Federal Accounting Standards Advisory Board

September 21, 2005

Memorandum

To: Members of the Board

From: Melissa L. Loughan, Assistant Director

Ross Simms, Assistant Director

Through: Wendy M. Comes, Executive Director

Subj: Conceptual Project--Objectives Phase TAB **A**[1]

At the August 2005 Board meeting, the Board agreed to proceed with the staff team's plan for conducting roundtable meetings on each of the four objectives of federal financial reporting – Budget Integrity, Operating Performance, Stewardship, and Systems and Control. Also, the Board provided comments on the draft white paper on financial reporting objectives and the meeting materials for the Budgetary Integrity and Operating Performance roundtables.

The staff team revised the draft white paper to address the comments raised by Board members. For example, the paper includes an explanation of the advantages of a GAAP standard setter, as well as elaborating that the purpose of the evaluation of the reporting objectives will focus on clarifying the objectives and defining the Board's role in achieving them. The revised white paper is the version that we have provided to the roundtable participants and is included for your reference at Tab 1. Although we don't plan to make any changes to the paper prior to completing the roundtable meetings (to ensure a consistent white paper is used for all the roundtable meetings), please feel free to bring up any issues that you may have.

The staff team held the roundtable on the Budgetary Integrity objective on September 19, 2005 and is in the process of analyzing the results. Staff would like to note that the meeting was robust, insightful and included participation by representatives from key groups. The transcript (as well as the staff analysis) will be available for your review. Additionally, staff will prepare a summary of the results and issues for inclusion in the

[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.

white paper after completion of all the roundtables. The staff team plans to complete the roundtable for the next objective, Operating Performance, on September 28, 2005.

Staff has prepared the roundtable meeting materials for the two remaining objectives, Stewardship (Tab 2) and Systems and Control (Tab 3). The Stewardship roundtable is planned for November 29, 2005 and the Systems and Control roundtable is planned for December 6, 2005. Based on prior Board discussions, it appears that these two objectives raise more issues among certain Board members. Therefore, staff would like to ensure the roundtable packages include all the issues and questions you wish to research.

The objective for the October Board meeting is to obtain the Board's input on the meeting materials for the roundtables on the Stewardship and Systems and Control objectives of federal financial reporting.

Please feel free to contact us (Melissa at 202-512-5976 or by email at loughanm@fasab.gov and Ross at 202-512-2512 or by email at simmsr@fasab.gov) to discuss any questions you may have.

I. Concepts Project Objective:

A. To ensure that federal financial accounting standards are based on a sound framework of objectives and concepts regarding the nature of accounting, financial statements, and other communications methods. The framework should:

- **provide structure by describing the nature and limits of federal financial reporting,**
- **identify objectives that give direction to standard setters,**
- define the elements critical to meeting financial reporting objectives and describe the statements used to present elements,
- identify means of communicating information necessary to meeting objectives and describe when a particular means should be used, and
- enable those affected by or interested in standards to understand better the purposes, content, and characteristics of information provided in federal financial reports.

B. The conceptual framework will refine and build on the current concepts promulgated by FASAB.

II. Objectives Phase of the Concepts Project--*Evaluate Objectives and Other Aspects of SFFAC 1*:

A. This phase of the overall Concepts Project relates to the evaluation of the reporting objectives and other aspects of Statement of Federal Financial Accounting Concepts (SFFAC) 1, *Federal Financial Reporting Objectives.* This phase supports the Board's efforts to improve the conceptual framework and will be accomplished through developing this white paper on objectives.[1]

B. Evaluation of the reporting objectives will focus on (1) clarifying the broad federal financial reporting objectives (by determining if they are still valid and appropriate and whether additional ones are necessary) and (2) defining the Board's role in achieving those broad objectives as the nature of the Board's involvement may vary for each objective. This phase will address questions such as:

- As drafted, are the objectives themselves clearly stated and complete?
- Have any events or circumstances arisen since the objectives were drafted that would cause the Board to reconsider them?
- Are certain objectives currently met by means other than GAAP financial statements? If so, how reliable (stable) are the means currently in place?

[1] The Objectives Phase of the Concepts Project and this white paper focuses on the bolded text in par. 1 (A).

- Does FASAB have a comparative advantage over other means of meeting certain objectives?
- Are the objectives overly inclusive? Some have suggested that the objectives are so broad that they do not narrow the field of alternatives. Is it appropriate to determine "FASAB's objectives" from among the current broad reporting objectives? Alternatively, is it appropriate to prioritize among the current objectives?
- How does the current reporting model contribute to meeting each reporting objective?

C. This white paper draws from the existing SFFAC 1 and other literature as needed. Ultimately, the white paper will inform the Board in its efforts to (1) amend or augment concepts statements regarding objectives of federal financial reporting in the future and (2) develop a strategic plan. This may be accomplished by updating SFFAC 1 to cover developments in federal financial reporting since its issuance and clarifying the Board's role relative to each reporting objective.

D. Following completion of the white paper, the Board may wish to develop a concepts statement that clarifies or ranks the previously stated objectives and presents any clarifying language related to other fundamental topics covered in SFFAC 1. The statement may address the current reporting environment (including non-GAAP reporting initiatives), how the original (broader) reporting objectives not retained (or no longer primary) are met, reasoning behind including additional reporting objectives and the Board's role in meeting the revised objectives.

E. The nature of the Board's involvement may vary for each objective. For example, objectives or sub objectives may be excluded because they were determined to be poorly aligned with the Board's mission or not a high priority for the Board in the near-term (five to ten years). Potential reasons for excluding objectives or sub objectives in the near term include the fact that others have made or are making progress in meeting the objective or sub objective, the Board's structure, processes and authorities do not support meeting the objective or sub objective, or other objectives or sub objectives are deemed to be more important. Additionally, the Board's involvement may be varied based on the type of documents issued--specifically, FASAB could issue products other than standards and concepts that would contribute to meeting objectives.

F. The clarification of the objectives and defining the Board's role relative to those objectives should (1) enhance the Board's selection of standards projects by making explicit the objectives attainable through GAAP financial reports and (2) communicate to users the Board's objectives. In addition, the white paper will support a strategic planning effort expected to begin in 2006.

III. White Paper:

A. SFFAC 1 Status

1. The Board relies on SFFAC 1 to support its deliberations on financial reporting issues. Briefly, SFFAC 1 provides:
   - *a) Background information on federal financial reporting, its environment, and the role of the Board,*
   - *b) User needs*
   - *c) Objectives*
   - *d) Cost and benefit considerations*
   - *e) Qualitative characteristics of information in financial reports*
   - *f) Relationships between accounting and financial reporting including operating performance*
2. SFFAC 1 acknowledges that many information sources other than financial statements help to attain the stated objectives. Further, SFFAC 1 does not assert that the Board will attempt to meet all the stated objectives. It simply states that "FASAB will consider where new accounting standards could make a useful and cost-effective contribution to improving the extent to which these objectives are attained."

3. As noted above, the Board is currently evaluating the objectives presented in chapter 4 of SFFAC 1 as part of its Conceptual Project. The objectives as included in SFFAC 1 are as follows:

Objective 1--Budgetary Integrity

Federal financial reporting should assist in fulfilling the government's duty to be publicly accountable for monies raised through taxes and other means and for their expenditure in accordance with the appropriations laws that establish the government's budget for a particular fiscal year and related laws and regulations. *Federal financial reporting should provide information that helps the reader to determine:*

1A. How budgetary resources have been obtained and used and whether their acquisition and use were in accordance with the legal authorization.
1B. The status of budgetary resources.
1C. How information on the use of budgetary resources relates to information on the costs of program operations and whether information on the status of budgetary resources is consistent with other accounting information on assets and liabilities.

Objective 2--Operating Performance

Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities. *Federal financial reporting should provide information that helps the reader to determine:*

2A. The costs of providing specific programs and activities and the composition of, and changes in, these costs.
2B. The efforts and accomplishments associated with federal programs and the changes over time and in relation to costs.
2C. The efficiency and effectiveness of the government's management of its assets and liabilities.

Objective 3--Stewardship
Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial condition has changed and may change in the future. *Federal financial reporting should provide information that helps the reader to determine:* 3A. Whether the government's financial position improved or deteriorated over the period. 3B. Whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due. 3C. Whether government operations have contributed to the nation's current and future well-being.

Objective 4--Systems and Control
Federal financial reporting should assist report users in understanding whether financial management systems and internal accounting and administrative controls are adequate to ensure that: 4A. Transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the purposes authorized, and are recorded in accordance with federal accounting standards; 4B. Assets are properly safeguarded to deter fraud, waste, and abuse; and 4C. Performance measurement information is adequately supported.

4. The ultimate focus of this white paper is on clarifying the four reporting objectives listed above and defining the Board’s role in achieving those broad objectives.

5. Before considering the four reporting objectives, the Board believes it is useful to develop further its views regarding FASAB’s role as well as the nature and limits of federal financial reporting. Given the changes in the federal financial reporting environment since SFFAC 1 was issued in 1993, the Board believes an up to date statement of views on these matters is helpful.

6. The Board also believes it would be beneficial to get feedback from the community on the reporting objectives in light of these changes. FASAB staff will be conducting separate roundtable discussions on each of the four reporting objectives. The primary purpose of the discussions will be to determine how the objectives might be improved to facilitate their use as a means for guiding the board in developing standards of financial accounting and reporting and in developing solutions to financial accounting and reporting issues. A brief summary of the results or main discussion issues of the roundtables will be incorporated into this white paper and will assist the Board as it considers the objectives.

B. Evolution in FASAB's Role

FASAB Created

7. In October 1990, the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Comptroller General of the United States established the Federal Accounting Standards Advisory Board (FASAB or "the Board") as a federal advisory committee.

8. The nine member FASAB consisted of representatives from the three principles, one Congressional Budget Office representative, one representative from the defense and international agencies, one representative from civilian agencies, and three representatives from the private sector. FASAB issued recommended statements of accounting concepts and standards for approval by its three principals. In developing the statements, the FASAB adhered to Federal Advisory Committee Act requirements and engaged a seven-step due process approach that included public participation.

    a) *Identification of accounting issues and agenda decisions.*
    b) *Preliminary deliberations.*
    c) *Preparation of initial documents (issue papers, and/or discussion memorandums).*
    d) *Release of documents (e.g., exposure drafts) to the public, public hearings, and consideration of comments.*
    e) *Further deliberations and consideration of comments.*
    f) *General consensus (at least a majority vote) reached among Board members and final documents submitted to the Treasury, OMB, and GAO for approval.*
    g) *The Principals provide for implementation guidance through the FASAB's Accounting and Auditing Policy Committee.*

9. Shortly after FASAB was established, the Chief Financial Officers Act of 1990 became law. The Act established the position of Chief Financial Officer in each department to ensure the development of integrated agency accounting and financial management systems, including financial reporting and internal controls, which comply with applicable accounting principles, standards, and requirements, and internal control standards. The CFO Act also required some executive agencies to have agency-wide audited financial statements and other agencies to have more limited statements. The Government Management Reform Act of 1994 for the first time required annual audited financial statements covering the entire executive branch as

well as agency-wide statements for each agency covered by the CFO Act.

10. Chapter 1 of SFFAC 1 provides that "any description of federal financial reporting objectives should consider the needs of both internal and external report users and the decisions that they make."[2] FASAB considers the information needs of both internal and external users because the distinction between them is in many ways less significant for the federal government than for other entities.

11. As stated above, FASAB was created to advise OMB, Treasury and GAO on accounting standards for federal agencies and programs in order to improve financial reporting practices. The text in Chapter 1 preceding par. 23 details FASAB's mission (when created) as *"The mission of the FASAB is to recommend accounting standards [for the federal government] after ... considering the financial and budgetary information needs of congressional oversight groups, executive agencies, and the needs of other users of federal financial information."*[3]

GAAP Status Attained

12. In October 1999, the American Institute of Certified Public Accountants' (AICPA) Council designated the FASAB as the accounting standards-setting body for Federal government entities under Rule 203 of the AICPA's Code of Professional Conduct. Rule 203 provides, in part, that an AICPA member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles (GAAP) or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with GAAP, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles, that has a material effect on the statements or data taken as a whole.

13. Until the AICPA action, the Federal Government did not have a Rule 203 designated accounting standards-setter[4]. With this designation,

[2] SFFAC 1 par. 23
[3] From the FASAB Mission Statement, approved by the Board and by the Secretary of the Treasury, the Director of OMB, and the Comptroller General of the United States in l991.
[4] The AICPA Council designated the Financial Accounting Standards Board (FASB) as the standards-setter for the private sector in 1973 and the Governmental Accounting Standards Board (GASB) as the

Federal Government reporting entities obtain audit opinions that indicate that the financial statements are presented in conformity with GAAP rather than an “other comprehensive basis of accounting” (OCBOA).

14. This designation came after an AICPA task force evaluated FASAB against the following criteria used in designating accounting standards-setting bodies under Rule 203: Independence; Due Process and Standards; Domain and Authority; Human and Financial Resources; and Comprehensiveness and Consistency.

15. The task force recommended some enhancements in FASAB’s procedures, and assisted in incorporating them in FASAB’s Memorandum of Understanding and Rules of Procedure. The most significant enhancements were:
    a) *creation of an Appointments Panel to assist in selecting non-federal members,*
    b) *opening Steering Committee meetings to the public, and*
    c) *establishing that FASAB would issue final standards following a review period.*

16. With the enhancements completed, the task force deemed the FASAB to have satisfied such criteria. Accordingly, the AICPA Board recommended that Council adopt a resolution to designate FASAB under Rule 203. On October 19, 1999, the AICPA Council approved the resolution.[5]

17. Subsequent to the Rule 203 recognition, the FASAB changed how it issued accounting concepts and standards. Previously, standards developed by FASAB did not become final until the sponsors explicitly approved them for issuance. With the change, FASAB forwards standards to the sponsors for a 90-day review. FASAB also forwards capital asset accounting standards to the Congress for the mandatory 45-day review. If there are no objections during these respective review periods, the standards are considered final and FASAB publishes them on its website.

18. Additional enhancements following the October 1999 AICPA recognition of FASAB as the standard setting body for the Federal Government are reflected in its operating documents. These enhancements included the following:

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standards-setter for states and local governments in 1986. These are authoritative standard-setting bodies under Rule 203.

[5] On May 23, 2003 the AICPA Council unanimously voted to continue for a second five-year period designation of the FASAB as the accounting standards-setting body for Federal government entities under Rule 203 of the AICPA’s Code of Professional Conduct.

- Minutes posted to the website (see http://www.fasab.gov/meeting.htm)
- Briefing materials available in advance of the meetings via the website (draft Board issuances are not posted).
- Procedures for issuing Technical Bulletins established.
- Exposure drafts are now published electronically. Hard copies are available on request.
- Publish any dissents and identify the authors in final statements.
- Press releases have been improved and a broader list of press contacts is maintained.
- Agenda setting process now includes a call for comments on proposed projects and permits identification of other project proposals.

Enhancements to Independence

19. In 2002, the Board's sponsors altered the Board's structure to increase the level of non-federal representation to enhance the perceived independence of the Board. The nine-member board would now have six non-federal members and three federal members. In addition, the Secretary of the Treasury relinquished his authority to object to any standard during the 90-day review period. Thus, only GAO and OMB may object to the issuance of a new standard or concept by FASAB.

20. In 2003, the Board was expanded to provide for additional legislative branch input. The Board grew to ten members with the addition of a representative from the Congressional Budget Office. The Board now has six non-federal members and four federal members.

Advantages of a GAAP Standards Setter

21. The GAAP designation confirms that the FASAB has established proper rules and procedures and enhances the Board in these respects:

    Credibility--GAAP recognition, with continued monitoring by the accounting profession, indicates that the Board meets the minimum requirements for a GAAP body. These are Independence, Due Process and Standards, Domain and Authority, Human and Financial Resources, and Comprehensiveness and Consistency.

    Ability to set a common framework for debate and offer a forum for consideration of financial reporting issues--While it does not limit the Board's role, GAAP status demands comprehensiveness and consistency. Thus, GAAP standards setters endeavor to establish a sound conceptual framework, address critical issues in a timely manner, and introduce discipline to financial measures. Through development of, continual improvement in, and application of financial accounting concepts and standards, GAAP governs the terms used in financial discussions and the financial representation given to transactions and events.

Due process is a requirement of both Rule 203 and the Federal Advisory Committee Act. Thus, the Board must continue to conduct outreach and consider the views of those interested in federal financial reporting. This is both a responsibility and an opportunity. Because of due process, the Board is challenged to produce concepts and standards that are defensible and understandable. Further, the Board may use due process as a means to engage members of the various professions having an interest in federal finances. Through the Board's efforts, public policy and budget experts may engage in financial accounting/reporting deliberations. This creates the opportunity to produce more useful and understandable concepts and standards.

Impact on external decision makers through ability to require unbiased information (to send "bad news") due to independence--Independence has been identified as the most significant criterion for a GAAP body. With an independent standard setter it is more likely that government organizations will be required to provide a complete financial report including "bad news."

22. FASAB's influence on federal financial reporting is unique. The Board determines financial reporting concepts and standards through an extensive and widely participative due process. Federal entities follow these standards in preparing financial statements subject to independent audit. Independent auditors determine whether the financial statements are presented fairly in accordance with GAAP which encompasses those concepts, standards, and practices required to define accepted accounting practices at a particular time.

23. Audited financial statements based on GAAP have an advantage in meeting users' needs in several ways. For example, the discipline introduced through audited financial statement preparation and through established definition, recognition, and measurement guidance can lead to enhanced systems and processes, and ultimately more reliable information. Also, internal reporting and analyses are enhanced along with focusing attention on areas of concern. Consequently, users can gain a level of assurance that the information they utilize is accurate.

24. In addition, knowledge that certain information will be made publicly available can have behavioral consequences, such as deterring fraud, waste, and abuse. It also may lead reporters, analysts, and others to expect certain information (outside of the Budget) on a routine schedule. Also, managers may desire to inform Congress of information that is not included in the Budget. Consequently, accrual-based information can be made available to demonstrate accountability and that can be useful for decision-making.

25. In addition, GAAP reports provide an advantage because the information in such reports must possess certain characteristics. To effectively communicate information to users, SFFAC 1 describes six characteristics that the information must possess-- Understandability, Reliability, Relevance, Timeliness, Consistency, and Comparability.[6]

26. All of the foregoing adds a degree of credibility and acceptability to FASAB's standards that may not exist elsewhere in the federal jurisdiction. Although there may be other reporting requirements (other than financial statements) that are achieving or are contributing to achieve certain objectives, information required by a FASAB standard brings a level of assurance about the reliability of the information because it is subject to audit.

C. **Evolution in Federal Financial Management and Reporting Laws and Regulations since the CFO Act of 1990**

27. The CFO Act could be considered the first of a series of major legislation passed to increase federal accountability through financial management reform. Briefly, the purposes of the CFO Act were to (1) bring more effective financial management practices to the Federal government, (2) provide for the production of complete, reliable, and consistent financial information for use in management and evaluation of Federal programs, and (3) improve agency systems of accounting, financial management, and internal controls. The CFO Act created 24 chief financial officers for the major executive departments and agencies. In addition to requiring those agencies to prepare and submit audited financial statements for each revolving and trust fund and for accounts that performed substantial commercial functions, the CFO Act required some agencies to have agency-wide financial statements.

[6] See SFFAC 1 par. 156-164 for discussion of the Qualitative Characteristics of Information in Financial Reports.

28. As mentioned above, FASAB was established shortly after passage of the CFO Act. SFFAC 1 was issued in September 1993. Since then, and following in the steps of the CFO Act, Congress has enacted a series of laws to reform and improve financial management in the federal government. Along the lines of the three purposes of the CFO Act described in the previous paragraph, the legislations and regulations since 1993 can be considered to broadly fall into the three areas:

- **Effective Financial Management Practices**--Legislation to bring more effective financial management practices to the Federal government,
- **Performance Measurement**--Legislation to provide for the production of complete, reliable, and consistent financial information for use in management and evaluation of Federal programs, and
- **Internal Controls**--Legislation to improve agency systems of accounting, financial management, and internal controls.

29. Accordingly, it would be appropriate to consider these and the related changes in the federal financial reporting environment since SFFAC 1 was issued. A brief summary and analysis of implications for pertinent laws and regulations is presented below.

Effective Financial Management Practices

30. <u>Government Management Reform Act of 1994 (GMRA)--</u>GMRA substantially expanded the requirements in the CFO Act by requiring audited financial statements covering all accounts in the 24 CFO agencies. In addition, GMRA also required the Secretary of the Treasury to prepare a consolidated financial statement for the executive branch. From its inception, the resulting Financial Report of the United States Government has also included financial information for the legislative and judicial branches.

31. *Impact/Analysis:* During FASAB's early years, it focused more on financial statements for components or segments of the federal government than it did on the government-wide statements. It was understood that some differences would be appropriate at the government-wide level (e.g., with regard to reporting on budgetary execution and financing). It was expected that—in the absence of specific guidance from FASAB—OMB, GAO and Treasury would determine how to report at the government-wide level. GMRA's requirement for audited financial statements at this level and AICPA's

recognition of federal accounting principles published by FASAB as GAAP (in SAS 91*, Federal GAAP Hierarchy*, April 2000), created a need for FASAB to define the applicable standards and to consider whether additional or different concepts were needed. FASAB has done so in SFFAC 4, *Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government*, and in SFFAS 24, *Selected Standards for the Consolidated Financial Report of the United Statements Government*. In addition, FASAB now includes a separate section detailing requirements for the Government-wide financial statement in applicable standards.

32. Reports Consolidation Act of 2000--This Reports Consolidation Act builds on a pilot program authorized in GMRA that allowed an agency to combine its audited financial statement, as required by GMRA, and its performance reports, as required by GPRA, to provide a more comprehensive and useful picture of the services provided.

33. The Reports Consolidation Act requires that a consolidated report:
    a) Shall be referred to as a *Performance and Accountability Report* if it incorporates the agency's GPRA program performance report;
    b) Contain a summary of the most significant portions of the agency's program performance report, including the agency's success in achieving key performance goals, if the program performance report is not incorporated;
    c) Include a statement by the agency's inspector general that summarizes the agency's most serious management and performance challenges; and
    d) Include a transmittal letter from the agency head containing an assessment of the completeness and reliability of the performance and financial data used in the report.

34. *Impact/Analysis:* With the Reports Consolidation Act, agency audited financial statements are included in a combined Performance and Accountability Report that contain other financial and performance reporting requirements.

35. Accountability of Tax Dollars Act of 2002--The Accountability of Tax Dollars Act extended the requirements for preparation of audited financial statements to virtually all executive branch agencies. OMB may exempt agencies with available budget authority under $25 million in a given year, if OMB determines that audited financial statements

are not warranted due to an absence of risk. The newly covered agencies are subject to OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*. (Note that FFMIA reporting requirements were not applied to these newly covered agencies.)

36. *Impact/Analysis:* The Accountability of Tax Dollars Act extends the requirement to produce and audit financial statements to some relatively small federal entities.

37. Improper Payments Information Act of 2002--The Improper Payments Information Act requires federal agencies to identify programs vulnerable to improper payments and to estimate annually the amount of underpayments and overpayments made by these programs. OMB has directed agencies to report this information in the MD&A section of the Performance and Accountability Report.[7]

38. *Impact/Analysis:* Some may believe that this law suggests a need for FASAB to focus on this topic, much as FASAB focused on accounting for direct loans and loan guarantees after the Credit Reform Act was passed, and as FASAB focused on government-wide reporting after GMRA was passed. Others may believe that existing standards adequately address this topic, and/or that OMB action in this area and related guidance is sufficient.

39. President's Management Agenda (PMA)--*Improved Financial Performance Initiative*--In addition to the above legislations and regulations, the President's Management Agenda represents an ongoing effort in the executive branch for improving management and performance in the Federal government. The PMA, announced in the summer of 2001, is an aggressive strategy for improving the management of the Federal government. It focuses on five areas of management weakness across the government where improvements and the most progress can be made.

40. Improved Financial Performance is one of the five government-wide initiatives. The financial management initiative seeks to enhance the

[7] "Agencies shall include the reporting requirements of this guidance in the Management Discussion and Analysis section of their Performance and Accountability Report for fiscal years ending on or after September 30, 2004. The annual estimate of erroneous payments reported in the Performance and Accountability Report can be based on data from a year other than the fiscal year the Performance and Accountability Report covers. Progress under the requirements of Section 57 of OMB Circular A-11 shall be reported in the FY 2003 Performance and Accountability Reports."

quality and timeliness of financial information. This initiative also focuses on improving assets management and reducing improper payments.

41. A "Management Scorecard" is used to measure progress on the Agenda initiatives. The scorecard uses a traffic light system for rating agencies--green for success, yellow for mixed success, and red for unsatisfactory. For each initiative, there are core criteria that the agency must meet in order to get a green rating. OMB updates the scorecard on a quarterly basis.

42. The core criteria for "getting to green" on the improving financial performance initiative are: 1. Financial management systems meet federal financial management system requirements and applicable federal accounting and transaction standards as reported by the agency head; 2. Accurate and timely financial information; 3. Integrated financial and performance management systems supporting day-today operations; and 4. Unqualified and timely audit opinions on the annual financial statements and no material internal control weaknesses.

43. A basic tenet of the PMA calls for improving financial performance by providing timely, reliable, and useful information. As a result, OMB amended OMB Bulletin 01-09 *Form and Content of Agency Financial Statements* to significantly accelerate financial reporting due dates. Specifically, beginning with FY 2004, Performance and Accountability Reports were due to the President, OMB, and the Congress by November 15th. Additionally, Treasury was required to issue the Financial Report of the United States Government to the President and the Congress by December 15th. In addition, beginning with the quarter ending March 31, 2004, agencies were required to prepare and submit to OMB its quarterly unaudited financial statements 21 days after the end of each quarter. OMB recently issued Circular A-136, *Financial Reporting Requirements*, which reiterates and incorporates the accelerated financial reporting and form and content requirements.

44. *Impact/Analysis:* The PMA has resulted in more timely financial reports and additional oversight by OMB and other agency initiatives to address these important areas related to improving financial performance.

45. ***Conclusion on Effective Financial Management Practices Legislation and Linkage to Objectives***--The legislation noted in this area focused on extending the requirements of the CFO Act--specifically audited financial statements, to other agencies as well as the consolidated government-wide financial statement. The legislation

also focused on streamlining reporting requirements by allowing agencies to produce a Performance and Accountability Report. Additionally, agencies are issuing more timely financial reports due to the accelerated due dates. It appears that the items in this area may indirectly contribute to meeting all of the reporting objectives, but do not appear to significantly contribute to meeting any one objective that would result in the Board excluding any aspect of the objective.

Performance Measurement

46. <u>Government Performance and Results Act of 1993 (GPRA)--</u>Briefly, the purposes of the GPRA include: (1) improved management of federal programs, (2) increased accountability and better assessment of results, (3) improved communication with Congress and the public, (4) better information for Congressional and agency decisions, and (5) increased public confidence in the government.

47. GPRA requires agencies to prepare strategic plans, annual performance plans, and annual performance reports. The annual performance report examines whether goals (as discussed in the annual performance plan) were met and what was accomplished with the resources expended. It should be noted that agencies are required to consolidate their audited financial statements and other financial and performance reports into combined Performance and Accountability Reports.

48. *Impact/Analysis:* SFFAC 1 includes “Operating Performance” as one of the four objectives of federal financial reporting. Also, chapter 8 discusses “How Financial Reporting Supports Reporting on Operating Performance.” Some may believe that these references to performance are sufficient and that no change is needed as a result of GPRA, but others may believe that an amplification of these sections of SFFAC 1 would be in order now that GPRA has led to performance reporting on a comprehensive basis while the Reports Consolidation Act have led agencies to include performance information with the audited financial statements in Performance and Accountability Reports.

49. However, other people may believe that no amplification of the concepts is needed, but that one or more statements of standards may be needed to address performance reporting. Some people may believe that provisions of existing concepts and standards issued by FASAB, such SFFAC 3 *Management’s Discussion and Analysis,* SFFAS 4 *Managerial Cost Accounting Concepts and Standards* and SFFAS 7 *Accounting for Revenue and Other Financing Sources*,

SFFAS 15 *Management's Discussion and Analysis*, and SFFAS 30 *Inter-Entity Cost Implementation* adequately respond to these laws. Alternatively, other people may believe that OMB action pursuant to GPRA have effectively ended any need for FASAB to act in this area.

50. President's Management Agenda (PMA)--*Budget and Performance Integration Initiative*--In addition to GPRA, the PMA represents an ongoing effort in the executive branch for improving management and performance in the Federal government. As stated above, the PMA, announced in the summer of 2001, is an aggressive strategy for improving the management of the Federal government. It focuses on five areas of management weakness across the government where improvements and the most progress can be made.

51. Another initiative under the PMA is Budget and Performance Integration. The Budget and Performance Integration initiative seeks to formally integrate performance review with Budget decisions. A "Management Scorecard" is used to measure progress on the Agenda initiatives. The scorecard uses a traffic light system for rating agencies--green for success, yellow for mixed success, and red for unsatisfactory. For each initiative, there are core criteria that the agency must meet in order to get a green rating. OMB updates the scorecard on a quarterly basis.

52. The core criteria for "getting to green" on this initiative include: agency demonstrates improvement in program performance and efficiency in achieving results; annual budget and performance documents incorporate measures identified in the PART; agency reports the full cost of achieving performance goals accurately in budget and performance documents and can accurately estimate the marginal cost (+/ - 10%) of changing performance goals; has at least one efficiency measure for all PART programs; and uses PART evaluations to direct program improvements, and PART ratings and performance information are used consistently to justify funding requests, management actions, and legislative proposals.

53. *Impact/Analysis:* The PMA has resulted in additional oversight by OMB and other agency initiatives to address these important areas related to budget and performance integration and full costing. See discussion under GPRA above for additional discussion.

54. OMB's Program Assessment Rating Tool (PART) Analysis--The Administration began (in the 2004 Budget) to assess Federal programs by a method known as the PART. The primary purpose of the PART is to improve program performance in the federal government and is a

key tool in the budget and performance integration initiative mentioned above.

55. The Administration set a target of assessing all Federal programs over five years. The PART system assesses each program in four components--purpose, planning, management, and results/accountability--and gives a score for each of the components. The scores for each component are weighted and the program is given an overall score. A program is rated effective if it receives an overall score of 85 percent or more, moderately effective if the score is 70 to 84 percent, adequate if the score is 50 to 69 percent, and inadequate if the score is 49 percent or lower. The program receives a rating "Results Not Demonstrated" if it does not have a good long-term and annual performance measure or does not have data to report on its measures.

56. *Impact/Analysis:* The PART Analysis has resulted in additional oversight by OMB and other agency initiatives in the area of agency performance measurement and accountability. See discussion under GPRA above for additional discussion.

57. ***Conclusion on Performance Measurement Legislation and Linkage to Objectives***-- The legislation noted in this area focused on the production of complete and reliable information for use in management and evaluation of Federal programs. It appears that most of the items in this area have a direct relationship with the Operating Performance Objective. Some may consider that agency efforts to meet the above requirements and the resulting oversight by OMB significantly contribute to meeting many aspects of the Operating Performance Objective. Therefore the Board may wish to consider whether certain aspects of the objective (or sub-objective) could be excluded or lowered from its priorities or revised accordingly to reflect that it is being addressed through other means.

Internal Controls

58. Federal Managers' Financial Integrity Act of 1982[8] (FMFIA)--Congress has long expressed concerns about controls in various laws, dating back to include the Budget and Accounting Procedures Act of 1950. The FMFIA required virtually all executive agencies to comprehensively report on internal control two decades before the Accountability for Tax Dollars Act of 2002 extended the requirement for

[8] Although FMFIA came before the CFO Act of 1990, staff believed it would be appropriate to include as it is relevant for the Board in understanding how the objective Systems and Controls is met.

audited financial statements to virtually all executive agencies. The requirement to report on internal controls under FMFIA and reporting on controls over financial reporting are not necessarily equivalent. Some would say that the scope of controls contemplated by FMFIA may be broader, including operational and legal compliance issues as well as financial reporting. Furthermore, judgments about materiality may be different as well.

59. The FMFIA requires GAO to prescribe standards of internal accounting and administrative control and agencies to comply with them. Internal control is to provide reasonable assurance that (1) obligations and costs comply with applicable law (2) assets are safeguarded against waste, loss, unauthorized use, or misappropriation, and (3) revenues and expenditures are recorded and accounted for properly so that accounts and financial and statistical reports may be prepared and the accountability of assets may be maintained.

60. FMFIA requires that the internal control standards include standards to ensure the prompt resolution of all audit findings. It also requires OMB to establish guidelines for agency evaluation of internal control to determine compliance with the internal control standards.

61. It requires agency heads to (1) annually evaluate their internal control using the OMB guidelines, and (2) annually report to the President on whether the agency's internal controls comply with the standards and objectives set forth in the FMFIA. If they do not fully comply, the report must identify the weaknesses and describe plans for correction. The report is to be signed by the head of the agency.

62. *Impact/Analysis:* SFFAC 1 includes "Systems and Controls" as one of the four objectives of federal financial reporting. See discussion under OMB A-123 below for a discussion of the impact/analysis of recent legislation and regulations.

63. <u>Federal Financial Management Improvement Act of 1996 (FFMIA)--</u> The FFMIA requires each agency to implement and maintain financial management systems that can comply substantially with system requirements, applicable federal accounting standards, and the Standard General Ledger. For each CFO Act agency, FFMIA requires that the annual audit report state whether the agency's financial management systems comply with the requirements.

64. *Impact/Analysis:* Some may believe that the legal requirement for reporting on accounting systems' compliance with accounting standards adds a new factor for FASAB to consider. However, others may believe that compliance with law is a matter for others to assess--meaning whether an entity is in compliance with the provisions of FFMIA is a legal determination and would not affect the opinion on the financial statements. More specifically, some have argued that compliance with accounting standards (e.g., with SFFAS 4) for FFMIA may imply something different than conformance with GAAP for the purpose of expressing an opinion on financial statements. That is, some would say that an agency might be able to publish financial statements in conformance with GAAP, but not be in compliance with SFFAS 4 for purposes of FFMIA.

65. Sarbanes-Oxley Act of 2002 (SOX)--This Act contains numerous provisions affecting publicly owned companies and public accountants. Of particular interest is Section 404, "Management Assessment of Internal Controls" that requires management to assess the effectiveness of internal control and an audit attestation on the assessment made by management.

> Section 404: Management Assessment Of Internal Controls
> Requires each annual report of an issuer to contain an "internal control report", which shall:
> (1) State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
> (2) Contain an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
> Each issuer's auditor shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this section shall be in accordance with standards for attestation engagements issued or adopted by the Board. An attestation engagement shall not be the subject of a separate engagement.

66. *Impact/Analysis:* Some have suggested that the public would expect federal practice to be comparable in this regard to what is now required of SEC registrants, and that action by FASAB to require management assertions about internal control, or at least controls over financial reporting, as an integral part of the basic financial statements would be one way to assure this. Others have suggested that existing requirements of FMFIA, FFMIA, Government Audit Standards and the recently revised OMB Circular A-123 (see next item for a further discussion of the impact/analysis) already accomplish a comparable result.

67. OMB Circular A-123 (REVISED December 2004) *Management's Responsibility for Internal Control*--In light of the new internal control requirements for publicly-traded companies (see SOX discussion above), OMB re-examined the existing internal control requirements for Federal agencies. As a result, OMB Circular A-123 (which implements FMFIA) was revised to significantly strengthen the requirements for conducting management's assessment of internal control over financial reporting. The Circular is effective in fiscal year 2006.

68. The revised A-123 requires an assessment of internal control by management. Specifically, management is required to assert to the effectiveness of internal controls via an assurance statement "as of June 30." A-123 does not require a separate audit. However, Agencies may secure a separate audit opinion on internal controls over financial reporting. In those situations, the "as of" reporting date of June 30 may be adjusted to align better with the "as of" date of the audit opinion. Also, the CFO Council and the President's Council on Integrity and Efficiency (PCIE) prepared an implementation guide to assist agencies in addressing the requirements included in A-123 Appendix A, *Internal Control over Financial Reporting*. Appendix A directs management to become more proactive in overseeing internal controls related to financial reporting.

69. *Impact/Analysis:* As noted above, SFFAC 1 includes "Systems and Controls" as one of the four objectives of federal financial reporting. Based on a staff analysis of the standards issued, FASAB has not addressed this objective as much as the others in its standards. For example, it appears that SFFAS 15, *Management's Discussion & Analysis* may be the only standard that directly relates to the system and control objective by requiring the MD&A to address systems and controls.

70. Some may believe that this reference to systems and controls may be sufficient and that no change is needed as a result of the strengthening of the regulations related to internal controls, but others may believe that an amplification of these sections of SFFAC 1 would be in order. However, other people may believe that no amplification of the concepts is needed, but that one or more statements of standards may be needed to address systems and controls. Some may believe that action by FASAB to require management assertions about internal control, or at least controls over financial reporting, as an integral part of the basic financial statements would be appropriate.

71. Others have suggested that existing requirements of FMFIA, FFMIA, Government Audit Standards and the recently revised OMB Circular A-

123 will accomplish a comparable result and has effectively ended any need for FASAB to act in this area.

COMPARISON BETWEEN A-123 AND SOX

	A-123	SOX
Management Assessment	Requires management assessment as of June 30[9], and update the report for any new issues coming to their attention before Sept. 30.	Requires management assessment as of the end of the company's fiscal year.
Audit Attestation	Does not require a separate audit attestation of controls over financial reporting. Note-Agencies are allowed to obtain an opinion. Also, OMB may require a separate audit if management is not achieving progress in correcting control weaknesses.	Requires audit attestation on the assessment made by management.
Framework	Provides a framework for evaluating internal controls and requires a reference to this in the management's report.	Requires management to identify the framework used to evaluate the effectiveness of controls.
Effectiveness of Controls	Precludes management from concluding internal controls are effective if there are one or more material weaknesses.	Precludes management form concluding that internal controls are effective if there are one or more material weaknesses.
Material Weaknesses	Require management to disclose all material weaknesses as of June 30.	Requires management to disclose any material weaknesses.

72. Department of Homeland Security Financial Accountability Act--The Act requires the Department of Homeland Security management to provide an assertion on the effectiveness of internal control over financial reporting for fiscal year 2005 and requires an auditor's opinion on internal controls over financial reporting for fiscal years beginning

[9] Unless an audit is done, at which time the report may be dated the same as the auditors report.

after 2005. The Act also required the CFO Council and the President's Council on Integrity and Efficiency study the potential costs and benefits of requiring other CFO Act agencies to obtain audit opinions on their internal control over financial reporting.

73. *Impact/Analysis:* A Draft Report entitled *Estimating the Costs and Benefits of Opining on Agency's Internal Control over Financial Reporting* was issued for comments in May 2005. The Draft Report concluded that given the significant estimated partial costs for agencies to obtain an audit opinion on internal control, all CFO Act agencies should not be required to conduct such an audit at this time. Rather, agencies should be given the opportunity to continue to implement OMB Circular A-123 and obtain an internal control audit only where particular circumstances appropriately warrant such an audit.

74. President's Management Agenda (PMA)--*Improved Financial Performance Initiative*--As noted above, the President's Management Agenda is an aggressive strategy for improving the management of the Federal government. For each initiative, there are core criteria that the agency must meet in order to get a green rating. OMB updates the scorecard on a quarterly basis.

75. One of the core criteria for "getting to green" on the improving financial performance initiative is: Unqualified and timely audit opinions on the annual financial statements and no material internal control weaknesses.

76. *Impact/Analysis:* OMB monitors internal control weaknesses regularly. To receive green on the PMA scorecard, agencies must eliminate all internal control weaknesses. Quarterly, OMB monitors agency performance in meeting corrective action plan targets established under the PMA scorecard. Agencies are required to submit corrective action plans to OMB to resolve internal control weaknesses reported. Quarterly, agencies are graded on their progress in achieving the corrective action milestones contained in their plans.

77. ***Conclusion on Internal Control Legislation and Linkage to Objectives***-- The legislation noted in this area focused on the improvement of agency systems of accounting, financial management, and internal controls. It appears that most of the items in this area have a direct relationship with the Systems and Controls Objective. Some may consider that agency efforts to meet the above requirements and the resulting oversight by OMB significantly contribute to meeting many aspects of the Systems and Control Objective. Therefore the Board may wish to consider whether certain

aspects of the objective (or sub-objective) could be excluded or lowered from its priorities or revised accordingly to reflect that it is being addressed through other means.

D. Objectives Roundtable Meetings

78. The Board also believes it would be beneficial to get feedback from the community on the reporting objectives given the changes in the environment over the past 10 years. FASAB staff will be conducting separate roundtable discussions on each of the four reporting objectives above. The primary purpose of the discussions will be to determine how the objective might be improved to facilitate its use as a means for guiding the board in developing standards of financial accounting and reporting and in developing solutions to financial accounting and reporting issues. A brief summary of the results or main discussion issues of the roundtables will be incorporated into this white paper and will assist the Board as it considers the objectives.

79. The roundtables will be on each of the four reporting objectives and will provide the Board with insights from experts involved in specific areas, as well as those external to the accounting community. The roundtables will also serve as an outreach opportunity with the goal of engaging the community. FASAB staff plans to include individuals from the following for participation: IG audit community, CFO financial statement preparation community, IPA firms, GASB, former FASAB Board members, OMB, GAO, Treasury, CBO, Public Interest Groups, Congressional staff members, and any other subject matter expert deemed appropriate.

80. The roundtable meetings will focus on the following general topics:
    - Participant's observations on the financial reporting objective;
    - Evaluating the objective in the evolutionary environment; and
    - Broad nature of the objective and determining the scope of FASAB's role.

81. Additionally each of the roundtable meetings will focus on specific issues related to the objective being discussed at the roundtable. FASAB staff will provide a participants package in advance of each of the roundtable meetings that further elaborates on the topics for discussion.

Next Steps

82. After completing the roundtable meetings, staff will prepare a summary of the results and issues for inclusion in the final white paper. The issues from the roundtables, in conjunction with the identification of relevant developments identified in this paper, and how they impact the Board's role or priorities in working towards the objectives will be basis for staff proposals. Specifically, staff will review and make an assertion regarding the Board's role in meeting each objective. It will be important to distinguish "narrowing down" that is based on poor alignment with the Board's comparative advantages (likely permanent narrowing down) from de-emphasis of an objective due to the current efforts of others (room to return if and when needed). Justification of any staff proposals can come from the views expressed in earlier sections of the white paper and summaries from the roundtable meetings.

Federal Accounting Standards Advisory Board
Roundtable Discussion on the
Stewardship Objective of Financial Reporting
November 29, 2005

Administrative Information

Roundtable Venue

Government Accountability Office (GAO)
441 G St NW - Room 7C13
Washington DC 20548

The meeting room is located on the 7th floor of the GAO building.

General Information

The session will begin at 9:00 am and conclude at noon. Participants are asked to arrive prior to 9:00 am to process through GAO security. The GAO building is located near the Judiciary Square or Gallery Place metro stops.

Federal Accounting Standards Advisory Board
Roundtable Discussion on the
Stewardship Objective of Financial Reporting
November 29, 2005

Agenda

8:45 - 9:00	Continental Breakfast
9:00 – 9:10	Introductions and Overview of Project
9:10 – 10:30	Group Discussion A. Participant's Observations on the Stewardship Objective B. Evaluating the Stewardship Objective in an Evolutionary Environment
10:30 – 10:45	Break
10:45 – 11:55	Group Discussion C. Broad Nature of the Stewardship Objective D. General Questions for Consideration
11:55 – 12:00	Wrap-up

Federal Accounting Standards Advisory Board
Roundtable Discussion on the
Stewardship Objective of Financial Reporting
November 29, 2005

Questions for Consideration

Introduction

FASAB is the source of GAAP for financial reporting in the federal government. The Board issues its guidance through a range of vehicles such as Statements of Federal Financial Accounting Concepts and Standards, Interpretations, Technical Bulletins, Technical Releases of the Accounting and Auditing Policy Committee, and Implementation Guides published by FASAB staff. SFFAC 1 is a conceptual statement on the objectives of financial reporting in the federal government, and it was part of the Board's initial set of concept statements and accounting standards. Each objective relates to the federal government's management and financial reporting systems in their entirety. As the Board's work progressed, members found that the broad nature of the objectives hinders their usefulness as a tool for guiding them in choosing among alternative solutions.

> "The term "objective" has no unusual meaning in financial accounting. An objective is something toward which effort is directed, an aim or end of action, a goal."
>
> FASB Discussion Memorandum, *Conceptual Framework for Accounting and Reporting: Consideration of the Report of the Study Group on the Objectives of Financial Statements,* June 6, 1974
>
> "…before a standard can be set for any product, the purpose of the product must be defined."
>
> David Solomons, "The FASB's Conceptual Framework: An Evaluation," Journal of Accountancy, June 1986, p.118

In June 2003, the Board began extensive review of the financial reporting objectives discussed in SFFAC 1. Since that time, the Board has:

- reviewed the changes in federal financial management legislation;
- considered the basis for SFFAC 1's inclusion of a dual focus on internal and external user needs;
- discussed how prior standards contributed to meeting certain objectives and indirect contributions to improving systems and controls; and
- discussed the foundational objectives of accountability and decision usefulness.

Roundtable Objective

To determine how the financial reporting objective, Stewardship, might be improved to facilitate its use as a means for guiding the Board in developing standards of financial accounting and reporting and in developing solutions to financial accounting and reporting issues.

Description of the Stewardship Objective

Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial condition has changed and may change in the future. Federal financial reporting should provide information that helps the reader to determine whether:

> For the Federal Government, there is no single number that corresponds to a business's bottom line. The Government is judged by how its actions affect the country's security and well-being, and that cannot be summed up with a single statistic.
>
> Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006, p. 199.

- the government's financial position improved or deteriorated over the period,
- future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due, and
- government operations have contributed to the nation's current and future well-being.

The Stewardship objective is based on the government's indefinite responsibility for the general welfare of the nation, and the objective concentrates on the requirement that the government report on the broad outcomes of its actions. Analysis of why the government's financial position has deteriorated or improved helps to explain whether financial burdens were passed on by current-year taxpayers to future-year taxpayers without related benefits. This concept may be referred to as interperiod equity[1]. In addition, information about previous government operations can help in assessing the level of stewardship exercised by the government.

The Stewardship objective also concerns the concepts of "financial condition" as well as "financial position." SFFAC1 explains that financial condition is a broader and more forward-looking concept than financial position. While the financial position of the government may be distinguishable from that of the nation as a whole, the financial condition of the national government and that of the national society are entwined. The

[1] See SFFAC 1, page 38, footnote 11 for a discussion on interperiod equity.

idea is that if the nation's wealth is deteriorating, the government's financial condition is or will soon be deteriorating too.

Reporting on financial condition requires both financial and nonfinancial information about the government and the national economy and society. SFFAC 1 discusses that information to address this objective may require the use of reporting mechanisms other than traditional financial statements and, although FASAB does not recommend standards for economic reporting, the Board may consider whether such information should be included in certain financial reports.

Discussion Topics and Questions

A. Participant's Observations on the Stewardship Objective

> Discuss your experience with the Stewardship objective.

1. What reporting requirements or other actions have contributed particularly well to meeting the objective and what could be improved?
2. Are there aspects of the Stewardship Objective (or sub-objectives) that should be clarified?
3. Are there specific issues that may relate to the Stewardship Objective that are not addressed (ie. Are there additional sub-objectives that should be added or considered)?

> Financial condition allows an assessment of an entity on the basis of additional data that could include financial and nonfinancial information about current conditions. These additional data provide a more complete indication of performance.
>
> Statement of Federal Financial Accounting Standard 8, *Supplementary Stewardship Reporting*

B. Evaluating the Stewardship Objective in an Evolutionary Environment

> "The objectives of financial reporting are not immutable – they are affected by the economic, legal, political, and social environment in which financial reporting takes place."
>
> FASB Statements of Financial Accounting Concepts 1: *Objectives of Financial Reporting by Business Enterprises*

FASAB issued SFFAC 1 in 1993. Since that time, the operations and structure of FASAB have changed and Congress has passed new laws. Federal accounting and reporting exists in the context of various laws that have impacted financial management practices, internal control, and performance measurement. For example, the Government Management Reform Act of 1994 (GMRA) required audited financial statements covering all accounts in the 24 CFO agencies, and it required the preparation of the consolidated government-wide financial statement. Also, the Reports Consolidation Act of 2000 allows agencies to combine its audited financial statements and its performance reports into an annual report referred to as a Performance and Accountability Report. Other changes in legislation and financial management initiatives are discussed in the FASAB staff white paper.

SFFAC 1 acknowledges the evolutionary nature of financial reporting. It states that FASAB recognizes that developing and implementing standards may take considerable time. Given the changes in the federal financial reporting environment since SFFAC 1 was issued, the Board believes that an up to date statement of views on this would be helpful. Board members noted that:

> *It (SFFAC1) was written years ago before new mechanisms were put in place regarding stewardship….*
>
> *They may not need wholesale revision, but the passage of time and changed conditions may suggest some changes.*
>
> *…the environment had changed, including new laws. We need to look at the objectives in light of the perceived effectiveness of new requirements.*
>
> *Maybe the torch has been passed as a result of some law; in which case (he) would want to take out the objective or in some way revise it accordingly.*

Discuss how changes in the federal environment since 1993 may affect the Board's reconsideration of the Stewardship objective.

1. What have been some key changes in the federal environment since the Stewardship objective was drafted?
2. Have any events or circumstances arisen that should cause the Board to reconsider the Stewardship objective?
3. Considering the evolutionary nature of financial reporting, what factors should the FASAB consider to guard against the risk of narrowing the scope of the Stewardship objective excessively?

C. Broad Nature of the Stewardship Objective

> "The objectives are also affected by the characteristics and limitations of information that financial reporting can provide."
>
> FASB Statements of Financial Accounting Concepts 1: *Objectives of Financial Reporting by Business Enterprises Accounting Information*

Some respondents to the exposure draft of SFFAC 1 noted that the Stewardship objective was too broad. They believed that information on the effects of policy decisions was outside the scope of federal financial reporting. The Board decided to substitute the phrase "provide information that helps…" for the word "enable…" and acknowledged that federal financial reporting by itself cannot accomplish the objective of evaluating stewardship, but it can contribute to achieving this goal. Also, SFFAC 1 states that many information sources other than financial statements help to obtain the financial reporting objectives, and that financial reporting is not the only source of information to support decision-making and accountability. Regarding this matter, a Board member noted that it is unclear in what areas the Board has a direct impact versus an indirect aid. Presently, the Board would like to determine FASAB's domain within the broad spectrum of federal financial reporting. Board members noted that:

There is a feeling, … that we have to give citizens more information than just the financial statements to give them a fair indication about the status of the government and its ability to continue.

FASAB's responsibility is to determine what kind of report a federal entity should issue to its constitutes, the citizens; i.e., what should that entity tell them? For a corporate entity, the report to its constituents should tell them about its financial position and something about the extent to which it has been successful. The focus is on net income and net assets, with some information about the future. But in government we have something different.

We need to have concepts to embrace all that the Government does regarding financial reporting, but we need to be a little cleaner and crisper about what we do versus what others do to meet those requirements.

It is not quite clear… where the role of the Board ends and others such as OMB come in….

The Board would look at the "whole world" of federal reporting, scope it down to where the Board believes its role and responsibilities are in federal reporting, and then develop a strategic plan.

One of the advantages we offer is the ability to set standards that subject information to audit.

Discuss what the scope of FASAB's role should be in meeting the Stewardship objective.

1. What are some of the other information sources that help achieve the Stewardship objective and to whom is the information reported?
2. Are the other sources effective in achieving the Stewardship objective?
3. Are there particular aspects of the Stewardship objective on which FASAB should focus?
4. What should be FASAB's role relative to reporting on:
    a. the nation's financial condition,
    b. the sustainabilty of public services, and
    c. whether government operations have contributed to the nation's current and future well-being?
5. Is there information that should be subjected to audit or have assurance of reliability?
6. Given the limitations of FASAB's guidance vehicles, should the FASAB clearly state the areas where it only has an indirect role?

D. General Questions for Consideration

Discuss general matters regarding the objectives of federal financial reporting and SFFAC 1.

1. Given that the nature of the Board's involvement in each objective could vary, should FASAB explore other types of guidance vehicles, possibly less formal, that would assist in achieving aspects of a financial reporting objective? If so, what are some examples of other types of guidance?
2. Do you have comments or suggestions concerning financial reporting objectives in general?
3. Do you have any areas of concern regarding SFFAC 1?

Federal Accounting Standards Advisory Board
Roundtable Discussion on the
Systems and Control Objective of Financial Reporting
December 6, 2005

Administrative Information

Roundtable Venue

Government Accountability Office (GAO)
441 G St NW - Room 7C13
Washington DC 20548

The meeting room is located on the 7th floor of the GAO building.

General Information

The session will begin at 9:00 am and conclude at noon. Participants are asked to arrive prior to 9:00 am to process through GAO security. The GAO building is located near the Judiciary Square or Gallery Place metro stops.

Federal Accounting Standards Advisory Board
Roundtable Discussion on the
Systems and Control Objective of Financial Reporting
December 6, 2005

Agenda

8:45 – 9:00	Continental Breakfast
9:00 – 9:10	Introductions and Overview of Project
9:10 – 10:30	Group Discussion A. Participant's Observations on the Systems and Control Objective B. Evaluating the Systems and Control Objective in an Evolutionary Environment
10:30 – 10:45	Break
10:45 – 11:55	Group Discussion C. Broad Nature of the Systems and Control Objective D. General Questions for Consideration
11:55 – 12:00	Wrap-up

Federal Accounting Standards Advisory Board
Roundtable Discussion on the
Systems and Control Objective of Financial Reporting
December 6, 2005

Questions for Consideration

Introduction

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> "The term "objective" has no unusual meaning in financial accounting. An objective is something toward which effort is directed, an aim or end of action, a goal."
>
> FASB Discussion Memorandum*, Conceptual Framework for Accounting and Reporting: Consideration of the Report of the Study Group on the Objectives of Financial Statements,* June 6, 1974
>
> "…before a standard can be set for any product, the purpose of the product must be defined."
>
> David Solomons, "The FASB's Conceptual Framework: An Evaluation," Journal of Accountancy, June 1986, p.118

In June 2003, the Board began extensive review of the financial reporting objectives discussed in SFFAC 1. Since that time, the Board has:

- reviewed the changes in federal financial management legislation;
- considered the basis for SFFAC 1's inclusion of a dual focus on internal and external user needs;
- discussed how prior standards contributed to meeting certain objectives and indirect contributions to improving systems and controls; and
- discussed the foundational objectives of accountability and decision usefulness.

Roundtable Objective

To determine how the financial reporting objective, Systems and Control, might be improved to facilitate its use as a means for guiding the Board in developing standards of financial accounting and reporting and in developing solutions to financial accounting and reporting issues.

Description of the Systems and Control Objective

Systems and Control

Federal financial reporting should assist report users in understanding whether financial management systems and internal accounting and administrative controls are adequate to ensure that:

- transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the purposes authorized, and are recorded in accordance with federal accounting standards;
- assets are properly safeguarded to deter fraud, waste, and abuse; and
- performance measurement information is adequately supported.

> "The Congress finds the following… Billions of dollars are lost each year through fraud, waste, abuse, and mismanagement among the hundreds of programs in the Federal Government. These losses could be significantly decreased by improved management, including improved central coordination of internal controls and financial accounting."
>
> "The purposes of this Act are the following… Provide for improvement, in each agency of the Federal Government, of systems of accounting, financial management, and internal controls to assure the issuance of reliable financial information and to deter fraud, waste, and abuse of Government resources."
>
> CFO Act of 1990

Attachment I may be helpful in providing insight on some of the Board discussions regarding the Systems and Control objective. Attachment I provides a summary of the issue of whether it is appropriate for FASAB standards to have an "indirect" impact on achieving the systems and control objective versus a more direct approach that would address this objective by perhaps requiring management's assertion about systems and control as basic information.

Discussion Topics and Questions

A. Participant's Observations on the Systems and Control Objective

Discuss your experience with the Systems and Control objective.

1. What reporting requirements or other actions have contributed particularly well to meeting the objective and what could be improved?
2. Are there aspects of the Systems and Control Objective (or sub-objectives) that should be clarified?
3. Are there specific issues that may relate to the Systems and Control Objective that are not addressed (ie. Are there additional sub-objectives that should be added or considered)?

B. Evaluating the Systems and Control Objective in an Evolutionary Environment

"The objectives of financial reporting are not immutable – they are affected by the economic, legal, political, and social environment in which financial reporting takes place."

FASB Statements of Financial Accounting Concepts 1: *Objectives of Financial Reporting by Business Enterprises*

FASAB issued SFFAC 1 in 1993. Since that time, the operations and structure of FASAB have changed and Congress has passed new laws. Federal accounting and reporting exists in the context of various laws that have impacted financial management practices, internal control, and performance measurement. For example, the Sarbanes-Oxley Act of 2002 requires management of publicly owned companies to assess the effectiveness of internal control and an audit attestation on the assessment made by management. In light of the new internal control requirements for publicly-traded companies, OMB re-examined the existing internal control requirements for Federal agencies. As a result, OMB Circular A-123, *Management's Responsibility for Internal Control*, was revised to significantly strengthen the requirements for conducting management's assessment of internal control over financial reporting. Specifically, management is required to assert to the effectiveness of internal controls via an assurance statement "as of June 30." A-123 does not require a separate audit. Other changes in legislation and financial management initiatives are discussed in the FASAB staff white paper.

SFFAC 1 acknowledges the evolutionary nature of financial reporting. It states that FASAB recognizes that developing and implementing standards may take considerable time. Given the changes in the federal financial reporting environment since SFFAC 1 was issued, the Board believes that an up to date statement of views would be helpful. Board members noted that:

They may not need wholesale revision, but the passage of time and changed conditions may suggest some changes.

…the environment had changed, including new laws. We need to look at the objectives in light of the perceived effectiveness of new requirements.

Maybe the torch has been passed as a result of some law; in which case (he) would want to take out the objective or in some way revise it accordingly.

…in passing the Sarbanes-Oxley Act of 2002, Congress evidently concluded that the financial statement audit had not been sufficient.

Discuss how changes in the federal environment since 1993 may affect the Board's reconsideration of the Systems and Control objective.

1. What have been some key changes in the federal environment since the Systems and Control objective was drafted?
2. Have any events or circumstances arisen that should cause the Board to reconsider the Systems and Control objective?
3. Considering the evolutionary nature of financial reporting, what factors should the FASAB consider to guard against the risk of narrowing the scope of the Systems and Control objective excessively?

C. Broad Nature of the Systems and Control Objective

SFFAC 1 states that many information sources other than financial statements help to obtain these objectives. Also, financial reporting is not the only source of information to support decision-making and accountability. Regarding this matter, a Board member noted that it is unclear in what areas the Board has a direct impact versus an indirect aid. Presently, the Board would like to determine FASAB's domain within the broad spectrum of federal financial reporting. Other Board member perspectives include:

"The objectives are also affected by the characteristics and limitations of information that financial reporting can provide."

FASB Statements of Financial Accounting Concepts 1: *Objectives of Financial Reporting by Business Enterprises Accounting Information*

We need to have concepts to embrace all that the Government does regarding financial reporting, but we need to be a little cleaner and crisper about what we do versus what others do to meet those requirements.

The Board would look at the "whole world" of federal reporting, scope it down to where the Board believes its role and responsibilities are in federal reporting, and then develop a strategic plan.

One of the advantages we offer is the ability to set standards that subject information to audit…

Reporting on internal control seems to go beyond the role of FASAB…coupled with the activities to address the issue underway, [he] does not see a need for FASAB to get into the issue.

In preparing financial statements, it is essential to have reliable controls. Particularly in light of the new accelerated reporting schedule…there is a strong relationship between financial reporting and control over financial operations.

…systems and control are a by-product of the standards: systems and control improves as the standards and requests for information are expanded.

Attachment I may be helpful in providing insight on some of the Board discussions regarding the Systems and Control objective. Attachment 1 provides a summary of the issue of whether it is appropriate for FASAB standards to have an "indirect" impact on achieving the systems and control objective versus a more direct approach that would address this objective by perhaps requiring management's assertion about systems and control as basic information.

Discuss what the scope of FASAB's role should be in meeting the Systems and Control objective.

1. What are some of the other information sources that help achieve the Systems and Control objective and to whom is the information reported?
2. Are the other sources effective in achieving the Systems and Control objective?
3. Are there particular aspects of the Systems and Control objective on which FASAB should focus?
4. Do you believe it is appropriate for FASAB standards to have an "indirect" impact on achieving the systems and control objective versus a more direct approach?

5. What should be FASAB's role relative to the third sub-objective--"performance measurement information is adequately supported"?
6. What should be FASAB's role relative to requiring a management's assertion about systems and control as basic information?
7. Is there information that should be subjected to audit or have assurance of reliability?
8. Given the limitations of FASAB's guidance vehicles, should the FASAB clearly state the areas where it only has an indirect role?

D. General Questions for Consideration

Discuss general matters regarding the objectives of federal financial reporting and SFFAC 1.

1. Given that the nature of the Board's involvement in each objective could vary, should FASAB explore other types of guidance vehicles, possibly less formal, that would assist in achieving aspects of a financial reporting objective? If so, what are some examples of other types of guidance?
2. Do you have comments or suggestions concerning financial reporting objectives in general?
3. Do you have any areas of concern regarding SFFAC 1?

Systems and Control
Indirect versus Direct Approach

Most would agree that FASAB standards have had an "indirect" impact on achieving the systems and control objective. Specifically, certain Board members have noted that there is an indirect correlation between most of the standards and the systems and control objective and certain members believe that improved systems and control is a by-product of the standards.

Further support for this indirect approach to achieving the systems and control objective can be found in the SFFAC 1 discussion relating to the objective. Specifically, par. 147-149 of SFFAC 1 describes the systems and control objective as follows:

> 147. This objective arises from the three preceding objectives[1], in conjunction with the fact that accounting supports both effective management and control of organizations and the process of reporting useful information. Indeed, accounting processes are an integral part of the management control system.
>
> 148. The ability to prepare financial reports that report all transactions, classified in appropriate ways that faithfully represent the underlying events, is itself an indication that certain essential controls are in place and operating effectively. The preparation of reliable financial reports also helps to ensure that reporting entities have early warning systems to indicate potential problems and take actions to correct material weaknesses or problems.
>
> 149. Sound controls over internal processes are essential both to safeguard assets and to ensure economy, efficiency, and effectiveness in many governmental programs.

It is important to note that "clean" or unqualified audit opinions don't always indicate effective internal controls. Federal agencies can receive clean audit opinions even though they lack an effective system of internal controls because there are no standards that require an audit be made of the effectiveness of internal controls before the issuance of a clean opinion. Even with the passage of the CFO Act of 1990 and the FFMIA of 1996, GAO and IG reports continued to report internal control deficiencies by noted material weaknesses. However, many agencies with noted internal control deficiencies during this time did receive clean audit opinions on their financial statements. The clean opinions on the financial statements in these situations were not a result of an effective system of internal controls, but rather a result of a huge year-end effort to prepare the financial statements by manual adjustments and such, as well as additional audit procedures to compensate for the limited reliance on the internal controls.

There is discussion in the Basis for Conclusions that demonstrates respondents (to the SFFAC 1 exposure draft) also believed that the systems and control object is accomplished through the other objectives, as par. 237 of SFFAC 1 includes the following:

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[1] The "three preceding objectives" refers to the first three Objectives of Federal Financial Reporting which are Budgetary Integrity, Operating Performance, and Stewardship.

> “Others suggested that a separate objective on this topic was not necessary because it could be inferred from the other objectives.”

However, the Board explained the following view in response to the above in par. 238 of SFFAC 1:

> “With regard to the fundamental point, however, the Board continues to believe that systems and controls are topics of sufficient importance and relevance to warrant addressing in their own right.”

In discussions, certain Board members have expressed concern and suggested that the “indirect” explanation for our standards’ impact on systems and control is not consistent with the language of the objective, particularly par. 150, which seems to imply some form of direct reporting. Specifically, par. 150 of SFFAC 1 states the following about the systems and control objective:

> 150. Information relevant to this objective helps financial report users to determine whether the entity has established reasonable, cost-effective programs to safeguard assets, prevent and detect waste and abuse, and reduce error rates. An example of information that would address this objective is management’s assertion about the effectiveness of the internal accounting and operational control system.

One Board member has suggested that FASAB should amend the language of the objective in some way, or require direct reporting by management regarding systems and control (while other Board members believe that the objective could be revised to focus on the indirect effect.) Additional support for the more direct approach to achieving the systems and control objective can be found in the Basis for Conclusions as follows:

> 239. The Board's user needs study, public hearings, and other sources of information make abundantly clear that users want assurance that reported information is credible and reliable. They also want to know that reasonable controls are in place to deter fraud, waste, and abuse. Independent audit can help provide this assurance, but whether information is audited or not, effective systems and controls are essential to providing such assurance in a cost-effective way. Furthermore, effective systems and controls are essential to achieving the other objectives.
>
> 240. Perhaps the unique contribution of accounting-based reports for objectives 1 and 4 is the "core" accounting data base on transactions, especially on controlled transactions subject to finance- related restrictions. Systems of accounting control are integral parts of this special role for financial reporting. Similarly, regarding objective 2 and, to some extent, objective 3, systems and controls are important because direct observation of outcomes and impacts is often infeasible or expensive. In these cases, reliance on accounting and administrative controls to ensure compliance with good practices and processes is often a cost-effective surrogate for trying to measure the value added by governmental activities.
>
> 241. Finally, the fundamental notion of accountability pervades the entire set of objectives. Effective systems and controls are essential prerequisites to accountable government. Thus, the Board regards systems and controls as an integral part of accounting, accountability, and financial reporting.

In Board discussions, there appears to be a split among Board members that support the indirect approach versus the direct approach in achieving the systems and control objective. In this context, it is important to recall that the Board originally envisioned the objectives articulated in SFFAC 1 as broad organizing principles for federal financial reporting in general, not merely for audited financial statements for which FASAB would recommend standards. “Broad” means that it is not limited to objectives to be met by the development of accounting standards.

SFFAC 1 acknowledges that many information sources other than financial statements help to attain the stated objectives. Further, SFFAC 1 does not assert that the Board will attempt to meet all the stated objectives. It simply states that “FASAB will consider where new accounting standards could make a useful and cost-effective contribution to improving the extent to which these objectives are attained”

In Chapter 1 (*Federal Financial Reporting and the Role of the FASAB)* of SFFAC 1 par. 36 and 37, the Board acknowledged its own limitations as follows:

> 36. The FASAB expects that some of these objectives may best be accomplished through means of reporting outside general purpose financial reports. Indeed, the FASAB recognizes that information sources other than financial reporting, sources over which the FASAB may have little or no influence, also are important to achieving the goals implied by these objectives.
>
> 37. In developing specific standards, the FASAB will consider the needs of financial information users, the usefulness of the information in relation to the cost of developing and providing it, and the ability of accounting standards to address those needs compared with other information sources.

The attached Draft White Paper on Objectives discusses several initiatives that could be perceived as directly contributing to achieving the Systems and Control objective, such as Federal Managers’ Financial Integrity Act of 1982 (FMFIA), Federal Financial Management Improvement Act of 1996 (FFMIA), and OMB Circular A-123, *Management’s Responsibility for Internal Control.* Most recently, OMB re-examined the existing internal control requirements for Federal agencies in light of the new internal control requirements for publicly-traded companies[2]. As a result, OMB Circular A-123 (which implements FMFIA) was revised to significantly strengthen the requirements for conducting management’s assessment of internal control over financial reporting. The Circular is effective in fiscal year 2006. OMB Circular A-123 requires an assessment of internal control by management. Specifically, management is required to assert to the effectiveness of internal controls via an assurance statement “as of June 30” but does not require a separate audit. See pages 17-23 of the white paper for a detailed description of each.

[2] Section 404 of the Sarbanes-Oxley Act of 2002, “Management Assessment of Internal Controls” requires management to assess the effectiveness of internal control and an audit attestation on the assessment made by management.