rental Payments
- Intragovernmental Lease Term
- Renewal or Extension Options of an Intragovernmental Lease

There were no objections to the above definitions. Mr. Showalter recommended that definitions for “intragovernmental rental income” and “initial direct costs” also be added. Mr. Dacey suggested more clarity on the “intragovernmental lease term” definition as it relates to the periods that are included.

At the October 2014 meeting, the Board directed staff to simplify intragovernmental lease accounting guidance. Staff presented revisions to the previously proposed recognition and disclosure lessee guidance for intragovernmental lease arrangements.

The following revised general guidance was presented by staff

Intragovernmental lease rental payments including lease-related operating cost (for example, maintenance, utilities, taxes, etc.) should be recognized as an expense by the lessee when the payments are due and payable, except in those instances discussed below. Scheduled rent increases which are included in intragovernmental lease rental payments should also be recognized as an

expense when the payments are due and payable.

A footnote reminder concerning the applicability of *SFFAS 4, Managerial Cost Accounting Standards and Concepts, par. 105-115 (as amended by SFFAS 30)* for non-reimbursed or under reimbursed intragovernmental lease arrangements was also added. Staff believes the intragovernmental nature of these provisions will raise the question of continued application of inter-entity costing and suggested that a general answer could be placed in the standards or within the basis for conclusions for clarity.

There were no Board objections to staff's proposed general lessee recognition guidance.

Staff then presented revisions to the previously proposed lessee guidance for recognition of specific intragovernmental lease topics. Staff proposed straight-line recognition for the following three lease activities.

- Lease Incentives

Chairman Allen commented that the language in the latter part of the lease incentive proposal needs to be clarified. The Board directed staff to clarify the language and to provide an illustration of the concepts.

- Lease Concessions
- Amortization of Leasehold Improvements

Several Board members commented on the proposed language for the amortization of leasehold improvements. They stressed consistency and the need for symmetry between the lessee and lessor accounting. Staff will revise the proposed language to address the Board member concerns.

There were no Board objections to the lessee disclosures proposed by the staff.

There were no Board objections to the lessor recognition and disclosures proposed by the staff.

FASAB Review of GASB Preliminary Views (PV) on Major Issues Related to Leases – Chapters 1 – 3

Ms. Valentine noted that the Board had previously directed staff to use GASB's lease proposal as a platform for developing the FASAB standards on non-intragovernmental leases – the GASB PV was released for comment in November. Staff presented a discussion paper that provides an analysis of the first three chapters of the PV so that the Board could discuss the GASB concepts as it relates to the development of federal lease standards.

GASB PV: Chapter 1 – Objective and Background

Staff presented to the Board proposed FASAB lease project objectives that would be included in FASAB lease proposal. Mr. Steinberg suggested that the importance of symmetry in the intragovernmental leasing standards, as well as the uniqueness of

intragovernmental leasing be added to the project objectives. There were no Board objections to Mr. Steinberg's suggestions.

Mr. Showalter stressed that the financial information needed by federal financial statement users be relevant and meaningful. Mr. Dacey suggested that the project objectives be more specific and indicate the type of information we are trying to communicate to the user.

The GASB Lease PV included the foundational principle, "all leases are financings of the right to use an underlying asset and, therefore, a single approach would be applied to accounting for leases." Staff noted that this foundational principle would not be applicable in the federal environment because the Board has already decided that intragovernmental leases are not financing arrangements. Staff recommended that the declaration of a foundational principle is not necessary in the body of the standard, but could be discussed in the Basis for Conclusions (BFC).

The Board agreed with staff's recommendation to not specifically declare a foundational principle in the body of the document but to discuss the Board's rationale in the BFC.

GASB PV: Chapter 2 – Applicability and Scope

Ms. Valentine noted that FASAB has tentatively decided on the following definition of lease – a lease is a contract or agreement that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. The primary differences between FASAB's tentative definition and GASB's PV definition are as follows:

- FASAB added "agreement" along side of "contract" in the definition so that the definition can be used for both intragovernmental and non-intragovernmental leases.
- GASB has added "nonfinancial" as a modifier to the asset in order to scope out financial assets. Staff recommends that the Board also define the underlying asset as a nonfinancial asset to exclude any financial assets from the lease standards.

Ms. Valentine added that Mr. McCall had previously suggested that the lease standards needed to specifically scope out leases involving financial assets. Mr. Dacey pointed out that if "nonfinancial" is added to the lease definition; both "nonfinancial assets" and "financial assets" will need to be defined in the standard. The Board agreed with staff's recommendation to scope out financial assets by adding "nonfinancial" to the lease

definition, as well as adding explanations of both “nonfinancial assets” and “financial assets.”

- GASB also added “or exchange-like transaction” to its lease definition. FASAB does not use the term “exchange-like transactions,” therefore “exchange-like transactions” are included in FASAB’s definition of “exchange transactions.”
- GASB’s lease definition is intended to exclude nonexchange transactions, because they have specific guidance for nonexchange transactions that would apply to any nonexchange lease transactions. Ms. Valentine noted that the current FASAB standards address nonexchange transactions for intragovernmental leases in SFFAS 4 in the inter-entity cost standard and that nonexchange non-intragovernmental lease transactions need to be addressed in the lease standards.

Ms. Valentine added that GSA has informed staff that they have very minimal instance of free or nominal rent. The Department of State stated that they do not have instances of free or nominal rent; they are always reimbursed for the cost. Staff will discuss nonexchange non-intragovernmental lease transactions with other members of the lease task force to identify the prevalence of these leases in the federal sector.

The Board previously agreed that any contract or agreement that meets the definition of a lease should be subject to the lease standards, unless it meets one of the scope exceptions.

The Board also previously agreed to the following scope exclusions:

- Agreements that contract for services that do not transfer the right to use an asset from one contracting party to the other, such as service concession arrangements (SCAs) which will be addressed in the FASAB Public-Private Partnership project.
- Federal natural resources is defined in Technical Bulletin (TB) 2011-1: *Accounting for Federal Natural Resources Other than Oil and Leases* involving oil and gas are covered in SFFAS 38: *Accounting for Federal Oil and Gas Resources* and leases involving other federal natural resources is covered in TB 2011-1.

Staff recommended that the Board adopt GASB’s recognition of lease contracts or agreements that transfer ownership of the underlying asset, and do not contain termination options, as financed purchases of that asset. Also, leases that contain a bargain purchase option would also be recognized as financed purchases of that asset.

Ms. Valentine informed the Board that although GSA has the authority to enter into lease contracts or agreements that transfer ownership of the underlying asset or leases that contain a bargain purchase option, they do not have any existing contracts and do not expect to enter into any at this time.

Staff acknowledged the need to also discuss the prevalence of leases that transfer ownership and/or bargain purchase options with the full lease task force.

The Board agreed with staff's recommendation to adopt GASB's recognition of lease contracts or agreements that transfer ownership of the underlying asset, and do not contain termination options, as financed purchases of that asset. Also, leases that contain a bargain purchase option would also be recognized as financed purchases of that asset.

The GASB Lease PV identified two types of multiple component lease contracts, those with both a lease and service component and those with multiple lease components.

- When a lease contract has both a lease (such as the right to use a building) and a service component (such as maintenance and landscaping service for that building), GASB believes that generally they should be separated so that each component is accounted for on its own. The exception is when measurement is not practical (i.e., the contract does not include prices for the individual components or if some of the prices are not reasonable based on observable stand-alone prices).
- When a lease contract contains multiple lease components that have different lease terms or different asset classes, GASB believes they should be separated so that each component is accounted for on its own, unless the contract does not include prices for the individual components or if some of the prices are not reasonable based on observable stand-alone prices.

Mr. Showalter suggested that a qualifier be added to the multiple components guidance to stress that only significant/material components should be separated. Staff agreed to bring back wording options to address Mr. Showalter's concerns. The Board agreed with staff's recommendation to adopt GASB's recognition of contracts with multiple components.

The GASB Lease PV states that governments should presume that lease contracts entered into at or near the same time with the same counterparty are not part of the same lease unless there is evidence to the contrary. The PV also states that if the lease

contracts are negotiated as a package with a single objective or the amount of consideration to be paid in one contract depends on the price or performance of the other, the contracts would be considered part of the same lease.

The Board agreed with staff's recommendation that the Board adopt GASB's recognition of contract combinations.

GASB PV: Chapter 3 – Lease Term

The GASB Lease PV definition of lease term is the same definition that the Board has tentatively agreed to for the "intragovernmental noncancelable lease term," with the exception of adding option periods. The PV points out that the lease term is an important factor in the measurement of the lessee's lease liability and the lessor's lease receivable.

The GASB Lease PV defines the lease term as the period during which a lessee has a noncancellable right to use an underlying asset (referred to as the noncancellable period), plus the following, if applicable:

- a. Periods covered by a lessee's option to extend the lease if it is probable, based on all relevant factors, that the lessee will exercise that option.
- b. Periods covered by a lessee's option to terminate the lease if it is probable, based on all relevant factors, that the lessee will not exercise that option.

GASB and FASAB's definitions of "probable" are different. GASB's threshold of "probable" is higher than FASAB's "probable" threshold which is defined as more likely than not (>50% probability).

The Board previously agreed to not changing the definition of "probable" to be a higher threshold as it relates to assessing the likelihood of a renewal option being exercised. The GASB PV also states that fiscal funding or cancellation clauses should be disregarded for accounting purposes if the possibility of cancellation is remote.

The Board agreed with staff's recommendation to adopt GASB's definition of lease term including (1) use of our existing definition of "probable" and (2) GASB's direction to disregard fiscal funding and cancellation clauses.

The GASB believes that the lease term should be updated when there is a known event that changes the initial determination.

The GASB Lease PV states that a government should reassess the lease term only if the lessee does one or both of the following:

- a. Elects to exercise an option to extend the lease even though the government had previously determined that it was not probable that the lessee would do so.
- b. Does not elect to exercise an option to terminate the lease even though the government had previously determined that it was probable that the lessee would do so.

The Board agreed that the reassessments of the lease term should be updated when there is a known event that changes the initial determination, including the specific instances noted in GASB's PV.

Staff will continue to work with the task force to further develop the intragovernmental lease standards. Staff will also continue to review the recently released GASB Preliminary Views on Leases and provide a staff analysis for the February 2015 Board discussion.

Adjournment

The meeting adjourned at 2:00 PM.

Appendices: All documents distributed in support of the meeting are available for review at <http://www.fasab.gov/board-activities/meeting/>