



February 3, 2010

Memorandum

To: Members of the Board

From: Eileen W. Parlow, Assistant Director

Through: Wendy M. Payne, Executive Director

Subj: Evaluation of Existing Standards: SFFAS 27, *Identifying and Reporting Earmarked Funds* – **Tab H**<sup>1</sup>

**MEETING OBJECTIVES**

To review a list of issues that staff has identified regarding federal reporting in compliance with Statement of Federal Financial Accounting Standards (SFFAS) 27, *Identifying and Reporting Earmarked Funds*, and to provide direction to staff, via responses to Questions 1 through 5, on how those issues can be resolved. A list of the four issues identified by staff appears on page 3 of this document.

**BRIEFING MATERIAL**

This transmittal memorandum includes a discussion of issues and recommendations. In addition, the following items are attached:

1. Summary of earmarked funds reported by federal agencies for fiscal year (FY) 2009 and total earmarked funds reported on the consolidated financial report of the U.S. Government (CFR) for FY 2008 (FY 2009 is not yet available).
2. Earmarked funds reporting by federal agencies for FY 2009
3. Earmarked funds reporting in the FY 2008 CFR (FY 2009 is not yet available)
4. Website posting from the Office of Management and Budget (OMB) on “earmarks”
5. Website posting from Taxpayers for Common Sense on “earmarks”

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

## **BACKGROUND AND ISSUES FOR DISCUSSION**

Prior to FY 2006, both earmarked funds (as defined in SFFAS 27) and fiduciary activities (as defined in SFFAS 31, *Accounting for Fiduciary Activities*) were classified as “dedicated collections” in accordance with SFFAS 7, *Accounting for Revenue and Other Financing Sources*, paragraphs 83-87. SFFAS 7 contained broad definitions of dedicated collections and allowed a wide range of options for reporting dedicated collections.<sup>2</sup>

The Board issued SFFAS 27 in December 2004, effective in FY 2006. The intent of SFFAS 27 was to provide appropriate reporting for certain government-owned funds that were formerly classified as “dedicated collections” in accordance with SFFAS 7. The Basis for Conclusions explains the intent of SFFAS 27 as follows:

- [54.] All earmarked funds have characteristics that justify special accountability. While many Government programs raise implied commitments for the future, there is a more explicit commitment associated with the statutory establishment of earmarked funds. The Government raises an expectation on the part of the public that the Government will use the amounts collected from specific sources and accumulated in earmarked funds for their stated purpose. There is often a direct link between the source of fund revenues and designated activities, benefits or purposes in an effort to charge beneficiaries or users for benefits received. Resource inflow is accounted for separately from general tax receipts, allowing the program’s status to be more easily examined. Many earmarked funds receive permanent appropriations in an amount equal to these inflows that become available without recurrent action by Congress through annual appropriations.
- [55.] Earmarked funds are of interest to a universe of contributors, taxpayers and recipients, who have an expectation that earmarked revenues will be used for the purposes specified in the law authorizing the collection of the revenues. For example, current contributors to Social Security programs may assume that their earmarked taxes in excess of payments to current recipients will be available to fund future social security benefits. The likelihood of the public making this assumption may reasonably be expected when the Federal Government issues projections of the availability of accumulated balances for future payments.

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<sup>2</sup> The SFFAS 7 definition of “dedicated collections” included activities later defined as fiduciary activities and earmarked funds. The reporting options included reporting on the face of the financial statements, reporting in the notes, or in certain instances reporting in separately-issued financial reports. The SFFAS 7 provisions in paragraphs 83-87 were rescinded by SFFAS 31.

Staff reviewed reporting of earmarked funds on the balance sheet and in the notes of individual federal component entities and the CFR and has identified the following five issues for consideration by the Board:

- 1) **Social Insurance versus Other Earmarked Funds**
- 2) **Cost/Benefit Considerations**
- 3) **Terminology (“Earmarked Funds”)**
- 4) **Credit Liquidating Funds**

## **STAFF ANALYSIS AND RECOMMENDATIONS**

### **Issue 1: Social Insurance versus Other Earmarked Funds**

At the time that SFFAS 27 was issued, the Board intended that by requiring separate reporting of net position of earmarked funds in the CFR, SFFAS 27 would prevent the federal government’s overall negative net position from being partially offset by positive net positions in major social insurance funds, such as Social Security.

However, numerous other funds that also meet the SFFAS 27 definition of earmarked funds, such as military and civil service retirement funds that recognize accrued long-term liabilities, currently report very large negative net positions, which offsets the majority of the social insurance positive net position. Accordingly, this objective of SFFAS 27 is not being met.

As a result, the net positions of earmarked funds largely offset on the CFR. For example, in FY 2008, Social Security and Medicare had a positive combined net position of \$2.48 trillion. This was offset on the FY 2008 CFR with numerous other earmarked funds, including military and civil service retirement funds with negative net positions totaling \$2.21 trillion. Instead of reporting the positive earmarked funds net position of \$2.48 trillion, the CFR reported positive net position for all earmarked funds of \$ 704.6 billion.<sup>3</sup>

### **Staff analysis and recommendation regarding Issue 1 (Social Insurance versus other types of Earmarked Funds)**

The current requirements of SFFAS 27 result in a reporting classification (earmarked funds) that includes (a) major funds that recognize accrued long-term liabilities (with negative net position totaling \$2.21 trillion in FY 2008) and (b) major funds that do not recognize accrued long-term liabilities (resulting in positive net position totaling \$2.48 trillion). These two categories largely offset each other when combined, which reduces the effectiveness and clarity of the display.

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<sup>3</sup> The remaining net position of \$427.9 billion was the net total of 500+ other federal earmarked funds. (\$2,483.6 billion-2,206.9 billion = 276.7 billion + 427.9 = \$704.6 billion)

The special accountability provided in SFFAS 27 for earmarked funds was justified because “the Government raises an expectation on the part of the public that the Government will use the amounts collected from specific sources and accumulated in earmarked funds for their stated purpose.”<sup>4</sup> In the case of earmarked funds with a zero or negative balance, the government has already fulfilled its obligation to “use the amounts collected.” The recognition of liabilities at least equal to the accumulated assets of the fund indicates that the government has already entered into an obligation to provide assets or services to another entity. That obligation is a deferred use of any amounts collected in advance and retained as earmarked funds.

In addition, there are too many earmarked funds (over 500 in FY 2008) to be individually reported on in many agency reports of reasonable length, or even to be listed by name in the CFR. Therefore, SFFAS 27 reporting does not provide special accountability on a fund by fund basis. Detailed budgetary reporting on the individual fund level is available in the Budget of the U.S. Government that allows readers to monitor the use of resources assigned to the fund. Staff questions what purpose is served by reporting at an aggregated level for most of the 500+ funds that are not reported separately in agency reports since readers would be unable to discern whether an individual earmarked fund was used for its stated purposes.

Staff has identified four options that may address this issue. Some of the options are mutually exclusive but others can be combined.

Option A: Restrict the definition and reporting of earmarked funds to social insurance programs. The category of “social insurance programs” would include only those programs that are identified in paragraph 14 of SFFAS 17, *Accounting for Social Insurance*, as amended. Staff believes that combining Option A with Option B (restricting the reporting to social insurance programs that do not have zero or negative net position) would continue to effectively accomplish this objective of SFFAS 27.

Option B: Restrict the reporting of earmarked funds to earmarked funds with a positive net position at fiscal year-end. The recognition of liabilities at least equal to the accumulated assets of the fund indicates that the government has already entered into an obligation to provide assets or services.

Option C: Eliminate the requirement for federal agencies to separately report on earmarked funds on the balance sheet and statement of changes in net position, and require reporting in a disclosure. This option could enhance clarity and/or cost-effectiveness of reporting by requirements to:

- disaggregate the reporting of earmarked funds into two sub-categories: social insurance programs (as defined in Option A) and all other earmarked funds, (or limit the reporting to social insurance funds as defined in Option A);
- include only material earmarked funds; and
- report only combined (not consolidated) amounts.

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<sup>4</sup> SFFAS 27, par. 54.

Option D: Rescind SFFAS 27 and do not require separate reporting of earmarked funds.

Staff recommends that the above options be considered in evaluating both Issue 1 (social insurance versus other earmarked funds) and Issue 2 (cost/benefit considerations).

## **Issue 2: Cost/Benefit Considerations**

Since SFFAS 27 is a principle-based standard, agencies must continually evaluate and re-evaluate each fund to see if the fund qualifies as an earmarked fund.<sup>5</sup> Agencies must also either perform manual analysis, or - if available - use a coding system to tag earmarked fund transactions that require elimination entries at (a) the entity level or (b) at the consolidated CFR level so that Treasury can perform the required intra-agency eliminations for earmarked funds for the CFR.

A large number of earmarked funds (over 500) are currently being reported. Many of these funds are immaterial at the CFR and even at the agency level. However, SFFAS 27 requires that if the total net position of earmarked funds is material, all earmarked funds must be reported as such even if the aggregate total of the immaterial earmarked funds is immaterial.<sup>6</sup> Accordingly, each year agencies must evaluate (or re-evaluate) each fund that it administers to see if each fund qualifies as an earmarked fund. In some instances, such as disgorgement-type funds, agencies have spent considerable time and effort debating whether a particular fund meets the definition of an earmarked fund.

SFFAS 27 also requires that transactions between earmarked funds should be eliminated.<sup>7</sup> In order to comply with this requirement, agencies must use a complex coding system to tag earmarked funds that require elimination entries (a) at the entity level or (b) at the consolidated CFR level. Agencies that do not have the system capacity for such a coding scheme must perform manual research. In addition, Treasury must perform additional eliminations for the CFR for all earmarked funds transactions (that is, eliminations for transactions between one agency's earmarked fund and another agency's earmarked fund).

## **Staff analysis and recommendation for Issue 2: Cost/Benefit Considerations**

Staff believes that:

- Numerous earmarked funds that were not the original intent or focus of SFFAS 27 are being included in reporting on earmarked funds. The FY 2008

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<sup>5</sup> Re-evaluation is necessary to determine (a) if there are any legislated changes to programs and (b) if so, whether those changes would change management's judgment about whether the fund meets the definition of an earmarked fund.

<sup>6</sup> SFFAS 27, paragraph 22.

<sup>7</sup> SFFAS 27, paragraph 22 footnote 9 and paragraph 30.

CFR reported that there were over 500 individual earmarked funds in FY 2008 and FY 2007.

- Reporting standards should not include requirements on mandatory reporting of immaterial items of any kind, including earmarked funds, and that
- The inclusion of the additional funds and the resulting eliminations among the various funds reduce rather than enhance the clarity and effectiveness of reporting on earmarked funds.

Staff believes that most of the Options A-C for Issue 1 would enhance the clarity and/or reduce the administrative burden/costs of reporting on earmarked funds. Option B (exclude funds with zero or negative net position) would enhance clarity but not necessarily reduce administrative burden or costs. Option D would reduce costs by eliminating the requirement but, as staff noted earlier, the intent of SFFAS 27 would not be met.

Staff recommends that in order to evaluate Options A through D, members should review the summary of reporting (at Attachment 1), the agency disclosures (at Attachment 2) as well as the CFR disclosure (at Attachment 3) and consider whether the type of information presented is useful, understandable and/or at an appropriate level of detail for agency financial statements and the CFR. Staff offers the following thoughts to consider:

- Many agencies have far more earmarked funds than could possibly be reported on individually. The Department of the Interior has over 100 earmarked funds, and there are over 500 earmarked funds government-wide.
- Other venues, such as performance reporting on the various programs that are funded by earmarked funds, may be more appropriately used to assess whether the government is using funds in an individual fund as intended. (However, conveying the magnitude of the financing provided by earmarked funds to general operations may remain an appropriate goal for the CFR.)
- Information on the individual programs that are funded by earmarked funds is also provided in the Budget of the U.S. Government.

#### Staff Recommendation:

Staff recommends Option B (exclude funds with zero or negative net position) and Option C (remove disaggregated reporting of earmarked funds by federal agencies from the face of the Balance Sheet and Statement of Changes in Net Position; retain reporting requirements on the face of the financial statements for the CFR only).

Staff believes that Option B (exclude funds with zero or negative net position) may be preferable to current requirements in SFFAS 27 because a zero or negative net position indicated that the funds collected are not available for future new obligations. Also, in particular for the CFR, it is important to report the extent to which dedicated collections are funding cash flows for the rest of the government.

Staff recommends Option C for the following reasons:

- Reporting a separate category of funds on the face of two of the financial statements (balance sheet and statement of changes in net position) clutters the financial statements with a category of funds that is not only unfamiliar to the general public but is also a large and heterogeneous group (as currently defined this category includes over 500 funds).
- Staff believes that moving the reporting to a disclosure and excluding earmarked funds with zero or negative balances and/or excluding non-social insurance funds would simplify the reporting and make it more understandable.

Staff believes that the Board should further enhance the clarity and/or cost-effectiveness of reporting of earmarked funds by adding requirements to:

- if the Board decides not to eliminate earmarked funds with zero or negative net positions, disaggregate the reporting of earmarked funds into two sub-categories: social insurance programs (as defined in Option A) and all other earmarked funds,
- include only material earmarked funds; and
- report only combined (not consolidated) amounts.

Staff recommends that staff should do further research by contacting agencies with significant dollar amounts and/or total number of earmarked funds for comments on Option A (limiting reporting to social insurance funds only). Option A might enhance the effectiveness and clarity of the reporting by excluding a large number of funds that were not originally intended to be the primary focus of reporting on earmarked funds. However, when SFFAS 27 replaced the “dedicated collections” provisions of SFFAS 7 it preserved the concept of special accountability for funds that not part of general fund revenues but are collected for a specific purpose. Accordingly, staff would like to do further research before making a recommendation regarding Option A.

Staff does not recommend Option D for the following reasons:

- Staff believes that the SFFAS 27 requires important information about social insurance programs that is not currently provided by the statement of social insurance.
- Staff believes that an important contribution of SFFAS 27 is the requirement to explain the nature of federal “trust funds” as follows:
  - [27] Investments in Treasury securities for earmarked funds should be accompanied by a note that explains the following issues:
    - The U.S. Treasury does not set aside assets to pay future expenditures associated with earmarked funds. Instead, the cash generated from earmarked funds is used by the U.S. Treasury for general Government purposes.
    - Treasury securities are issued to the earmarked fund as evidence of earmarked receipts and provide the fund with the authority to draw upon the U.S. Treasury for future authorized expenditures (although for some funds, this is subject to future appropriation).

- Treasury securities held by an earmarked fund are an asset of the fund and a liability of the U.S. Treasury, so they are eliminated in consolidation for the U.S. Government-wide financial statements.
- When the earmarked fund redeems its Treasury securities to make expenditures, the U.S. Treasury will finance those expenditures in the same manner that it finances all other expenditures.

[28] Below is one example of a note that addresses the points in paragraph 27 above.

*Intra-governmental Investments in Treasury Securities*

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds (or name/s of fund/s). The cash receipts collected from the public for an earmarked fund are deposited in the U.S. Treasury, which uses the cash for general Government purposes. Treasury securities are issued to the (component entity) as evidence of its receipts. Treasury securities are an asset to the (component entity) and a liability to the U.S. Treasury. Because the (component entity) and the U.S. Treasury are both parts of the Government, these assets and liabilities offset each other from the standpoint of the Government as a whole. For this reason, they do not represent an asset or a liability in the U.S. Government-wide financial statements.

Treasury securities provide the (component entity) with authority to draw upon the U.S. Treasury to make future benefit payments or other expenditures. When the (component entity) requires redemption of these securities to make expenditures, the Government finances those expenditures out of accumulated cash balances, by raising taxes or other receipts, by borrowing from the public or repaying less debt, or by curtailing other expenditures. This is the same way that the Government finances all other expenditures.

**Questions 1, 2 and 3 for the Board:**

1) Should the issues discussed above (Issue 1: the different nature of social insurance earmarked funds and Issue 2: Cost/Benefit Considerations) be addressed by:

Option B: Restrict the reporting of earmarked funds to earmarked funds with a positive net position at fiscal year-end and

Option C: Eliminate the requirement to separately report on earmarked funds on the balance sheet and statement of changes in net position, and require reporting in a disclosure?

2) Should the clarity and/or cost-effectiveness of reporting on earmarked funds be further enhanced by adding requirements to:

- (if the Board decides not to approve Option B (restrict reporting to earmarked funds with net positions greater than zero) disaggregate the reporting of earmarked funds into two sub-categories: social insurance programs (as defined in Option A) and all other earmarked funds,
- include only material earmarked funds; and
- report only combined (not consolidated) amounts

3) Should the staff contact federal agency for comments on Option A (Restrict the definition and reporting of earmarked funds to the social insurance funds that are identified in paragraph 14 of SFFAS 17)?

### **3) Terminology (“Earmarked Funds”)**

The term “earmarked funds” has at times caused confusion because a similar term, “earmarks” is used as a federal government budgetary term but means something entirely different.

Subsequent to the issuance of SFFAS 27, the use of the budgetary term “earmarks” as a reference to earmarked spending has been formalized and highlighted, for example, by the OMB’s website posting of a database to track earmarked spending.

The budgetary term “earmarks” is defined on the OMB website, which displays a question “What are earmarks?” with the following answer:

Earmarks are funds provided by the Congress for projects, programs, or grants where the purported congressional direction (whether in statutory text, report language, or other communication) circumvents otherwise applicable merit-based or competitive allocation processes, or specifies the location or recipient, or otherwise curtails the ability of the executive branch to manage its statutory and constitutional responsibilities pertaining to the funds allocation process.

(See full OMB website page on “earmarks” at Attachment 4)

The budgetary term “earmarks” has also been used widely by public advocacy groups such as Taxpayers for Common Sense (See Attachment 5).

Accordingly, there is some confusion over the meaning of the term “earmarked funds” which has resulted in some agencies reporting American Recovery and Reinvestment Act (ARRA) funds as earmarked funds, even though in some cases the ARRA funding does not appear to be separate from the General Funds)

### **Staff analysis and recommendation for Issue 3: Terminology**

Staff believes that with an increasing emphasis on “earmark” as a reference to spending, the similarity of the terms “earmarks” and “earmarked funds” is increasingly a

source of confusion for both preparers and users of the financial statements. Staff believes that the previous term that was used in SFFAS 7 prior to the development of SFFAS 27, “dedicated collections,” is distinct from other federal budgetary terms and inherently more intuitive. Staff recommendation depends upon the Board’s decision relative to Question 1.

a) If the Board decides to restrict the reporting of earmarked funds to social insurance programs, the term “social insurance dedicated funds” could be used instead of “earmarked funds.”

b) If the Board decides not to restrict the reporting of earmarked funds to social insurance programs, staff recommends the term “funds from dedicated collections” should be used for funds previously called “earmarked funds.”

#### **Question 4 for the Board: Terminology**

Depending upon the Board’s decision on Question 1, does the Board agree with staff recommendation (a) or (b) above?

#### **4) Credit Liquidating Accounts**

Credit liquidating accounts<sup>8</sup> are budget accounts that include all cash flows to and from the federal government resulting from direct loan obligations or loan guarantee commitments made prior to October 1, 1991. Credit liquidating accounts are normally “swept” by the Treasury Department<sup>9</sup> at year-end and accordingly would not meet the definition of earmarked funds.<sup>10</sup> However, since the Credit Reform Act of 1990, as amended, permits unobligated balances in credit liquidating accounts to be swept early in the following fiscal year, credit liquidating accounts may still have balances and net position at the end of the fiscal year.<sup>11</sup> Also, since certain budgetary obligations (such as undelivered orders) are not recognized on the accrual-based statements such as the balance sheet, credit liquidating accounts may also have a positive net position at fiscal year-end. Although the Credit Reform Act states that such balances are not available for future new obligations, staff believes that guidance should clarify that credit liquidating accounts should be excluded from the reporting category of earmarked funds. Such guidance could be issued as staff implementation guidance or an Interpretation. Several of the options being presented to the Board to resolve other issues would eliminate the need for clarifying guidance on credit liquidating accounts.

<sup>8</sup> As authorized by the Credit Reform Act of 1990, as amended. See note 4 of this memorandum.

<sup>9</sup> “Swept” is the common term when Fund Balance with Treasury is automatically reduced to zero at year-end.

<sup>10</sup> This appears to be required by Section 505(d)(2) of the Credit Reform Act of 1990: “Amounts credited to liquidating accounts in any year shall be available only for payments required in that year.” [Staff note: Miscellaneous receipt accounts are reduced to zero by Treasury at the end of each fiscal year.]

<sup>11</sup> Credit Reform Act of 1990, as amended, Section 505(d)(2) states that “Any unobligated balances in liquidating accounts at the end of a fiscal year shall be transferred to miscellaneous receipts as soon as practicable **after** the end of the fiscal year.” (**Bold added.**)

## **Staff analysis and recommendation for Issue 4: Credit Liquidating Accounts**

SFFAS 27 explicitly excluded credit financing accounts<sup>12</sup> from its requirements<sup>13</sup> because financing accounts would otherwise have met the definition of earmarked funds and the Board did not wish to have financing account balances included in reporting earmarked funds. (Financing accounts are non-budgetary accounts that should always have a net position of zero.<sup>14</sup>) SFFAS 27 did not explicitly address credit liquidating accounts because credit liquidating accounts normally do not retain funds from one fiscal year to the next. Subsequent to the issuance of SFFAS 27, FASAB staff was informed that some liquidating accounts are not swept by Treasury at fiscal year-end. Credit liquidating accounts have characteristics of both credit financing accounts (which the Board explicitly excluded from the provisions of SFFAS 27) and credit program accounts (which are funded by the general appropriations and so do not meet the definition of earmarked funds promulgated in SFFAS 27). Accordingly, staff recommends that credit liquidating accounts should be explicitly excluded from reporting earmarked funds.

a) If the Board's decision on Question 1 is to restrict reporting on earmarked funds to social insurance programs that do not recognize accrued long-term liabilities, no further action would be necessary to exclude credit liquidating accounts.

b) If the Board's decision on Question 1 is not to restrict reporting on earmarked funds to social insurance programs that do not recognize accrued long-term liabilities, staff recommends that credit liquidating accounts should be explicitly excluded from reporting on earmarked funds. In accordance with staff analysis above, staff believes that this would not represent a change in existing requirements and so could be accomplished by staff implementation guidance or an Interpretation of SFFAS 27.

### **Question 5 for the Board: Credit Liquidating Accounts**

Depending upon the Board's decision on Question 1, does the Board agree with staff recommendation (a) or (b) above?

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<sup>12</sup> Credit financing accounts are nonbudgetary funds that do not accumulate results of operations; they primarily serve as clearing accounts for cash activity relating to federal credit programs. (SFFAS 27, paragraph 18)

<sup>13</sup> SFFAS 27, paragraph 18.

<sup>14</sup> See Credit Reform Act of 1990, as amended, Section 502(7).