Federal Accounting Standards Advisory Board

December 12, 2012

Memorandum

To: Members of the Board

From: Melissa Loughan, Assistant Director

Wendy M. Payne

Through: Wendy M. Payne, Executive Director

Subj: **Federal Reporting Entity--Tab A- Alternative Views and Staff Response**[1]

MEETING OBJECTIVES

- As explained in the November 29 memo, time is available on December 19th to discuss the alternative views (AVs) to the ballot exposure draft (ED). There are two alternate views submitted by Mr. Steinberg for consideration. Four additional Board members support the views. The discussion should enable the Board to identify changes to the ballot ED or to direct staff regarding a new majority view.
- Members should also raise any concerns regarding minor edits suggested by Board members to the ballot ED and marked in attachment 3.

BRIEFING MATERIAL

- **Staff Paper** (beginning at page 3 of this memo)
- **Attachment 2**--*Two Alternative Views prepared by Mr. Steinberg*
- **Attachment 3**--*Track-changes to ballot draft ED, Reporting Entity (with alterative views and proposed edits)*
- **Attachment 4**--*Section 8 of the Constitution of the United States*
- **Attachment 5—**Related Party Disclosure from the Treasury FY2012 Agency Financial Report

[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.

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You may electronically access all of the briefing material at http://www.fasab.gov/board-activities/meeting/briefing-materials/

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MEMBER FEEDBACK

If you require additional information or wish to suggest another alternative not considered in the staff proposal, please contact staff as soon as possible. In most cases, staff would be able to respond to your request for information and prepare to discuss your suggestions with the Board, as needed, in advance of the meeting. If you have any questions or comments prior to the meeting, please contact me by telephone at 202-512-5976 or by e-mail at loughanm@fasab.gov with a cc to paynew@fasab.gov

Attachment 1-Staff Issue Paper Federal Reporting Entity

Staff Analysis and Recommendations

Issue 1—Alternative View "Federal Reserve Funds"

The Alternative View "Federal Reserve Funds," presented by Mr. Steinberg and supported by other members is presented as **Attachment 2**). (Attachment 3 incorporates the text in the Ballot ED and shows staff proposed edits and comments for consideration as needed.) The alternative view (AV) departs in two main ways from the majority view agreed in October and presented in the pre-ballot ED:

1) The Federal Reserve System would appear to be explicitly classified as a disclosure entity
2) The Statement would require additional disclosures specific to the central bank

Staff believes this is inconsistent with the Board's principles-based approach that allows for professional judgment about classification as well as disclosures needed to meet the stated disclosure objectives. Some aspects also depart from the Board's commitment to remaining cognizant of important matters such as audit costs and the cost/benefit of requiring additional information when such information may already be available.

Based on staff's interpretation of the AV as written, to present specific additional disclosures for the Federal Reserve System (FRS) it would appear the FRS would have to be classified as a disclosure entity. This is implied in the text of the AV but not explicitly stated. The Board has consistently voted to approve that the FRS should be assessed against the inclusion principles and the criteria for classification as a disclosure or consolidation entity. The Board has acknowledged events and circumstances could change over time and therefore the Statement should be flexible for those situations and it should not designate the classification of any particular entity. Furthermore, at the October meeting, the Board explicitly approved the basis for conclusion stating that it was not the role of the standards-setter to make those types of judgments.

In addition, the Statement offers flexibility by identifying information that may need to be disclosed to meet the reporting objectives regarding disclosure entities because the range of disclosure entities is broad and diverse. Providing this flexibility allows the preparer to present information judged most necessary to meet reporting objectives while also considering the cost-benefit and providing an understanding of the potential effect of the relationship on the consolidation entity's financial statements.

To accomplish the needed flexibility, the Board developed a list of factors to be considered in conjunction with disclosure requirement objectives for disclosure entities. Much Board deliberation was focused on potential audit cost of requiring specific

disclosures. Staff also held a round table meeting with the audit community during the development of the ED to discuss various aspects of the project, with the focus on audit cost. The Board chose to list "Examples of information" that may meet the objectives and provide an understanding of the disclosure objectives in paragraph 72 of the Statement. The Board's position on this matter was summarized in par. A73 of Basis for Conclusion:

> A73. The Board recognizes that although the Statement provides flexibility in meeting the disclosure objectives, there is a wide variety of information listed as examples that may be disclosed to meet the intended objectives. Care should be taken to ensure the objectives are met, without producing unintended consequences. Preparers should keep in mind there are associated costs and potential audit implications with any information included in a GPFFR. Incorporating by reference or including summary financial statements or summary financial information generally would result in an auditor being required to gain audit assurance on that information and thereby may result in additional audit costs.

Staff believes the Board's position—based on Board vote and input--regarding the Federal Reserve System has been adequately summarized in:

- Paragraph A85 (The principles can be applied to the entities previously excluded and conclusions reached to include the entities—either as consolidation or disclosure entities—or to continue to exclude the entities.)
- Paragraphs A30-A35 (Regarding assessment of Federal Reserve System as a Consolidation entity or Disclosure entity)

If the AV was to be presented as such, staff does not recommend any changes to the previously approved Basis for Conclusion to respond to the AV. That is, if the AVs were included as a minority position, the present basis for conclusions would be adequate. [Staff made some suggested edits to the AV for consideration by the members offering AV because the text appeared to be inconsistent with the ED.]

However, if the AV in fact establishes a new majority position, significant changes would be required to the proposed standards and related basis for conclusions. (Members previously supporting the ballot draft position on this matter might also express alternative views before issuance of a proposal.)

Staff also believes it worth noting that the August 2012 ED also required specific disclosures for entities "exercising powers reserved to the sovereign" but that approach was rejected[2] unanimously by the Board.

At this point, staff would like Board input regarding a revised majority position. Note that the AV does not provide precise wording for insertion in the proposed standards. So, if

[2] Mr. Steinberg's alternate draft provided at the August meeting did not provide for the disclosures, and the Board subsequently voted to drop the disclosures from the staff prepared ED.

the AV is sustained as the majority view we will need to consider conforming changes to the document before voting. Options for modifying the ballot ED, include (1) incorporating the AV as the new majority view or (2) developing an option having greater majority support.

Because the earlier majority view did not specifically classify the FRS as a disclosure or consolidation entity, staff proposes clarifying that the disclosures are required without regard to classification. This would result in incorporating certain aspects of the AV proposal while preserving the Board's approach—a principles-based standard not specifying how a particular entity is classified. The following language for the standards is offered for consideration. It builds on the required disclosures regarding entities exercising powers reserved to the sovereign that were included in the August ED but names the central bank as the subject, explicitly avoids classifying the central bank, and adds aspects of the AV disclosures. If adopted, it would appear as a separate section of requirements within the standards.

Alternative View Draft Disclosures for Reference
1. **the following additional disclosures should be incorporated into the exposure draft:** • the bank's unique organizational and governance structure and how that structure provides the bank with greater independence and insulation from political influence; • the bank's significant monetary and fiscal policy activities, such as purchases of Treasury securities, mortgage-backed securities, and the debt of government-sponsored entities; central bank liquidity swaps; investments made in consolidated variable investment vehicles, and other lender of last resort activities, with disclosure for each, why and how the activity was undertaken, and trends in the level of activity; and • the bank's other roles and responsibilities, such as supervising and regulating banking institutions and providing financial services to depository institutions, the government, and foreign official institutions.

The central bank is a unique federal organization. Whether classified as a consolidation entity or a disclosure entity, the reporting entity must disclose, at a minimum, the following regarding the central bank:

a. Its mission including identification of significant roles and responsibilities
b. The relationship of its mission to federal policy objectives
c. Its organizational and governance structure with particular emphasis on matters affecting its independence and insulation from political influence
d. A discussion of the nature and purpose of significant monetary and fiscal policy activity during the period, and significant balances between the central bank and the reporting entity during and at the end of the period
e. A description of any significant financial and non-financial risks and potential benefits

f. If possible, the amount of the federal government's exposure to gains and losses from the past or future operations
g. The availability of its annual financial report and how it can be obtained

QUESTIONS FOR THE BOARD

What options would the Board prefer to explore for modifying the ballot ED (adopting the AV as the majority position or considering the disclosures presented above to incorporate aspects of the AV while maintaining a principles-based approach)? The revised draft would be discussed at the February 2013 meeting before proceeding again to a ballot.

Issue 2—Alternative View "Receiverships, Conservatorships, Intervention Entities"

The Alternative View "Receiverships, Conservatorships, Intervention Entities," presented by Mr. Steinberg and supported by other members (see **Attachment 1**) and with staff proposed edits and comments in the Ballot ED at paragraphs A100-108, states that the AV:

> "proposes that these problems can be corrected by removing receiverships, conservatorships, and intervention entities from the proposed standard by 1) adding a fourth principle for determining whether an entity should be included in the reporting entity -- namely that it fulfills a sovereign function; and 2) stating that less than permanent receiverships, conservatorships, and intervention entities are not part of the entity."

Staff believes this approach is not consistent with the Board's principles-based approach, previous deliberations and Board votes. In summary, staff believes the Board deliberated several of the topics discussed in the AV. For example, the Board considered creating an "exception" similar to the approach taken in SFFAC 2 but determined this approach was not principles-based. The Board believed the Statement should focus on defining the relationships that create a need for accountability.

The Board also discussed adding a fourth inclusion principle consistent with the alternative view—that is, "fulfills a sovereign function." However, the Board did not approve adding the principle.

More importantly, the alternative view implies that the fourth criterion would act as an exclusionary criterion such that organizations owned or controlled by the federal government would only be included if they also fulfill a sovereign function. Staff believes assessing the functions performed by the organization would not be an effective way to identify organizations for which accountability is needed. Instead, assessing the organization's relationship with elected officials would be more effective.

In addition, given the scope of sovereign functions, there may be diverse views regarding what qualifies. Staff has included Section 8 of the Constitution in the briefing materials for your reference. The original text of the Constitution and an explanation (from the Senate website) should provide some perspective on the powers enumerated in the Constitution. Staff believes diverse views may lead to unintended consequences if the alternative view was adopted.

Staff notes the current Ballot ED includes "fulfills a sovereign function" in a manner similar to current SFFAC 2 provisions. Paragraph 29(a) provides that a persuasive indicator of control exists when the federal government has the unilateral authority to "establish or amend the fundamental purpose and mission of the organization, which may include authorizing the organization to exercise sovereign powers of the federal government and requiring the organization to carry out federal missions and objectives." Continuing this long-standing practice should be understandable despite any ambiguity

in the meaning of the term "sovereign powers" because it is one consideration among others.

Staff believes that excluding intervention organizations requires that clear criteria exist for identifying those organizations and determining when those organizations may cease to function as "interventions." If the members agree, staff recommends including the following response to the AV in the Basis for Conclusion (paragraphs A52-A58) in the Ballot Draft ED. It is included here for your reference:

A1. In an alternative view presented at paragraphs XXX through XXX, Messrs. Granof, McCall Showalter, Smith, and Steinberg propose explicitly excluding interventions, receiverships, and conservatorships as well as adding a fourth criterion – "fulfills a sovereign function." As noted above, the Board considered creating an "exception" similar to the approach taken in SFFAC 2 but determined this approach was not principles-based. The Board believed the Statement should focus on defining the relationships that create a need for accountability.

A2. The Board also discussed adding a fourth inclusion principle consistent with the alternative view—that is, "fulfills a sovereign function." While specific language is not provided, the alternative view implies that the fourth criterion would act as an exclusionary criterion such that organizations owned or controlled by the federal government would only be included if they also fulfill a sovereign function. The Board believes assessing the functions performed by the organization would not be an effective way to identify organizations for which accountability is needed. Instead, assessing the organization's relationship with elected officials would be more effective. An example is the case of the intervention establishing a federal conservatorship for Fannie Mae. Fannie Mae was initially established and operated as a government agency which implies it performs a sovereign function.[3] Given the scope of sovereign functions, there may be diverse views regarding what qualifies.

A3. These diverse views may lead to unintended consequences if the alternative view was adopted. For example, some may believe that any function the federal government engages in must be a sovereign function while others believe sovereign functions are limited to the powers enumerated in the constitution. Hence, preparers, auditors, and users of financial information may have a difficult time applying the proposed criterion "fulfills a sovereign function." Further, respondents to the ED may have to do significant research to fully appreciate the organizations that may be excluded by such a criterion.

A4. The Board also notes that existing SFFAC 2 guidance does not require that an entity fulfill a sovereign function in order for it to be included in the reporting entity. Instead, it provides that:

> No single indicative criterion is a conclusive criterion in the manner that appearance in the "Federal Programs by Agency and Account" section of the budget is. Nor can weights be assigned to the indicative criteria. Thus, while the

[3] A 1938 amendment to the National Housing Act established Fannie Mae. Originally, Fannie Mae was a federal government agency. Its mandate was to act as a secondary mortgage market facility that could purchase, hold, and sell FHA-insured loans. By purchasing FHA-insured loans from private lenders, Fannie Mae created liquidity in the mortgage market, providing lenders with cash to fund new home loans. (Source: http://fhfaoig.gov/LearnMore/History last accessed December 11, 2012.)

indicative criteria are presented in descending order of importance, judgment must be based on a consideration of all of the indicative criteria. (SFFAC 2, par. 43)

A5. The majority proposal includes "fulfills a sovereign function" in a manner similar to current SFFAC 2 provisions. Paragraph 29(a) provides that a persuasive indicator of control exists when the federal government has the unilateral authority to "establish or amend the fundamental purpose and mission of the organization, which may include authorizing the organization to exercise sovereign powers of the federal government and requiring the organization to carry out federal missions and objectives." Continuing this long-standing practice should be understandable despite any ambiguity in the meaning of the term "sovereign powers" because it is one consideration among others.

A6. The Board also believes that excluding intervention organizations requires that clear criteria exist for identifying those organizations and determining when those organizations may cease to function as "interventions." With the passage of time and changing circumstances, intervention actions may develop into permanent federal operations. Absent clear guidance regarding changes in circumstances, an exclusion based on the initial nature of the relationship may become an inappropriate permanent exclusion.

A7. The alternative view states the proposed Statement would result in standards overload. The Board notes the purpose of this Statement is to determine what organizations to include in GPFFR—it provides reporting entity standards. This Statement does not address the many transactions that occur between included entities such as investing, lending, or other exchanges. The decision to include an organization is one required decision among many needed to provide GAAP-based financial statements. The new Statement will fill the role SFFAC 2 currently fills. Other aspects of intervention relationships and conservatorship/receivership relationships may be addressed in future Statements and the Board welcomes input on any remaining voids in guidance.

QUESTIONS FOR THE BOARD

Do members wish to adopt the AV proposal to explicitly exclude interventions, conservatorships and receiverships as the new majority view?

Do members wish to add a fourth inclusion principle regarding fulfilling a sovereign function? If so, members are asked to describe the outcome they wish to achieve to aid staff in drafting the principle.

If not, does the Board believe additional language needs to be added to the Basis for Conclusion? If so, comments on the staff proposed response will assist staff in making revisions.