Federal Accounting Standards Advisory Board

June 7, 2018

Memorandum

To: Members of the Board

From: Melissa L. Batchelor, Assistant Director

Wendy M. Payne

Through: Wendy M. Payne, Executive Director

Subj: Evaluation of Existing Standards--Assigning Liabilities **Tab A**[1]

MEMBER ACTIONS REQUESTED:

- Respond to staff questions (p.11) by June 21st
- Prepare to approve staff recommendation or provide alternatives

MEETING OBJECTIVES

The objective of this session is to discuss options for guidance on selected liabilities.

BRIEFING MATERIAL

The staff analysis is attached along with questions for the Board on page 11. You may electronically access all of the briefing material at http://www.fasab.gov/board-activities/meeting/briefing-materials/. Appendices immediately follow.

BACKGROUND

As you may recall, at the April 2018 Board meeting, staff provided the Board with an analysis of the topic 'assigning liabilities' which relates to the last flexibility area previously requested by DoD. This paper continues the analysis of the issue area 'assigning liabilities.'

At the April 2018 meeting, staff presented staff did not believe the "liability issue" should be addressed by providing broad flexibility as provided with assets. Staff based this on the issuance of the recent pronouncements and analysis of the three specific cases identified after extensive outreach. Staff believed the liability issue differed from that of assets, and, therefore, such broad flexibility proved harder to justify. Instead, staff

[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.

believed each of the three specific cases should be considered. After assessing each case, staff determined that additional guidance was needed for environmental liabilities. While staff recognized other challenges DoD may have been encountering, some were related to other areas, such as the reporting entity topic and certain pronouncements that needed to be updated based on the issuance of recent pronouncements.

At the April meeting, the Board members focused on whether there was a more general principle that could be established to address the issues instead of addressing each one separately. The Board noted concern that addressing the three cases individually may set precedence, and there may be additional issues in the future.

NEXT STEPS

The next steps will depend on the Board's answers to the staff questions. If the Board agrees with the staff recommendation, staff will provide a draft Exposure Draft Interpretation before the August Board meeting for comments.

MEMBER FEEDBACK

Please contact me as soon as possible to convey your questions or suggestions. Communication before the meeting will help make the meeting more productive. You can contact me by telephone at 202-512-5976 or by e-mail at batchelorm@fasab.gov with a cc to paynew@fasab.gov.

Attachment A- Staff Analysis

Recap of April 2018 Board Meeting

As noted in the cover memo, this memo and analysis continues discussion of issue the area 'assigning liabilities' that was previously requested by DoD. Specifically, this topic relates to providing flexibility regarding assignment of liabilities within a reporting entity.

As you may recall, at the April 2018 meeting, staff presented the "liability issue" should not be addressed by providing broad flexibility as provided with assets. Staff based this on the issuance of the recent pronouncements and believed the liability issue differed from that of assets, and, therefore, such broad flexibility proved harder to justify. Instead, staff believed each of the three specific cases presented at the April 2018 should be considered and assessed on a case-by-case basis. After assessing each case, staff determined that additional guidance was needed for the environmental liabilities case.

While staff recognized other challenges DoD may have been encountering, some were related to other areas, such as the reporting entity topic and that certain pronouncements needed to be updated based on the issuance of recent pronouncements. Staff believed that there was a need for an interpretation related to environmental liabilities, but the other areas identified were not strictly 'liability' specific.

During the April 2018 meeting, Board members focused on whether there was a more general principle that could be established to address the cases instead of addressing each one separately. The Board noted concern that addressing the cases individually may set precedence.

The Board agreed with staff recommendation that guidance is needed in the environmental liabilities area but members requested staff determine if there is a general liability principle that could be applied to address the liability issue. The Board also agreed with staff that TB 2002-1, *Assigning to Component Entities Costs and Liabilities that Result from Legal Claims Against the Federal Government* also needs to be updated (perhaps replaced or rescinded), but members requested staff determine if there is a general liability principle that could be applied.

Consideration of Current Pronouncements

It is important to note that SFFAS 5, *Accounting for Liabilities of the Federal Government*, begins with the first subsection "Definition and General Principle for Recognition of a Liability" just under "Liability Standards." SFFAS 5 par 5. defines liability as a probable future outflow or other sacrifice of resources as a result of past transactions or events." Further, SFFAS 5 requires recognition of liabilities that are probable and measurable. Measurable means that an item has a relevant attribute that can be quantified in monetary units with sufficient reliability to be reasonably estimable.

SFFAS 5 provides discussion on the various aspects of the liability definition and types of transactions and events.

Staff thought this important to point out that the general principle has been established in SFFAS 5. The Board may wish to use other terms if something is developed such as broad liability principle, basic liability premise, or basic liability. Staff will use 'broad liability principle' in this document.

Staff believes FASAB GAAP provides a broad liability principle that *liabilities are reported by the component reporting entity that will liquidate the liability (that is, has a probable future outflow)*. The following specific guidance relevant to this broad principle and the DoD cases exists in GAAP:

1. Interpretation 2: *Accounting for Treasury Judgment Fund Transactions: An Interpretation of SFFAS 4 and SFFAS 5*—Because the Treasury Judgment Fund (TJF) pays claims after litigation is settled and is not a party to litigation before it is settled and the cost of each claim relates to another entity's operations, Interpretation 2 provides guidance for the entity involved in the claim to recognize a contingent liability as well as how to transfer the liability to TJF once it is determined that TJF will settle the liability.
2. Technical Bulletin 2002-1: *Assigning to Component Entities Costs and Liabilities that Result from Legal Claims Against the Federal Government*—Because some legal claims relate to defunct federal entities (that is, entities that no longer exist), preparers requested that some liabilities be recognized at only at the government-wide financial report level. The Board established the principle that every liability should first be recognized at the component entity level. The principles for assigning such liabilities were derived from SFFAS 4, *Managerial Cost Accounting*. **Staff has determined this Technical Bulletin should be updated to align terminology with SFFAS 47, *Reporting Entity.*
3. Technical Bulletin 2006-1: *Recognition and Measurement of Asbestos-Related Cleanup Costs*—This TB requires entities to recognize cleanup costs for non-friable asbestos. The TB's scope paragraph indicates that entities that "<u>own</u> buildings, facilities, ships, or other tangible PP&E that contain forms of asbestos" are affected by the guidance. **Staff believes this guidance may require updating in light of the TB on assigning assets.
4. Technical Release 2: *Determining Probable and Reasonably Estimable for Environmental Liabilities in the Federal Government*—This TR provides guidance for implementation of cleanup cost standards in SFFAS 5 and 6. It states that "an agency is required to recognize a liability for environmental cleanup costs as a result of past transactions or events when a future outflow or other sacrifice of resources is probable and reasonably estimable." This reiterates the broad principle that the reporting entity (agency) must assess whether a future outflow or sacrifice of resources is probable. **Staff believes this guidance may require updating in light of the TB on assigning assets.
5. Technical Release 10, *Implementation Guidance on Asbestos Cleanup Costs Associated with Facilities and Installed Equipment*—This TR addresses important

implementation questions regarding the consistent application of TB-2006-1 as it relates to asbestos cleanup costs associated with facilities and installed equipment. The methodology was developed on the premise that federal entities must recognize a liability when a future outflow or other sacrifice of resources as a result of past transactions or events is "probable" and "reasonably estimable." This reiterates the broad principle that the reporting entity (agency) must assess whether a future outflow or sacrifice of resources is probable. **Staff believes this guidance may require updating in light of the TB on assigning assets.

6. Technical Release 11, *Implementation Guidance on Cleanup Costs Associated with Equipment*—This TR focuses on cleanup of hazardous waste associated with equipment. It focuses on when cleanup costs should be recognized as an environmental liability and when it should be expensed as a cost of routine operation.
7. Technical Release 14, *Implementation Guidance on the Accounting for the Disposal of General Property, Plant & Equipment*—This TR clarifies existing SFFAS 6 requirements for the disposal, retirement, or removal from service of general property, plant, and equipment as well as related cleanup costs. The implementation guidance differentiates between permanent and other than permanent removal from service of G-PP&E assets. The implementation guidance also recognizes the many complexities involved in the disposal of G-PP&E, as well as delineates events that trigger discontinuation of depreciation and removal of G-PP&E from accounting records.

***It is important to note that the changes or updates to each of the documents are necessary exclusive of the liability issue. Further, the changes or updates must be made in separate GAAP documents to ensure the GAAP hierarchy appropriate level of guidance results. For example, changes to a TR can't be combined with a SFFAS ED because they are AAPC documents.*

As explained, the above guidance provides a broad liability principle that liabilities are reported by the component reporting entity that will liquidate the liability (that is, has a probable future outflow). The broad principle then is modified or augmented with the following specific guidance:

1. For cases to be paid by the TJF, the entity involved in the case should recognize contingent liabilities until amounts to be settled by the TJF are decided.
2. If multiple entities or defunct entities are involved in litigation, one or more should recognize the liability so that the liability is not recognized only at the government-wide level. SFFAS 4 cost assignment principles should be used to assign the liability. (If the cost assignment principles do not resolve the debate, OMB guidance should be sought.)
3. Guidance related to cleanup cost (TB 2006-1, TR 2 and TR10) offers guidance in two areas –ownership of the asset and the general principle that a future outflow is probable. [As noted, these principles may be in conflict given the new asset assignment guidance as well as the DoD cases.]

Staff believes the broad principle that liabilities should be reported by the component reporting entity having the probable future outflow must be maintained. It is consistent with the definition of a liability as well as the general liability standards. Staff also believes the broad principle that all liabilities should be recognized by a component reporting entity before being consolidated into the government-wide financial statements should be preserved.

Staff believes there are two specific principles derived from the other guidance identified above. These specific principles augment the broad principles and clarify the standards:

1. Reporting entities designated to settle certain liabilities generally[2] do not have information needed to determine that a future outflow is probable and measurable until entities more directly involved communicate certain determinations to them. Therefore, reporting entities designated to settle liabilities need not recognize liabilities until designation of the amount and/or timing of settlement is made.
2. Some reporting entities settle their liabilities by designating (either themselves or through law) another federal entity to assume responsibility for the liabilities. Such entities should recognize the liabilities until specific assets are transferred, or the amount and/or timing of the settlement is determined.

Note that there are only two known cases where the above specific principles are applied—contingent liabilities and cleanup costs. Despite a request for examples, these continue to be the only cases.

Consideration of Potential Risks with Approaches

Staff thought it important to consider what the potential risks are with the different approaches to clarifying or expanding these principles beyond these two cases. Staff believes there are certain risks when expanding beyond this versus being specific.

May not be in accordance with liability definition—expanding may result in situations where there is an inconsistency with the liability definition per SFFAS 5 and the broad principle. Also it leads to the question of in what type of GAAP document the principle would be established? If it's too wide, are we in fact clarifying any particular point?

Could result in several options—expanding could result in several options or inconsistency in practice, which is no better than current practices at DoD. There needs to be a clear path forward for conforming guidance or inconsistencies in reporting may continue, especially in environmental liabilities.

[2] Note that in some cases, the entity responsible for settling litigation will have the needed information. This is true in the DoD case when one military service is responsible for all litigation in a geographic region.

Unintended consequences—Staff believes expanding could lead to greater the risk of unintended or unknown consequences. Unintended consequences, includes the effects on other agencies as well as the consistency with current GAAP pronouncements. For example, any changes to environmental liabilities may affect the DOE.

Attempting to solve a narrow scope with a big project—could be the same as above. It widens the scope of the project but also leads to the unintended consequences. It appears there is a preference to be generic and provide broad guidance but that may complicate the guidance. Staff understands the Board's concern regarding additional questions that may come up regarding assigning liabilities, but at this point there haven't been other examples provided.

<u>CONSIDERTATION OF OPTIONS</u>

Option 1 Broad Approach- (expands beyond the 2 examples) similar language used in the Assigning Assets Technical Bulletin

Using similar wording from the TB 2017-2, *Assigning Assets to Component Reporting Entities*:

<u>Draft Wording:</u>

With the exception of liabilities covered in rates charged by business-type activities, liabilities may be assigned to component reporting entities on a rational and consistent basis so long as all such liabilities are assigned. There should be a process in place to ensure all liabilities within a reporting entity are assigned. In addition, liabilities may only be assigned by a component reporting entity to its own sub-component reporting entities (such as bureaus, components, or responsibility segments within the same larger reporting entity or department).

While staff considered a broad approach similar to TB 2017-2, staff does not believe this option is feasible. As indicated in the discussion of potential risks, staff believes that this alternative leads to more risk than reward.

As noted above, the following broad principles are consistent with the liability definition in our standards

> *Liabilities should be reported by the component reporting entity having the probable future outflow
> *Liabilities should be recognized by a component reporting entity before being consolidated into the government-wide financial statements

Staff does not believe the above broad principles could be coupled with the approach used in the assets TB. Instead, the broad principles could be the basis or part of an explanation within an interpretation. Therefore, this leads to Option 2, specific guidance.

Option 2 Provide Specific Guidance (Interpretation)

This option could be offered through an interpretation.[3] As noted, the primary issue is environmental liabilities, but there are also aspects related to contingent liabilities that need clarifying. An interpretation could be focused on these specific topics. This approach would be consistent with the Board's approach by offering specific guidance through other GAAP documents that augments and is consistent with the general liability standards and principles.

Draft Wording (Interpretation)

Introduction

The Federal Accounting Standards Advisory Board (FASAB) was asked for guidance regarding accounting at the component reporting entity level as it pertains to certain liabilities. Specifically, clarifications were requested about the recognition and measurement standards related to contingent liabilities and cleanup costs. The recognition and measurement standards are provided in Statement of Federal Financial Accounting Standards (SFFAS) 5, *Accounting for Liabilities of the Federal Government* and SFFAS 6, *Accounting for Property, Plant and Equipment*.

With the issuance of recent pronouncements such as SFFAS 47, *Reporting Entity*, and SFFAS 55, *Amending Inter-entity Cost Provisions,* and TB 2017-2, *Assigning Assets to Component Reporting Entities,* there is a need for additional guidance to assist in the application of the general liability standards and principles in certain situations. This is especially needed for organizations with complex environments and structures, and those with shared common missions.

Guidance is needed regarding clean-up costs where the component reporting entity responsible for financially reporting the asset is different from the component reporting entity that will eventually be responsible for environmental remediation upon disposal of that asset. Clarification may be needed for contingent liabilities specific to complex organization structures with common missions where a component reporting entity assigns the responsibility for adjudicating claims to one component reporting entity, even when claims are due to actions of another component reporting entity. These situations may lead to inconsistent application of the standards and financial reporting. In addition, these types of examples warranted additional explanation due to the issuance of the new pronouncements.

Interpretation

SFFAS 5 par 5. defines a liability as "a probable future outflow or other sacrifice of resources as a result of past transactions or events." Further, par. 91 of SFFAS 6 as amended provides the recognition and measurement standards for cleanup costs.

[3] In addition, in conjunction with this effort the necessary updates would be made to the other GAAP documents identified in this memo.

Cleanup costs are subject to the criteria for recognition of liabilities included in SFFAS 5:

> That is, liabilities shall be recognized when three conditions are met:
> • a past transaction or event has occurred,
> • a future outflow or other sacrifice of resources is probable,[67] and
> • the future outflow or sacrifice of resources is measurable.[68]
>
> [Fn67] Probable means that the future confirming event or events is more likely than not to occur.
> [Fn68]The unit of analysis for estimating liabilities can vary based on the reporting entity and the nature of the transaction or event. The liability recognized may be the estimation of an individual transaction or event; or a group of transactions and events. For example, an estimate of the cleanup costs could be made on a facility by facility basis, or an entity by entity basis.

Some assets requiring cleanup are transferred to another entity after they are removed from service. In such cases, the component reporting entity that recognized the asset during its useful life may not be responsible for future outflows or other sacrifices of resources to settle the liability for cleanup costs. Instead, the component reporting entity receiving the asset upon removal from service has or assumes that responsibility.

For purposes of meeting the SFFAS 5 recognition criteria that "a future outflow or other sacrifice of resources is probable," the criteria should be considered met by the component reporting entity that recognizes the asset during its useful life. In that case, the liability should be reported on the balance sheet of the component reporting entity recognizing the asset until the asset and the associated liability are transferred for cleanup. At that time, the asset and the liability should be de-recognized by the component reporting entity that recognized them during the asset's useful life and recognized by the component reporting entity that will liquidate the liability. De-recognition and recognition of the asset and liability should be in accordance with existing standards.

Key Points for the BFC

A question was raised about the recognition and measurement standards related to contingent liabilities and cleanup costs. The question was posed to FASAB because there was a need for clarity due to the issuance of several pronouncements. For example, with the issuance of SFFAS 55, *Amending Inter-entity Cost Provisions*, SFFAS 30 and Interpretation 6 will be rescinded; therefore the requirement to impute costs for these activities will be eliminated. Further, the Board's intent with TB 2017-2, *Assigning Assets to Component Reporting Entities* was to provide flexibility with asset assignment. SFFAS 47, *Reporting Entity* recognized the extremely complex organization of the federal government and provided and a basis for understanding the organizational approach and component reporting entities (and sub-components) with the federal government. Considering this and that there are organizations with complex environments and structures, and those with shared common missions, it appears that guidance may be required to clarify certain aspects of the existing liability standards and situations that may not have been considered or contemplated when the standards were written.

Guidance is needed regarding clean-up costs where the component reporting entity responsible for financially reporting the asset is different from the component reporting entity that will eventually be responsible for disposal of that asset. Clarification may also be needed for contingent liabilities specific to complex organization structures with common missions where a component reporting entity assigns the responsibility for adjudicating claims to one component reporting entity, even those actions due to a claim of another component reporting entity. With the issuance of recent pronouncements such as SFFAS 47, SFFAS 55 and TB 2017-2, there is a need for additional guidance to assist in the application of the general liability standards and principles in these situations. This is especially needed for organizations with complex environments and structures, and those with shared common missions.

These situations may lead to inconsistent application of the standards and financial reporting. These types of examples and the issuance of the new pronouncements warranted the need for guidance of how the general liability standards and related broad liability principles may be applied.

The following may occur at component reporting entities in their assessment of contingent liabilities and clean-up costs:

1.Component reporting entities designated to settle certain liabilities generally do not have information needed to determine that a future outflow is probable and measurable until component reporting entities more directly involved communicate certain determinations to them. Therefore, component reporting entities designated to settle liabilities need not recognize liabilities until designation of the amount and/or timing of settlement is made.
2.Some component reporting entities settle their liabilities by designating (either themselves or through law) another federal entity to assume responsibility for the liabilities. Such component reporting entities should recognize the liabilities until specific assets are transferred, or the amount and/or timing of the settlement is determined.

For example, in meeting “a future outflow or other sacrifice of resources is probable” for purposes of meeting the liability definition of clean-up costs at the component reporting entity level (where multiple sub-components have distinct responsibilities for an asset and for settling the related liability) the condition could be considered met as long as the liability is reported with the asset until the asset is removed, contained, or disposed. At that time, the liability would be transferred with the asset to the component reporting entity that will liquidate the liability.

Although guidance regarding the application of the general liability standards has been provided through other pronouncements such as technical bulletins and technical releases, those pronouncements and related guidance may require updating to ensure conformance and consistency with new pronouncements. Necessary updates will be made to the other GAAP documents. Those updates are considered exclusive of the liability issue presented within this interpretation. Further, the changes or updates must be made in separate GAAP documents to ensure the GAAP hierarchy appropriate level of guidance results.

Staff Recommendation is Option 2 for the reasons explained throughout the Staff analysis.

Questions for the Board:

Does the Board agree or disagree with the staff recommendation to prepare an Interpretation? If not, Board members please identify your preferred an alternative.

If in agreement, do Board members have any comments on the draft wording for the Interpretation?

SFFAS 6 – excerpts related to cleanup costs

88. This standard applies only to cleanup costs from Federal operations known to result in hazardous waste which the Federal Government is required by Federal, state and/or local statutes and/or regulations that have been approved as of the balance sheet date, regardless of the effective date, to cleanup (i.e., remove, contain or dispose of).66 These cleanup costs meet the definition of liability provided in Statement of Recommended Accounting Standards no. 5, Accounting for Liabilities of the Federal Government (SRAS no. 5).

89. However, due to the nature of the liability and the timing associated with cleanup costs, additional guidance is provided in this standard on the recognition of cleanup costs over the life of the related PP&E. Guidance is required since cleanup can not occur until the end of the useful life of the PP&E or at regular intervals during that life.
[Fn66] Accounting for environmental liabilities such as cleanup costs is currently undergoing change—due to both improved measurement techniques and increased attention from the accounting community. The Board will monitor these changes and revisit these standards as needed.

90. This standard is intended to supplement the accounting requirements for liabilities in SRAS no. 5. SRAS no. 5 defines liabilities as a “probable future outflow or other sacrifice of resources as a result of past transactions or events.” Further, SRAS no. 5 requires recognition of liabilities that are probable and measurable. Measurable means that an item has a relevant attribute that can be quantified in monetary units with sufficient reliability to be reasonably estimable.

91. The recognition and measurement standards provided in this standard are subject to the criteria for recognition of liabilities included in SRAS no. 5. That is, liabilities shall be recognized when three conditions are met:

• a past transaction or event has occurred,
• a future outflow or other sacrifice of resources is probable,[67] and
• the future outflow or sacrifice of resources is measurable.[68]

[Fn67] Probable means that the future confirming event or events is more likely than not to occur.

[Fn68] The unit of analysis for estimating liabilities can vary based on the reporting entity and the nature of the transaction or event. The liability recognized may be the estimation of an individual transaction or event; or a group of transactions and events. For example, an estimate of the cleanup costs could be made on a facility by facility basis, or an entity by entity basis.

92. SRAS no. 5 also provides for disclosure of liabilities that do not meet all of the above criteria; these standards apply to cleanup costs as well.

93. Other cleanup costs, such as those resulting from accidents or where cleanup is an ongoing part of operations, are to be accounted for in accordance with liability standards and are not subject to the recognition guidance provided in this standard. This guidance does not apply to these other types of cleanup since the cleanup effort is not deferred until operation of associated PP&E ceases either permanently or temporarily.69

[Fn69] Cleanup may be deferred for other reasons, such as availability of resources. However, this type of deferral does not affect the recognition of the liability.