Federal Accounting Standards Advisory Board

December 3, 2009

Memorandum

To: Members of the Board

From: Melissa Loughan, Assistant Director

Wendy M. Payne

Through: Wendy M. Payne, Executive Director

Subj: **Federal Entity-Tab F**[1]

MEETING OBJECTIVE

The primary objective for the December Board meeting is to provide the Board with a summary of the Federal Reserve Briefing to the Federal Entity Task Force that was held on November 18, 2009. The session will also allow staff to seek Board concurrence on issue areas and planned actions for the Federal Entity project.

BRIEFING MATERIAL

Attached to this memo is a Summary of the Federal Reserve Briefing. Also, this transmittal includes a Staff Discussion and Questions for the Board on the next page and a list of issues identified and planned actions in the project for your consideration.

BACKGROUND

At the October 2009 meeting, staff provided the Board with the revised principles and related criteria for defining the boundaries of the federal reporting entity. Staff has developed a list of issues or concerns identified with the draft principles to be researched.

NEXT STEPS

Staff will address the open issues at upcoming meetings and develop an ED on the Federal Reporting Entity by the end of 2010.

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

STAFF DISCUSSION AND QUESTIONS FOR THE BOARD

Attached to this memo is a Summary of the Federal Reserve Briefing that was held last month. The session was very informative for the task force. The summary is prepared similar to the way we prepare our minutes to enable Board members to gather much of the same information conveyed to the task force. The Federal Reserve reconsideration is included below in the list of issues, and it notes the task force will develop a recommendation for the Board's consideration and present this at perhaps the next Board meeting.

QUESTIONS FOR THE BOARD:

- Does the Board have any questions regarding the Summary of the Federal Reserve Briefing to the Federal Entity Task Force?

- Does the Board wish to invite Federal Reserve representatives to a future Board meeting or will the Summary of the task force briefing be sufficient? (Staff notes it often takes time to coordinate schedules so I'd like to alert them to this and provide upcoming meeting dates.)

As an update on the project, it would be good to assess what issues remain to be addressed or resolved in the project. The issues and planned actions are included for your consideration. The issues are not presented in any particular order, staff started with the Federal Reserve issue since the Summary of the Briefing is also included with the Board materials.

QUESTIONS FOR THE BOARD:

- Does the Board have any questions or comments regarding the list of issues and planned actions in this project?

- Is the Board aware of any other issues that need to be researched or addressed?

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If you have any questions or comments prior to the meeting or would like to provide feedback prior to the meeting, please contact me by telephone at 202-512-5976 or by e-mail at loughanm@fasab.gov.

Federal Entity Project--Issues to be Addressed

Issue 1: What about the Federal Reserve?

It was agreed that as part of the federal entity project, the Federal Reserve exclusion from consolidation in the financial statements of the U.S. government would be reconsidered. Par. 47 of SFFAC 2, *Entity and Display* specifically provides the exclusion as follows:

> In establishing and monitoring monetary policy, the Federal Reserve System, i.e., the Board of Governors of the Federal Reserve System and the Federal Reserve Banks, could be considered as functioning consistent with the indicative criteria presented in paragraph 44. However, in the United States, the organization and functions pertaining to monetary policy are traditionally separated from and independent of the other central government organizations and functions in order to achieve more effective monetary and fiscal policies and economic results. Therefore, the Federal Reserve System would not be considered part of the government-wide reporting entity. Payments made to or collections received from the Federal Reserve System would be reported in the financial statements of the Federal Government. Certain other disclosures might also be appropriate in the financial statement for the entire government.

Therefore, Federal Reserve representatives were invited to provide a briefing to the Federal Entity Task Force so that it may make a recommendation to the Board. See the Summary of the Federal Reserve Briefing attached to this memo. The detailed summary should enable Board members to gather much of the same information that was presented to the task force.

Planned Actions for Issue 1: *The Federal Entity Task Force will develop a recommendation for the Board. The Task Force will first focus on the entity issue as this is the first question and display should not bias the decision on entity. The Task Force will consider the Federal Reserve as a whole, the Board of Governors, and the Federal Reserve Banks against the conclusive principle, the indicative principles, and misleading to exclude framework and then provide a final conclusion/recommendation with justification on whether each is part of the federal reporting entity. If considered part of the federal reporting entity, the Task Force will recommend whether consolidation or other reporting is appropriate. This may be an area where the reporting model project would have relevance if perhaps some other presentation may be more appropriate than consolidation.*

Issue 2: Conclusive really just means in the Budget

The principles were revised to include the Conclusive Principle for directly financially accountable "Federal reporting entities include all entities that the federal government is directly financially accountable for. This includes entities in the program and financing schedules of the *Budget of the United States Government* (the President's budget) as well as those entities the federal government has an ownership interest of 100%." Members expressed concern over using the terminology "directly financially accountable" and also with including the notion of ownership in the conclusive principle.

Planned Actions for Issue 2: *Staff will rewrite the conclusive principle with focus on the budget and not bring in other terminology. This type of language could be included in the Basis for Conclusions if necessary. Staff will also put all ownership criteria in the indicative principles.*

Issue 3: Unintended Consequences of Proposed Standard

Members agreed that most of the principles and related criteria in the proposal sound appropriate, but there was concern whether it would result in unintended consequences or changes. Members suggested a separate study to determine what changes may result.

<u>Planned Actions for Issue 3:</u> *Staff will perform test cases either prior to, and perhaps some in conjunction with the exposure draft. Staff will consider the best timing and method to incorporate testing. Staff would want to include certain or a sample of the entities from the following sources—*

- *entities listed in the Appendix to the CFR that are excluded*
- *entities listed in the Appendix to the CFR as the 112 additional entities (specifically those included in this list but not in the Budget of the United States Government)*
- *entities listed in the Budget of the United States Government but not included in the CFR in any particular list in the Appendix*
- *entities included in the CRS Report for Congress RL30533 Quasi Government: Hybrid Organizations with Both Government and Private Sector Legal Characteristics*
- *other entities identified through work on the project*

Staff believes the best assessment would result from working directly with the selected entities versus performing assessments without their input, but this would involve more time to complete.

Issue 4: Entities partially on budget

Certain entities, such as the Smithsonian, are partially on budget and presently only the budgeted portion is included in the CFR and the other parts (trust fund) are not included. There is inconsistency in how entities that are partially on budget are handled because the Holocaust is included in its entirety. The proposal addresses these situations with the following paragraph which would require the entire entity to be included.

> "Certain entities may be partially on budget and receive funding from other sources, such as fees, premiums, or donations that are not included in the budget. [FN For example, the Smithsonian Institution receives additional funding from non-federal sources (trust fund receipts) that are not included in the budget as trust funds are not subjected to the budgetary constraints inherent in being included in the budget. Clearly, the Smithsonian Institution is still accountable for their handling of general revenue appropriations, offsetting collections (e.g. donations) that are appropriated for their uses as well as the non-budgetary trust funds.] However, it is the authorities provided by Congress that allow these financing activities to be undertaken and thus accountability is for the entity in totality. In these cases, the whole federal entity is considered within the boundaries of the federal reporting entity based on this conclusive principle."

Members disagreed and didn't believe there can be the general rule that if a portion of the entity is federal then the whole entity is federal because there are public policy arguments that would lead to something different. However, consideration should be given to the fact that generally there is an authorization for the endowments and there are federal officials that have oversight of the endowment. There is an ongoing relationship and ultimately those resources fulfill a public purpose, the question is what the best presentation of that relationship is.

<u>Planned Actions for Issue 4:</u> Staff will research the issue further, seek task force input and determine options for the Board's consideration. Staff will also consider this in performing the assessments in Issue 3 and contact Smithsonian for input. This may be an area where the reporting model project would have relevance if perhaps some other presentation may be more appropriate than consolidation.

Issue 5: Legal status or legislation

Statutes or regulations may establish an entity and clearly indicate its status as outside of the federal government for various reasons. This raises the question if legislation is worded so as to indicate that an entity is not a "federal" entity, can it still be considered part of the federal reporting entity for financial reporting purposes. There are examples of entities that meet the conclusive and indicative criteria of SFFAC 2, yet legislation indicates that they are not a federal entity. The standard should address whether the conclusive and indicative criteria should override such legislative language (which often is for something very different than financial reporting purposes) in order to ensure that the federal reporting entity is complete.

In the draft, staff addresses this in the conclusive principle by noting "Even in cases where Congress defines an entity as not an agency or instrumentality of the federal government, an entity included in the *Federal Programs by Agency and Account Schedule* is part of the federal reporting entity for financial reporting purposes."

In the indicative principle "Existing as a Matter of Law within or Established by the Federal Government" staff includes the following footnote to address this issue: "Statutes or regulations may establish an entity and clearly indicate its status as outside of the federal government by stating that the entity is "private" or that it is "not an agency or instrumentality of the United States Government." Congress defines what constitutes an agency or instrumentality of the federal government for purposes of a particular statute or set of statutes that assigns duties, liabilities, and administrative requirements and grants privileges of the federal government to individual entities or types of entities. Even in cases where Congress defines an entity as "not an agency or instrumentality" of the federal government, the entity may be found to be part of the federal government for certain purposes."

<u>Planned Actions for Issue 5:</u> Staff will work with FASAB legal counsel on this issue and ensure the appropriateness of the language. Staff will confirm the Board's position that meeting the criteria in the standard should override such legislative language (which is often directed at something very different than financial reporting) to ensure the federal reporting entity is complete. Staff will also consider this in performing the assessments in Issue 3.

Issue 6: Confirm Board's Views on Reporting Model Interface (and if there should be a middle ground considered in this project)

At the October Board meeting, the Board discussed the potential interface between the reporting model project and the federal entity project that should be considered. The Board had agreed that consolidation is not the only option for presentation. The federal entity project was initiated to answer the question of what gets consolidated in the federal entity. However, in doing so one must also consider what type of reporting may be required for entities not consolidated. Therefore, when considering other reporting formats, there are questions that relate to the reporting model and what information is important for presentation and how tightly this needs to be integrated with the reporting model project. The Board agreed the two different projects that can continue simultaneously.

The Board also discussed whether alternative display options (discrete presentation) could be considered or if this was considered outside of the scope of the entity project and belonged in the reporting model project. The Board member responses did not give staff a clear direction in this area. Two members were very clear in not wanting to explore other options and believed Note Disclosure would be appropriate for entities not consolidated. Four members appeared comfortable with exploring other options for presentation. Three members suggested that there were advantages to considering other options but it should be done in the Reporting Model project.

Staff believes it is important to confirm the Board's view because many of the other issue areas to be addressed involve determining options for disclosures or other alternatives and specifically an area where the reporting model project would have relevance if perhaps some other presentation may be more appropriate than consolidation.

<u>Planned Actions for Issue 6:</u> Staff will coordinate with the Reporting Model project in all areas. However, the federal entity project will be completed much earlier. Unless otherwise directed, staff will bring all presentation alternatives for consideration and allow the Board to determine if it is outside the scope.

Issue 7: Clarification of Ownership Indicative Principle

Members suggested the language be clarified to address that in many situations; there may not necessarily be an ownership interest. For example, if an organization was created by the federal government such as a non-profit, then there may not be ownership.

<u>Planned Actions for Issue 7:</u> Staff will revise the language in the Ownership Indicative Principle to address this.

Issue 8: Criteria for Consolidation

Once the issues included in this list are addressed, FASAB will have a standard that addresses which entities are within the boundaries of the federal reporting entity. Specifically when assessing the entities against the indicative principles and criteria, there may be entities that meet all three while others may only meet one or two. From this, there are many variations of how an entity may fall within the boundaries of the federal reporting entity, which ultimately would relate to how the entity is presented and disclosed.

Consolidation highlights the ultimate aggregation of entities is into the entire federal government; the independent federal entity controlling and financing its components. However, ensuring adequate disclosures for those entities that are not consolidated is equally important.

Another consideration is an entity would be consolidated if it meets the first indicative principle (established by the federal government) and at least one of the other two (control or ownership) unless it meets the temporary exclusion.

Another consideration is using some sort of risk and rewards approach as a test to determine what would be consolidated.

Planned Actions for Issue 8: *Staff will work with the task force to develop criteria for determining when entities meeting indicative principles are consolidated and disclosures for entities that are not consolidated.*

Issue 9: Misleading to Exclude

As proposed, the Misleading to Exclude ("Federal reporting entities should also include entities not meeting the conclusive or indicative principles if the nature and significance of their relationships with the federal government are such that the exclusion would cause the federal reporting entity financial statements to be misleading or incomplete.") criterion helps to ensure that the proposed Standard could accommodate rare or unique situations that may arise in the future.

Members agreed this principle should be included. However, members believed this should lead to disclosures, not consolidation. It was agreed there should be some flexibility in determining the disclosure and that it should discuss the relationship and other pertinent facts.

Planned Actions for Issue 9: *Staff will revise the requirements for disclosures for the misleading to exclude principle. This may be an area where the reporting model project would have relevance if perhaps some other presentation may be more appropriate than consolidation.*

Issue 10: Temporary Exclusion

The Draft contained the Exception for Temporary Conditions to reflect that there are temporary situations where the conditions are not likely to remain in existence permanently and provided language specific to long-term interventions and proposed disclosures for entities meeting the temporary exclusion.

Members questioned if the focus should be on demonstrating that something is temporary or demonstrating there is no plan to make it permanent. Members appeared to prefer the approach used in the examples—"Temporary control-- the federal government has no plan to continue control permanently and instead plans to relinquish or cede control; and Temporary ownership-- the federal government acquires ownership of an entity but it is held exclusively with the view of being disposed." Certain members believed the focus of the definition needed to be based on intent. However, certain members expressed concern if things are too open ended or if it is based on intent.

Members noted concern with the requirements for disclosure of a brief description of the formal plan that describes the interventions is not expected to be permanent. A member noted that often no such plan exists and that a written assertion may be more appropriate. Also, it was suggested that the description of the plan wasn't necessary since it isn't required.

Members also noted that the disclosures are required for each entity, and this should be revised to include aggregations by agency, condition, etc.

<u>Planned Actions for Issue 10:</u> Staff will work towards a revised proposal for the Temporary Exception that addresses Board members concerns while finding a middle ground considering intent. Staff will also revise the required disclosures. This may be an area where the reporting model would have relevance in perhaps some other presentation may be more appropriate over consolidation.

Issue 11: Exception for Agency Mission-Related Interventions

The Draft included language for Agency Mission-Related Interventions as a separate exception to note that certain agencies do interventions as part of their mission and naturally may not require as detailed disclosures as the temporary conditions. Certain members noted this seemed very similar to the Temporary Exclusion. There was also concern regarding the title of the section as most actions are mission related. This section was drafted to address the more routine interventions such as receiverships at the FDIC and NCUA (which are different than what's described under the Temporary Exclusion because it's described as extraordinary activities that are rare, not routine or normal activities, not part of strategic planning and so forth.)

<u>Planned Actions for Issue 11:</u> Staff will confirm this is best handled with a separate section (versus incorporated with the temporary exception), clarify the language in the section, and determine a more appropriate title.

Issue 12: Flowchart

A Flowchart *Determining the Boundaries of the Federal Reporting Entity and Display* was included with the proposal because the task force thought it would be a useful Appendix to the Standard. The Flowchart will have to be updated to reflect the final standard.

<u>Planned Actions for Issue 12:</u> Staff will revise the flowchart for consideration with the Draft Exposure Draft.

Issue 13: Related Parties

The Board agreed Related Parties should be addressed after completing the Draft Standard (either within this standard or a separate standard on Related Parties.)

<u>Planned Actions for Issue 13:</u> The Related Party issue will be researched and explored further once the draft is near completion.

Issue 14: Amendments to SFFAC 2

Once the Draft Standard is near completion, a detailed review of SFFAC 2 must be done to determine if any areas should be amended or rescinded.

SUMMARY
Federal Reserve Briefing to the Federal Entity Task Force
Wednesday, November 18th
9:00 am - 11:00 am
GAO Building, Conference Room 1Q66

Federal Reserve System Representatives
Greg Evans - Deputy Associate Director, Division of Reserve Bank Operations and Payment Systems, Board of Governors of the Federal Reserve System

Bill Mitchell - Senior Associate Director and CFO, Management Division, Board of Governors of the Federal Reserve System

Elaine Boutilier - Deputy Associate Director, Management Division, Board of Governors of the Federal Reserve System

Brenda Richards - Manager, Division of Reserve Bank Operations and Payment Systems, Board of Governors of the Federal Reserve System

Craig Delaney - Manager, Management Division, Board of Governors of the Federal Reserve System

Larry Mize - Project Leader, Division of Reserve Bank Operations and Payment Systems, Board of Governors of the Federal Reserve System

Arun Sundaram - Financial Analyst, Division of Reserve Bank Operations and Payment Systems, Board of Governors of the Federal Reserve System

Federal Entity Task Force Members
Regina Kearney, OMB
Abe Dymond, GAO Office of General Counsel
Ann Davis, Treasury
Rich Brady, DoD, USMC Financial Management School
James Chan, University of Illinois at Chicago
Terry Bowie, (Deputy CFO) NASA
Joel Grover, (Dep. IG for Fin. Management & IT) Treasury OIG
Mark Reger, (CFO) Office of Personnel Management
Tom Daxon, Former Oklahoma State Auditor
Dan Kovlak, KPMG
Jim Hagen, NCUA
Wendy Payne, FASAB
Melissa Loughan, FASAB

NOTE: Tom Allen, FASAB Chairman also attended the meeting.

Purpose

As part of the federal entity project, the Federal Reserve System's exclusion from consolidation in the financial statements of the U.S. government is being reconsidered. Therefore, Federal Reserve System (Federal Reserve) representatives were invited to provide a briefing to the Federal Entity Task Force so that it may make a recommendation to the Board.

Par. 47 of SFFAC 2, *Entity and Display* specifically provides the exclusion as follows:

> In establishing and monitoring monetary policy, the Federal Reserve System, i.e., the Board of Governors of the Federal Reserve System and the Federal Reserve Banks, could be considered as functioning consistent with the indicative criteria presented in paragraph 44. However, in the United States, the organization and functions pertaining to monetary policy are traditionally separated from and independent of the other central government organizations and functions in order to achieve more effective monetary and fiscal policies and economic results. Therefore, the Federal Reserve System would not be considered part of the government-wide reporting entity. Payments made to or collections received from the Federal Reserve System would be reported in the financial statements of the Federal Government. Certain other disclosures might also be appropriate in the financial statement for the entire government.

Generally, the expectations for the briefing included the following:

1. Federal Reserve's assessment of whether it (the Board of Governors of the Federal Reserve System and the Federal Reserve Banks if different conclusions) should be consolidated in the US Government-wide Statements based on the draft principles and criteria.
2. Federal Reserve's suggestions on what would be adequate disclosure or presentation in the US Government-wide Statements based on the unique relationship.
3. Discussion of any pertinent facts, reasoning, and justification that leads the Federal Reserve to conclusions on the first two items.
4. Any comments or suggestions on the draft principles are also welcome.
5. Opportunity for task force members to ask questions.

Summary of Discussion

After brief introductions, Mr. Evans explained that Mr. Mitchell would be discussing the Board of Governors, and Mr. Evans would be discussing the specifics of the Federal Reserve Banks.

Mr. Evans noted that recent events have made questions arise as to what is the Federal Reserve, where does it get its money, what is its relationship with the federal government, etc. He understands these questions naturally play a part in determining if the Federal Reserve is part of the federal reporting entity. He noted the current Concepts Statement 2 provides for the Federal Reserve to be excluded.

Mr. Evans explained that the Federal Reserve has not taken an official position on whether the Board of Governors or the Reserve Banks should be included in the federal reporting entity or on the applicability of the criteria presented in the draft for inclusion in the federal reporting entity to determining the extent of inclusion. Instead, he hoped this could be an informational session about the Federal Reserve's transactions with the federal government, its governance, and its current accounting policies.

Mr. Evans explained the Federal Reserve System was created by the Federal Reserve Act and that it was created to operate independent from the federal government. He explained that the issue of governance within the System and among the Reserve Banks can be quite complex and often has been debated internally. For example, he noted that the Reserve Bank financial statement footnotes once referred to the Reserve Banks as federal instrumentalities based on a the view of the Board's legal staff until the legal staff of one Reserve Bank objected. To expedite the financial statements, a different approach to describing Reserve Banks was chosen.

Mr. Evans explained that the Reserve Banks' financial disclosures are transparent and appropriately describe their financial relationship with the US Treasury, but they try avoiding the term "Related Party." However, the Board of Governors uses that term a little more freely in their financial statements. Mr. Mitchell agreed and noted the Board of Governors considers itself to be an independent quasi-governmental entity. He noted they are subject to federal rules and legislation that specifically mentions the Board of Governors and they tend to follow the spirit even when not mentioned.

Mr. Evans explained that the purposes and functions of the Federal Reserve System include:

- Conducting the nation's monetary policy;
- Supervising and regulating banking institutions;
- Maintaining the stability of the financial system and containing systemic risk that may arise in the financial markets; and
- Providing financial services to depository institutions, the U.S. government, and foreign officials.

Mr. Evans explained the Chairman of the Federal Reserve Board of Governors and other members of the Board of Governors are appointed by the President of the United States with the advice and consent of U.S. Senate. The 7 members of the Board of Governors are confirmed for specified, staggered terms.

Mr. Evans explained the Reserve Banks are considered to be 12 separate legal entities. He explained that each Reserve Bank has a Board of Directors of each Reserve Bank and that is comprised of nine members (three appointed by Board of Governors to represent the public; six elected by member banks). The Reserve Bank presidents are appointed by each Bank's Board of Directors. Capital stock is held by member depository institutions as a condition of membership. Member banks must subscribe to stock in their regional Federal Reserve Bank in an amount equal to 6 percent of their capital and surplus. Member banks receive a 6 percent dividend annually on their stock, as specified by law.

Mr. Evans explained the Board of Governors does influence the Reserve Banks through its broad authority and oversight. There are many delegated functions the Reserve Banks are performing on behalf of the Board of Governors. The Board of Governors approves the budgets. However, at the core of the understanding of the Reserve System is that they are 12 independent banks that are independent from the Board of Governors. Mr. Evans explained that is very real in the day to day activities.

Mr. Evans provided a brief explanation of monetary policy from an accounting perspective. He explained that the traditional method for conducting monetary policy is to change the level of reserve account balances through the purchase and sale of government securities. Essentially, the Reserve Banks balance sheet is the tool for conducting monetary policy; Manipulating the balance sheet of the Reserve Banks—increase the money supply by buying assets, decrease it by selling assets. If you look at what creates money in our economy—the Federal Reserve note—it is one of the biggest obligations or liability of a Federal Reserve Bank. The other big liability of the Federal Reserve Banks is Depository Institution (DI) Accounts—these represent deposits of DIs held at the Reserve Bank and can be used by DIs to settle the transactions among themselves. When the Federal Reserve is trying to provide liquidity to the market, it will buy assets in the open market; the buyer's payment for that asset will end up an account of a depository institution and, as a result, is a credit to the Reserve Bank's balance sheet.

Mr. Evans explained that each morning the Board of Governors and the FRB of NY use the daily Reserve Banks balance sheets as an input to determining monetary policy actions for that day. He stated that the Banks have produced balance sheets daily for many years. He explained there is an elaborate process done each morning. He stated one must understand that is integral to their primary mission—to get these balance sheets constructed and into the hands of the people to make the monetary policy decisions for operations for the day. The Reserve Banks reflect their holding of federal government securities in a weekly report as well as annually at par value, and premiums and discounts are in other assets and liabilities.

Mr. Evans explained that people are looking at the Reserve Bank financial statements, not necessarily to know the financial assets but more for an understanding of the changes. He noted years ago, much of the policy related information wasn't reported; people discerned it by watching if more government securities were purchased and so forth. Therefore, now the presentation of the material is focused on making it easier for the reader to see what actions were taken versus particular accounting principles used because the reader is most focused on whether the Federal Reserve is buying or selling securities and to the effect on reserves.

Mr. Evans explained that 20 plus years ago the Reserve Banks prepared various schedules and reports, but didn't prepare audited financial statements. He explained that it was determined that the Board of Governors would set the accounting principles for the Reserve Banks to reflect the unique nature of the Reserve Banks' powers and responsibilities as part of the nation's central bank. The Chairman of the Federal Reserve explained to Congress why the Reserve Banks were unique and should not follow GAAP. However, it was agreed there needed to be a policy that could be articulated more clearly. When deciding, the Federal Reserve considered FASB but believed it didn't completely consider the uniqueness of a central bank in all standards. It was agreed that GASB didn't fit and FASAB was just initially beginning to take form. Therefore it was agreed the Board of Governors would establish the principles for the Reserve Banks. The Board of Governors adopted a fairly simple standard—for private sector like transactions, FASB would be used and for transactions that were unique to a central bank's purpose and function, the Board of Governors would use FASB Concept 2 and other Concept Statements to guide them like an accounting standard setter in reference to meeting the information needs of users. The Board of Governors wanted a framework for making the decisions when GAAP wasn't used. Mr. Evans explained the Reserve Banks use accounting principles established by the Board of Governors in the *Financial Accounting Manual for the Federal Reserve Banks* (FAM) or the 'Red Book' which is, in some cases, prescriptive. FAM is also a collection point of other rules applicable to the Reserve Banks and includes things like capitalization threshold and not marking securities at fair value.

Mr. Evans explained the biggest difference between the Reserve Bank accounting principles compared to FASB GAAP is the Reserve Banks don't mark their federal securities to market but instead uses amortized cost. Mr. Evans noted the Reserve Banks have come a long way in transparency during his career and that deviations from GAAP exist for operational, policy, or conceptual reasons – not as a means to avoid transparency. For example, the Reserve Banks don't mark to market or fair value most financial assets (although it is disclosed in the footnotes). He explained that doing this would complicate the monetary policy process because if earnings increase then the amount remitted to Treasury increases. In order to sterilize the affect of that, they would wind up selling securities to get back down to the same number they started at. He also explained they could have gotten around this issue by simply saying they are holding them to maturity (FAS 115 allows this). However, they have resisted saying this because in theory the Federal Reserve does not hold any asset for investment purposes, that's not the reason they hold government securities. Mr. Evans noted although it is a great benefit, the purpose of holding most financial assets is not to make earnings; but rather, as a monetary policy tool.

Mr. Evans noted another big difference between Reserve Bank accounting principles is that they don't produce a cash flows statement. He explained the Federal Reserve Banks are the ultimately liquid entity—they create dollars—the medium of exchange in the United States is currency and the movement of reserve among DI accounts. Mr. Evans explained that the Reserve Banks other comprehensive basis of accounting is very close to GAAP. He noted that the Reserve Banks have always been concerned with transparency.

Mr. Evans introduced a summary of selected financial information from the Reserve Banks.

Reserve Bank—Selected Financial Information:

(Amounts in $millions)	
	As of 9-30-2009
Gold certificates	$ 11,037
Special drawing right certificates	5,200
U.S. government and agency securities	896,178
Agency guaranteed mortgage-backed securities	692,196
Loans	288,214
Other Assets	251,614
Total assets	$ 2,144,439
Federal Reserve Notes outstanding, net	$ 873,497
Depository institutions' deposits	848,085
U.S. Treasury deposits	273,269
Other liabilities	98,483
Total liabilities	$ 2,093,334
Capital paid-in	$ 24,918
Surplus and undistributed earnings	26,187
Total Capital	$ 51,105
Total liabilities and capital	$ 2,144,439
Memo: Remitances to the U.S. Treasury as interest on Federal Reserve notes	$ 26,977

Mr. Evans explained the asset described as gold certificates does not represent holdings of gold but, rather, is an interest free loan to the federal government that they are required by the Federal Reserve Act to transact when requested by the U.S. Treasury. The government can monetize the gold by issuing a gold certificate and the Federal Reserve gives the federal government an equal amount in dollars (approximately $42 per ounce). When the federal government wants to demonetize it, the Reserve Banks debit the Treasury account then take the gold certificates off the balance sheet. The Special Drawing Right Certificates are a bit more complicated, yet the principles and from the Reserve Banks perspective work very similar.

Mr. Evans explained US Government and Agency Securities have always been the dominant asset of Reserve Banks. Recent events have caused the Reserve Banks to do a lot more lending and they have purchased a lot of Mortgage Backed Securities, which has led to the Agency Guaranteed MBS on the balance sheet. The big effect of this is also on the liability side as well in the Depository's Institutions' Deposits. Mr. Evans noted the accounting has been much more complicated with the purchasing of some of these complex securities. He noted they are accounted for at amortized cost, but there are many complexities as compared to the accounting for U.S. Treasury bills, notes, and bonds.

Typically, Depository's Institutions' Deposits liability is around $60 billion; however, with the lending and purchases made recently it was over $800 billion at September 30, 2009. This is the offset to all the liquidity, so once those actions start to unwind, one would expect that liability to come down again. For example, Federal Reserve Notes typically represent 90% of liabilities, and some day we would expect that to be true again. It should be noted that Federal Reserve Notes have not gone down, they are in fact growing, but the other actions have resulted in other larger liabilities.

Mr. Evans noted in the past two years, the Reserve Banks have remitted over $30 billion in excess earnings to Treasury each year. To date this year, they have remitted approximately $27 billion. In essence, Federal Reserve Notes are effectively interest free loans to the Federal Reserve. The Reserve Banks conduct monetary policy by buying government securities and other assets that produce income. Because of this, the Federal Reserve is self-funding and doesn't require other sources of funding. Often people ask where the Federal Reserve comes up with the trillion dollars that has been used to purchase securities and other activities. The simple answer is—that's what the Federal Reserve does in monetary policy every day—it increases and decreases the money supply through the buying and selling of securities—it is in the core essence of what a central bank does.

Mr. Evans explained the Reserve Bank remittance to Treasury is done because the Board of Governors uses the power in the Federal Reserve Act to levy an interest rate on the Reserve Banks. This is considered an expense to the Reserve Banks based on accrual accounting. There is no legislation that requires the remittance. Although in the past there was a franchise tax and there have been laws passed that required certain amounts in certain years to be transferred, there is no current legislative requirement that monies be transferred to the Treasury. Mr. Evans explained section 16 of the Federal Reserve Act enables the Board of Governors with its broad oversight authority to levy an interest charge on the Reserve Banks on the amount of Federal Reserve Notes outstanding greater than the Reserve Banks holdings of gold. Instead of stating a certain rate, the charge is defined as a formula—net earnings of the Reserve Bank after providing for its expenses and operations and providing for the payment of the 6 percent dividend and providing for an amount necessary to raise (or reduce) surplus up to the level of capital paid in--then whatever is left the Reserve Banks remit to the Treasury. The timing of the transfer has changed over time. Long ago, it was an annual transfer, and then it became a quarterly transfer. Currently it is a weekly transfer with a one-week lag. Mr. Evans explained there is internal conversation about automating the entire process.

A task force member questioned why the Reserve Banks makes these transfers if they are not legislatively required to do so. Mr. Evans stated because the Board of Governors requires the Reserve Banks to do it. He explained that Reserve Banks had once considered creating reserves for contingencies and so forth as a way to preserve their capital. Mr. Evans explained the Board of Governors required it because practically speaking; the Reserve Banks do not need all of those earnings to fund operations. He noted that on the Balance Sheet—every asset (left side) owned provides reserves in the banking system and everything other than reserves on the right hand side absorbs them. Therefore, if the Reserve Banks held on to the reserves then it would wind up absorbing reserves and then would have to buy more and more assets to offset the same money supply.

Mr. Evans also explained there is a political component that leads to the earnings being voluntarily transferred. He noted the larger the excess earnings balance gets, the more enticing it would be for the U.S. government to use it in budget scoring or to require certain transfers. He stated there have been a few times in history where Congress attempted to balance a bill by using a transfer from the Reserve Bank earnings. However, these instances have been for certain years and always expire, whereas the formula used by the Board of Governors has been on the books since the ‘60s.

A task force member asked if the remittance is placed in the Treasury General Fund or is designated for a certain purpose, such as to reduce the national debt. Mr. Evans stated he believed it was considered an interest cost offset and is placed in the general fund. A task force member asked if there was a target transfer that is expected. Mr. Evans explained the target by policy would be to equate it capital paid in.

Mr. Evans reiterated the fact the Federal Reserve System was created to be independent from the Treasury and actually independent of the federal government and that is why it is such a unique structure. The fact they transfer excess earnings also relates to the mission and purpose of the system, which is not to make money or profit—they are simply trying to manage the money supply and this is a by-product and the earnings are incidental to the functions.

Mr. Bill Mitchell discussed the operations and selected financial information for the Board of Governors. Mr. Mitchell noted the Board of Governors pale in comparison to the size and complexity of the Reserve Banks. He noted the financial statements are prepared in accordance with FASB GAAP. Mr. Mitchell noted the unique items relate to where the Board of Governors gets their money and currency transactions. He explained the Federal Reserve Act authorizes the Board to levy an assessment on the Reserve Banks for its expenses. He explained that twice a year they budget what will be required for expenses and then they send a notification to the Federal Reserve Bank of Richmond detailing what money will be required. The assessment is then paid by installments based on each Reserve Banks’ surplus and paid in capital.

Board of Governors—Selected Financial Information:

	As of 9/30/2009
Cash	$ 51,839,203
Accounts receivable	29,828,701
Prepaid expenses and other assets	2,648,829
Property and equipment, net	150,685,723
Other assets	2,071,492
Total assets	$ 237,073,948
Accounts payable and accrued liabilities	$ 37,765,424
Accrued payroll, taxes, and leave	24,766,196
Other short term payables	2,130,503
Retirement, postretirement, & postemployment obligations	35,832,138
Other long term liabilities	1,753,897
Total liabilities	102,248,158
Total cumulative results of operations	134,825,790
Total liabilities and cumulative results of operations	$ 237,073,948
Total Operating Expenses	$ 294,301,924
Currency Costs/Assessments	$ 373,300,132

Mr. Mitchell noted that on the Statement of Revenues and Expenses, the currency cost section shows an 'in' and an 'out' for the exact same amount—this is for the currency transactions. The Federal Reserve Act authorizes the Board of Governors to deal with the Bureau of Engraving and Printing (BEP) to place orders for the new currency of the system. There is a print order—as the BEP prints it, the Board of Governors gets a bill for it; the Board of Governors automatically assesses the Reserve Banks for this amount that represents currency transactions. Therefore, the expenses always equal the assessments for the currency transactions on the Board of Governors financial statements.

A task force member asked why the Board of Governors financial statements weren't prepared in accordance with FASAB GAAP. Mr. Mitchell explained the Board of Governors has never considered itself to be a federal government entity and there wasn't FASAB back when they first started preparing financial statements. Mr. Evans added that it's just never been in their DNA to think of themselves that way and it's a cultural reality.

A task force member asked if the Board of Governors objective is to break-even each year. Mr. Mitchell explained it was or to come close to breaking even each year. He added the Board of Governors isn't supposed to assess for things it doesn't need.

A task force member asked how the individual Reserve Bank rates were determined. Mr. Evans explained the assessments were based on capital ratios. The Reserve Banks consider the assessments as taxes from their perspectives and it is an expense when it is levied. He noted the amounts levied are not material to the Reserve Bank balances.

A task force member noted the Board of Governors may be considered immaterial to most federal agencies. However, it appears there is a large property, plant and equipment balance considering the nature of the operations. Mr. Mitchell explained the Board of Governors owns several buildings that house employees in DC.

Mr. Mitchell noted the Federal Reserve is not part of the US Budget. However, certain information regarding the Board of Governors is included in an Appendix to the Budget to be transparent, but the amounts are not included in the deficit or surplus (other than the amounts remitted to Treasury). Mr. Evans noted they are often asked by OMB what the estimated earnings may be and why there are fluctuations.

A task force member understood the cultural difference discussed, but asked if the Federal Reserve Act states specifically whether the Board of Governors is a federal agency. Mr. Evans explained there is a core debate about that issue. He noted there are differing opinions across the organization, as well as if they are considered within one of the three branches of government. Another member noted this could be compared to FASAB as one may question which branch of the federal government FASAB falls.

A task force member noted the Board of Governors does have control over the Reserve Banks since it can remove an officer from the Federal Reserve Banks. The member questioned if this control was beyond the fact the Board of Governors appoints three members (of the twelve) to the Reserve Bank Board of Directors. Mr. Evans explained that is true but it has to be for just cause, and in practice he doesn't believe that power has ever been exerted as it gets to the core of the independence of operations. He noted the Reserve Bank Board of Directors would deal with such issues before it was raised to the Board of Governors. Mr. Evans explained it is a unique structure and there are many untested aspects of the powers. He said they typically find compromises and consensus building to avoid situations where the Board of Governors would have to intervene. Mr. Evans explained that certain functions are delegated to the Reserve Banks—for example, the supervision and regulation duties of the Board of Governors have been delegated. Mr. Evans explained the 'control' the Board of Governors exercises over the Reserve Banks has evolved over time and now is much more distant as the powers of persuasion and influence would characterize the present relationship, except for core policies that are necessary to bring the system together.

Mr. Evans explained that most Reserve Banks would not consider themselves to be under the control of the Board of Governors. He noted the Board of Governors does approve the budgets of the Reserve Banks, but it is more of an implicit dialogue. He explained the mission of monetary policy is the core for the Reserve Banks and independence is necessary. Mr. Evans noted the Board of Governors oversees the revenues and expenses of the Reserve Banks, yet there isn't a way the Board of Governors can prevent it short of using its legal authority to remove officers at the Reserve Banks. He added that if the Board of Governors steps in to remove officers, a negative signal would be sent regarding the independence.

A task force member suggested the federal government does control the Board of Governors because seven members are appointed by the President. Mr. Mitchell confirmed the members are appointed, and explained the term of members is fourteen years, and the appointments are staggered so that one term ends every other year. He explained it was set up in this manner so it would span administrations. A task force member commented this is consistent with the structure of other types of independent regulatory bodies such as the Supreme Court. A task force member noted the reference to the independent culture and environment, and asked how this would be considered different than the Supreme Court and their independence. The member didn't view this as a hurdle to preventing consolidation with the federal entity. Mr. Evans explained Federal Reserve System employees don't consider themselves government employees—they have their own pension, pay, etc.

Mr. Evans explained that he liked the aspect of the proposed draft that described control along a continuum and that at one end of control continuum, it will be clear that an entity does not have the power to act independently and is controlled by the federal reporting entity and at the other end of the control continuum, the entity will have the power to act independently and, while the Federal government may have a level of influence on the entity, it will be clear that it does not have control. He added that the Federal Reserve is at this other end of the continuum and that is what the Federal Reserve was created to be, independent although the federal government may have some level of influence.

Mr. Evans suggested this is a situation where an entity chooses to create an entity that is so independent of it, that it wouldn't be considered meeting consolidation criteria even though the entity created it. He added the federal government created the Federal Reserve to be independent for all the good reasons that independence would enable -- confidence in the currency, the ability to manage the money supply and for the good of the people.

Mr. Evans suggested that when determining what is considered to be part of the federal reporting entity, one must consider who the users of financial information are and what information needs you are trying to meet. He sees this as a challenge, especially when you consider the culture the Federal Reserve has been operating in and how it perceives itself in relation to the federal government. He believes footnote disclosures about the significant assets, especially those that are the debt of the U.S., is sufficient.

One task force member noted that changes in the money supply results in changes in the values of securities, which in essence dictates the values on the balance sheet. The member suggested the issue is more about how the accounting principles used affect the values of assets and it is important that information be conveyed. Mr. Evans explained the Board of Governors has the authority to impose accounting principles on the Reserve Banks and they developed their own accounting principles to address this very issue—they hold assets at amortized costs and disclose the fair value. He added when they determined the appropriate accounting principles, they followed the considerations in FASB Concepts 2 and determined who their users were. They believe their users fall into three groups—1. monetary analysts who try to understand what they are doing policy wise 2. fiscal analysts such as Congress and the public who try to understand their fiscal position and 3. creditors who want to know the Federal Reserve can pay its bills.

Mr. Evans described the uniqueness of the Reserve Banks as an entity whose financial statements are denominated in the thing that it creates and controls and this causes oddities.

A task force member noted that much of the debate on where the Federal Reserve resides, depends on the perspective of the person. He explained that most would wonder why the Federal Reserve is not part of the federal reporting entity.

A task force member noted that care must be taken with the use of conveying control and independence. He added that control and independence is difficult to articulate in the federal environment when you consider the government was established with checks and balances and independent branches. The member noted that he hopes most would agree the Federal Reserve is part of the federal government although it may be more independent and under less control than some of the other federal agencies.

Mr. Evans reiterated this is a situation where an entity chose to create an entity that is so independent of it, that it shouldn't be consolidated even though the entity created it. He added that this is not necessarily unique to the federal government, as he believes it could be compared to variable interest entities (which were created by the Reserve Banks pursuant to certain Federal Reserve lending activities) and whether they should be consolidated. He noted that they struggled with the concept of control versus financial instruments and what exactly that means. He explained the answer of whether to consolidate is not always clear, and they have added complexities of determining if certain things should be consolidated with the Reserve Bank versus with Treasury. He added there for certain TARP programs, the Reserve Banks could have argued that in accordance with GAAP, a particular entity should not be consolidated and the Treasury could do the same thing, but in the end one of the entities involved needed to consolidate.

Mr. Evans explained these aren't easy answers and that's why it must be viewed as proposed in the draft—as you move down the continuum, it goes from the balance sheet to perhaps the notes, then further down it may go to other information. He agrees the information should help users understand how the Federal Reserve fits in and how the results of its operations fits in to understanding the overall federal government financial statements. However, it's important to note the operations of the Reserve Banks are more about the policy they are trying to conduct instead of the finances. A task force member explained that including some of these controversial entities in note disclosures may lead to important information getting lost in the voluminous notes that already exist. It was agreed that determining what is the core unit of the federal government to be consolidated is a challenge.

A task member noted that the accounting policies, especially those regarding the presentation of the government-wide financial statement and what entities are included is not meant to dictate operational activities of any governmental entity. A task force member suggested a driving concern in determining whether something is included is if there is risk to the taxpayer. He added accounting should help readers understand the risk. The member asked if the Federal Reserve presents risk to the taxpayer.

A task member explained that it is very important to keep in mind the federal government created the Federal Reserve. The member noted the Federal Reserve is accountable to the oversight of the Congress and subject to the appointments process of the President with Senate confirmation. Mr. Evans stated this is a situation where an entity chose to create an entity that is independent of it, even though the entity created it. A task force member stated that is okay and wouldn't necessarily lead to it not being consolidated. He added that the Federal Reserve in its independence continues to act in the authority of the federal government. He explained the reason the Federal Reserve continues to be structured and function in the manner it does is because the federal government continues to support it and stand behind that structure--it has nothing to do with the members or banks of their own volition. Mr. Evans agreed with this statement in the fact it operates under the authorities of the Congress, but noted Congress often passes legislation that affects the banking industry and those entities are not included in the federal entity.

A task force member questioned if it is appropriate for the federal government as a sovereign entity to create an entity that would in fact move some of the responsibilities out of the federal government sufficient to the point where the government doesn't have to report it. A task force member noted transparency should be used to guide decisions.

A task force member commented the purpose of consolidation is so the economic substance trumps legal form. He questioned if consolidated reports are the best vehicle to report government finances when there are different sources of funds and different levels of controls across entities. The member suggested there must be a means of aggregating and displaying financial information for the different entities within the federal government.

Mr. Evans questioned what the federal government does in a situation where they believe an entity should be consolidated yet it doesn't have sufficient control to get the information it may need to do so. A task force member commented that we currently deal with that in obtaining information from the judicial branch.

NEXT STEPS— The Federal Entity Task Force will develop a recommendation for the Board. The Task Force will first focus on the entity issue as this is the first question and display should not bias the decision on entity. The Task Force will consider the Federal Reserve as a whole, the Board of Governors, and the Federal Reserve Banks against the conclusive principle, the indicative principles, and misleading to exclude framework and then provide a final conclusion/recommendation with justification on whether each potential unit is part of the federal reporting entity. If considered part of the federal reporting entity, the Task Force will recommend whether consolidation or other reporting is appropriate.