

Defining the Boundaries of the Federal Government Reporting Entity

**FASAB is Laying the Chalk Lines
of this Wide Field in its
Federal Entity Project**

By: Melissa Loughan, CPA

Defining the boundaries of the federal reporting entity can be compared to defining a field of play in sports—often you have to look closely and from several angles to determine what is in-bounds.

The Federal Accounting Standards Advisory Board¹ (FASAB) has a very important project on its agenda—the Federal Entity Project²—that will define the boundaries of the federal government reporting entity as well as individual component entities. Guidance on entities is currently in FASAB Statement of Federal Financial Accounting Concepts (SFFAC) 2, *Entity and Display*. The most apparent shortcoming in the FASAB literature is that the guidance resides entirely in a concepts statement and no standard addresses the topic. The project will address issues such as:

- ▶ Criteria for including entities/boundaries of the entities;
- ▶ Criteria for consolidating entities; and
- ▶ Reporting on other entity relationships when not consolidated.

Defining the boundaries of the federal reporting entity can be compared to defining a field of play in sports—often you have to look closely and from several angles to determine what is in-bounds. There will be many close calls.

Why is the Field Important and Why Do the Lines Need to be Just Right?

Drawing the lines around the federal reporting entity determines which entities are included in the financial report of the federal government. Clear lines ensure the financial statements provide information about all activities relevant to fair presentation of the financial position and results of operations of the reporting entity and exclude information not relevant to fair presentation. This ensures completeness from the perspective of activities by determining which activities are within the field of play. Clear lines also ensure consistency in what reporting entities encompass.

Since the decision whether to include or exclude entities impacts the completeness of the picture provided, some consider establishing the boundaries of the federal reporting entity as having greater impact on the federal government's financial reporting than any other issue. While drawing the lines of this field may be difficult, identifying the entities

for inclusion in the federal government's financial statements is critical to creating transparent reports to support accountability.

Consolidation highlights the ultimate aggregation of entities into the entire federal government—the independent federal entity controlling and financing its components. Although many government organizations prepare their own financial statements, individually those financial statements provide a partial or fragmented view of the federal government as a whole. Most of these components operate through authorities granted to them in legislation and rely on the financing derived from general fund sources such as taxes and borrowing. Consolidated statements covering the activities of the federal government provide a complete economic picture. However, ensuring adequate disclosures for those entities that are not consolidated is equally important. A corollary objective in this project will be to consider reporting and other disclosures for those activities outside the boundaries, as in those not qualifying for consolidation but still relevant for various reasons.

Guideposts for the Field or Underlying Parameters

Just as the size and shape of playing fields are typically guided by regulations of the individual sport, the lines around a federal reporting entity should be guided by reference to the objectives of federal financial reporting. The objectives of federal financial reporting are detailed and discussed in SFFAC 1, *Objectives of Federal Financial Reporting*.³

SFFAC 1 provides that the “objectives are designed to guide the board in developing accounting standards to enhance the financial information reported by the federal government to

- ▶ demonstrate its accountability to internal and external users of federal financial reports,
- ▶ provide useful information to internal and external users of federal financial reports and
- ▶ help internal users of financial information improve the government's management.”

Further, the objectives “reflect many of the needs expressed by current and potential users of federal financial information.”⁴

SFFAC 1 discusses accountability and users’ information needs as the foundation of governmental financial reporting. Specifically, par. 71 states, “It may be said that ‘accountability’ and its corollary, ‘decision usefulness,’ comprise the two fundamental values of governmental accounting and financial reporting. Therefore, the notion of accountability and users’ information needs should be underlying parameters when considering the boundaries of the reporting entity.”

What’s Currently on the Playing Field?

SFFAC 2 defines two types of criteria, conclusive and indicative, that must be considered when deciding what to include as part of a financial reporting entity. The conclusive criterion is that if the entity is included in the budget of the federal government, it should be considered as part of the federal reporting entity.⁵

If the entity is not included in the budget of the federal government, indicative criteria⁶ (no single criterion is conclusive in and of itself) are to be considered as a whole in determining if the organization is part of the reporting entity. These are that the entity:

- ▶ Exercises sovereign power (for example, coining money, collecting taxes, borrowing funds for government use);
- ▶ Is owned by the federal government (this can be determined by identifying who is at risk or whom do the employees work for);
- ▶ Carries out federal missions and objectives (for example, national security);
- ▶ Is subject to direct or continuing control by the reporting entity (for example, approve budget, veto decisions, hiring approval);
- ▶ Determines outcome of matters affecting the recipients of services (grant awards, for example); and
- ▶ Has a fiduciary relationship with the reporting entity.

Why Mess with the Field or Change the Lines?

While SFFAC 2 provides criteria for determining if an entity should be included as a federal entity, questions continue regarding whether certain organizations should be included with an entity. FASAB conducted a survey of the financial management community and learned that reporting is inconsistent among agencies. As noted, the guidance resides in a concepts statement and is therefore not GAAP. A primary objective of the project is to develop a standard⁷ clarifying the boundaries of the federal reporting entity and complementing the concepts presented in SFFAC 2.

As noted, accountability and users’ information needs are underlying parameters in defining the field. As a result of current events, the American public is aware of the federal government’s involvement in economic stabilization activities and the use of taxpayer dollars in non-traditional

ways. With this, accountability and transparency of financial information has become even more important to the taxpayer and many will want information on these activities. However, the current guidance does not adequately address these non-traditional relationships and make clear which ones should be consolidated. Further, there needs to be additional guidance regarding what information may be important to report for entities that are not consolidated. As a result, certain areas within SFFAC 2 may need to be amended or rescinded. For example, it is anticipated that the discussion of Government-Sponsored Enterprises⁸ in SFFAC 2 will be amended, and the provisions regarding the Federal Reserve System⁹ are currently being revisited.

Another significant challenge is the effect that legislation has on the completeness of the reporting entity field. For example, entities in the legislative and judicial branches are not required to prepare financial statements or provide transaction detail to the Department of the Treasury in the format required for the consolidated financial report of the U.S. government. While some of these entities voluntarily comply, reliable and complete information for all three branches is not presently available even though it is believed that all three should be included.

Furthermore, 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 will address whether the conclusive and indicative criteria should override such legislative language—often directed at something very different than financial reporting—to ensure the federal reporting entity is complete.

Close Calls—In or Out? What About When It’s Right on the Line?

Just as there are many “close calls” in sports due to differing points of view, a number of challenges make defining the reporting entity very difficult. Not the least of these challenges is the fact that the broad array of federal programs and relationships makes it extremely difficult to define the boundaries of the federal reporting entity. Further, many entities may be viewed as hybrid organizations¹⁰ because they are federally related entities that possess legal characteristics of both the governmental and private sectors.

Here are a few examples of close calls, in which it is difficult to determine whether these types of entities are in or out of bounds of the federal field:

- ▶ Quasi official agencies—The National Archives and Records Administration (NARA) provides the following defining characteristic for quasi official agencies in that they “are not agencies under the definition of 5 U.S.C. 105 but are required by statute to publish certain information on their programs and activities in the Federal Register.”
- ▶ Federally Funded Research and Development Centers (FFRDCs)—FFRDCs¹¹ were designed to meet a federal long-term research needs through the use of private

organizations. FFRDCs are nonprofit corporations with facilities and equipment that are owned or financed, for the most part, by the federal government; and they receive fees for operating expenses without having to assume business risks or costs associated with competing for most federal work.¹²

- ▶ **Government-Sponsored Enterprises (GSEs)**—GSEs are defined by Congress in enabling legislation.¹³ GSEs typically have four characteristics: private ownership; implicit federal guarantee of obligations; activities limited by congressional charter; and limited competition.¹⁴ Although GSEs were created to help make credit more readily available to sectors of the economy believed to be disadvantaged, GSEs have long been criticized when it comes to accountability and financial safety and soundness.
- ▶ **Agency-related nonprofit organizations**—Agency-related nonprofit organizations are organizations that share a legal relationship with a department or agency of the federal government. These organizations can be further considered in three groups: organizations under the control of a department; organizations independent of, but dependent upon departments; or organizations voluntarily affiliated with a department.¹⁵

- ▶ **Public-private partnerships or joint ventures**—Public-private partnerships are just what the name implies—contractual relationships where the resources, risks and rewards of both the public agency and a private company are combined for greater efficiency, better access to capital and improved compliance with a range of government regulations regarding the environment and workplace.

Other close call situations relate to federal government interventions or relationships that are not expected to be permanent.¹⁶ For example, the federal government may take certain actions to provide stability to the financial markets or military occupation of another country.¹⁷ In these instances, the focus continues to be on governance and protection, rather than maximizing profits or the federal government entering new lines of business. These types of federal government interventions are considered rare.¹⁸ Often the duration of such interventions may be several years but not be permanent, and consolidation of these types of organizations may lead to less meaningful presentation.¹⁹ Consider the following examples and whether consolidation would be appropriate:

- ▶ **Housing-related GSEs**—Fannie Mae and Freddie Mac were placed into a conservatorship²⁰ under the Federal Housing Finance Agency, which offers new complexities in determining if these unique organizations are within the boundaries of the federal reporting entity.

Figure 1: Comparison of U.S. Standards

Country	Standard	Scope	Consolidation Requirement	Definition / Criteria
United States of America	FASAB Statement of Federal Financial Accounting Concepts No. 2, Entity and Display	Federal Sector	Financial Accountability and existence of a Significant Relationship where exclusion would cause the financial statements to be misleading or incomplete. (¶ 38)	<p><i>Conclusive criterion</i></p> <ul style="list-style-type: none"> • Any organization, program, or budget account, including off-budget accounts and government corporations, included in the federal budget section currently entitled "Federal Programs by Agency and Account." <p><i>Indicative criteria</i></p> <ul style="list-style-type: none"> • It exercises any sovereign power of the government to carry out federal functions. • It is owned by the federal government • It is subject to the direct or continuing administrative control of the reporting entity. • It carries out federal missions and objectives. • It determines the outcome or disposition of matters affecting the recipients of services that the federal government provides. • It has a fiduciary relationship with a reporting entity.
	GASB Statement No. 14, The Financial Reporting Entity	Public Sector Entities	Financial Accountability	A primary government is financially accountable for legally separate components under either of the following circumstances: <ol style="list-style-type: none"> a. The primary government appoints a voting majority of the organization's governing board and (1) it is able to impose its will on that organization or (2) there is potential for the organization to provide specific financial benefits to, or impose specific financial burdens on the primary government. b. If an organization is fiscally dependent on the primary government. (¶ 20)
	FASB Statement of Financial Accounting Standards No. 96	Private Sector Entities	Controlling Financial Interest	The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over 50 percent of the outstanding voting shares of another company is a condition pointing toward consolidation. (¶ 13)

Figure 2: Comparison of National & International Standards

Country	Standard	Scope	Consolidation Requirement	Definition / Criteria
Australia	Australian Accounting Standard AAS 24, Consolidated Financial Reports	Private and public sector entities, excluding those at the "whole-of-government" level for each state, territory and the federal government	Control	Control means the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity. (¶ 18)
Canada	CICA Handbook Section 1590, Subsidiaries	Profit-oriented enterprises	Control	Control of an enterprise is the continuing power to determine its strategic operating investing and financing policies without the cooperation of others. (¶ .03)
	Public Sector Accounting Recommendations, Section PS 1300, Government Reporting Entity	Federal, provincial, territorial and local governments	Control	Control is the power to govern the financial and operating policies of another organization with expected benefits or the risk of loss to the government from the other organization's activities. (¶ .08)
International Accounting Standards Board	International Accounting Standard IAS 27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries	Private sector parent entities	Control	Control is the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. (¶ 6)
International Federation of Accountants	International Public Sector Accounting Standard 6, Consolidated Financial Statements and Accounting for Controlled Entities	Public sector entities other than Government Business Enterprises	Control	Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities. (¶ 8)

- ▶ In conjunction with the conservatorships, Treasury entered into a Senior Preferred Stock Purchase Agreement²¹ with each GSE and received \$1 billion of senior preferred stock in each GSE and warrants for the purchase of common stock of each GSE representing 79.9 percent of the common stock.
- ▶ Treasury is named sole beneficiary of the American International Group, Inc. (AIG) Credit Facility Trust with stock that was initially convertible into approximately 77.9 percent of the issued and outstanding shares of AIG's common stock. This is in addition to the \$40 billion of AIG-preferred stock that Treasury had previously purchased.
- ▶ The federal government provided financial assistance to the automotive industry resulting with the American taxpayers as the owners of 10 percent and 61 percent of post-bankruptcy Chrysler and GM, respectively.²²

What Will this New Playing Field Encompass?

The board is considering a draft developed by staff²³ with the assistance of the Federal Entity Task Force.²⁴ The proposal includes a conclusive principle, indicative principles and a misleading-to-exclude principle, which will complement concepts presented in SFFAC 2.

When considering the field—the conclusive principle could be viewed as the area covering the major portion of the

field; it's the infield and majority of the outfield. Everyone has a clear view of the area and there is no question, it's within the field. The three indicative principles could be viewed as the area along the two foul lines and the outfield fence where a little more judgment is often required to determine if it's within the field. Last, there is a misleading-to-exclude principle that is similar to areas outside the field, yet still in the playing area. Consider a foul ball that is caught—the out still counts, therefore it must be considered.

Conclusive Principle

The conclusive (meaning definitive or irrefutable) principle includes all entities in the program and financing schedules of the *Budget of the United States Government* (the president's budget). The boundaries of the federal reporting entity should naturally include all the entities that are funded wholly or predominantly by public funds, that is, in the president's budget. This boundary is perhaps one of the most straightforward as users are interested in the government's accountability of those funds and specifically, knowing how efficiently the policies of the federal government were carried out with respect to the resources entrusted.

Inclusion in the budget means that allocation of resources to its activities is determined through federal legislation—making the entity itself financially accountable to Congress and the Office of Management and Budget (OMB). Financial reporting objectives—budgetary integrity, operating performance, stewardship and systems and controls—could not be met if entities included in the budget were not included in the financial reports.

Indicative Principles

The conclusive principle represents a starting point in analysis but does not mean that entities not addressed in the budget should be excluded. The budget's purposes differ from financial reporting objectives in many respects (such as the forward-looking focus of the budget and decisions on the allocation of resource flows). It is possible that entities or activities might be excluded from the budget for reasons that do not justify exclusion from financial reports. Determining boundaries for the federal reporting entity strictly by those included in the budget would provide only a portion or fragmented view of the federal reporting entity.

Therefore, there are indicative (denote or indicate a certain reality) principles that should also be considered when determining the boundaries of the federal reporting entity. For entities that were not captured with the conclusive principle, an assessment against the indicative principles is the second test for determining whether an entity is within the boundaries of the federal reporting entity.

The indicative principles provide for an assessment of other entities that may have been established by, controlled by or owned by the federal government. Specifically, the indicative principles provide that federal reporting entities may also include entities:

- ▶ Existing as a matter of law within or established by the federal government to fulfill a public purpose or federally related mission

Entities such as administrations, agencies, banks, boards, commissions, corporations, foundations and institutions that were established by the federal government often exercise a power of the federal government (whether or not other entities could exercise such powers) and should be considered within the boundaries of the federal government.

- ▶ **Over which the federal government has the ability to exercise control with expected benefits or risk of loss**

For our purposes, "control" is the power to govern the financial and/or operating policies of another entity with expected benefits (or the risk of loss)²⁵ to the federal reporting entity. As noted in Figure 1, control is used to determine the boundaries of entities for many standards-setters. However, determining whether control exists requires the application of professional judgment. Control generally exists when the federal government has the authority to:

- ▶ Unilaterally appoint or remove a majority of the governing board members of another entity;
- ▶ Govern or direct the governing body on the financial and operating policies of the entity;
- ▶ Access entity's assets or has the ability to direct the ongoing use of those assets, or has ongoing responsibility for losses; or
- ▶ Unilaterally dissolve the entity thereby having access to the assets and responsibility for the obligations.

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Other indicators, when considered in the aggregate, would provide evidence that control exists. This list would be more exhaustive and include things such as power to:

- ▶ Provide significant input into the appointment of members of the governing body of the entity;
- ▶ Establish or amend the entity's fundamental purpose and mission;
- ▶ Appoint or remove key executives or personnel;
- ▶ Approve the budgets or business plans for the entity;
- ▶ Veto, overrule or modify governing board decisions or otherwise significantly influence normal operations;
- ▶ Establish, rescind or amend management policies;
- ▶ Establish limits or restrictions on borrowing and investments of the entity; or
- ▶ Restrict the capacity to generate revenue of the entity, especially the sources of revenue.

Because of the uniqueness of the federal government, it may help to distinguish what does not constitute control. Specifically, control would not be inferred from things such as the authority to exercise regulatory powers over an entity, constitutional responsibility, or economic dependency on the federal government in relation to the entity.

▶ **In which the federal government has an ownership interest**

An ownership interest is a claim on the net residual assets of an entity, such as a legal claim on the net residual assets or holding shares or other formal equity structure. It should be noted, the holding of an ownership interest often entitles the holder to an equivalent percentage interest in voting rights, but not always. In the federal government there may be instances of: ownership interest with voting (controlling) interest; ownership interest without voting (controlling) interest; and control without ownership interest.

Misleading-to-Exclude Principle

Although expected to be rare, the misleading-to-exclude principle captures entities that don't meet 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's financial statements to be misleading or incomplete.

With the various principles forming the boundaries of this field, great care must be taken to ensure professional judgment and materiality are considered when assessing entities against the chalk lines, as there is the risk of visualizing the field much larger than it actually is.

When is the Anticipated Completion of this New Field?

As noted, the board is considering a draft proposal that was developed with the assistance of the Federal Entity Task Force. More issues remain to be deliberated by both the board and task force. An exposure draft is anticipated by the end of 2010. The standards being developed as a result of this effort could affect each federal agency, so please stay tuned for progress on this important field of play. ¶

End Notes

1. FASAB is the official standards-setting body for federal entities. In October 1999, the AICPA recognized FASAB as the standards-setting body for federal governmental entities under Rule 203 of the AICPA Code of Professional Conduct. As a result of having Rule 203 status, the pronouncements resulting from the FASAB process represent generally accepted accounting principles, GAAP, for the entire federal government.
2. The Federal Entity Project history, which includes links to all board materials, can be found on the FASAB website at <http://fasab.gov/projectsfedentity.html>.
3. See <http://fasab.gov/pdffiles/sffac-1.pdf>
4. SFFAC 1, par. 3-4
5. SFFAC 2 par. 42
6. SFFAC 2, par. 43-44
7. SFFAS 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board*, describes FASAB Statements of Federal Financial Accounting Standards (Standards) as category a.) in the hierarchy of generally accepted accounting principles; whereas Concepts Statements are considered Other Accounting Literature.
8. SFFAC 2 par. 48-49
9. SFFAC 2 par. 47 provides that the Federal Reserve System is not considered part of the government-wide entity because functions pertaining to monetary policy are traditionally separated and independent from the other government organizations.
10. Also called quasi-government entities. The one common characteristic of quasi-government entities is that they are *not* agencies of the United States as that term is defined in Title 5 of the *U.S. Code*. (The Quasi Government: Hybrid Organizations with Both Government and Private Sector Legal Characteristics, CRS Report for Congress RL30533, p.2)

11. FFRDCs is a World War II and postwar phenomenon because in World War II there was a national emergency requirement that scientific and engineering talent be rapidly assembled and put to work. After the war, DoD was reluctant to part with this talent and sought ways to keep them in service to the government. The decision was to establish private, nonprofit corporations to do contract work and these corporations would be largely dependent on the federal government contract projects. (The Quasi Government: Hybrid Organizations with Both Government and Private Sector Legal Characteristics, CRS Report for Congress RL30533)

12. The Quasi Government: Hybrid Organizations with Both Government and Private Sector Legal Characteristics, CRS Report for Congress RL30533, p. 10-12

13. Congress defined the term GSE for budgetary purposes in the Omnibus Reconciliation Act of 1990 as a corporate entity created by a law of the United States that is privately owned.

14. Ibid, p.10

15. The Quasi Government: Hybrid Organizations with Both Government and Private Sector Legal Characteristics, CRS Report for Congress RL30533 p.16

16. The National Council of Public-Private Partnerships (PPP) Top Ten Facts about PPPs

17. After the signing of the Japanese Instrument of Surrender in 1945, Japan was supervised for six years by the Allied (primarily American) forces and subject to military control, with General MacArthur at the head of the Occupation administration. (Takemae, Eiji 2002 p. xxvi and Wikipedia http://en.wikipedia.org/wiki/Occupation_of_Japan)

18. For example, the current financial crisis is considered to be the most severe since the Great Depression. (White Paper on Changes to Financial Regulations)

19. One approach is to consider the goal is to ensure the basic financial statements measure and communicate the risks and rewards assumed by the citizens. SFFAC 1, par. 99-102 describes the users need information to assess the effect of the government's activities on its financial condition and that of the nation, which includes information on

the federal government's exposures and risks. Citizens have an interest in the risks and rewards assumed, but it is less clear that full consolidation provides the most relevant, understandable or consistent measure.

20. A conservatorship is a statutory process designed to stabilize a troubled institution with the objective of returning the entities to normal business operations.

21. They were indefinite in duration and have a capacity of \$100 billion each.

22. Congressional Oversight Report, The Use of TARP Funds in the Support and Reorganization of the Domestic Automotive Industry, September 9, 2009.

23. The Federal Entity Project History has links to all board materials, including versions of the Staff Draft and other Issue Papers can be found on the FASAB website at <http://fasab.gov/projects/fedentity.html>

24. The Federal Entity Task Force consists of approximately 20 members from the financial management community. The Task Force makes recommendations to the FASAB on certain issues related to the federal entity project and works with staff on developing language for the board's consideration.

25. The expected benefit or risk of loss may be financial or non-financial. For example, a non-financial benefit would be the federal government benefits from a service being provided on its behalf.



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REAL SOLUTIONS

PROBLEM: Due to a realignment, an agency's financial management responsibilities expanded to include servicing other entities and dealing with three stand-alone accounting systems. There was no methodology for integrating accounting data into the agency's accounting system.

SOLUTION: After developing specifications that interfaced the three accounting systems into the agency's legacy system, AOC upgraded the interfaces with a centralized, web-based translator, providing an automated interface from each feeder system. AOC's efforts provided the agency with the data needed to facilitate more detailed reconciliation, analysis, and decision making.

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