Federal Accounting Standards Advisory Board

December 6, 2013

Memorandum

To: Members of the Board

Wendy M. Payne

From: Wendy M. Payne, Executive Director

Subj: Risk Reporting Framework – **Tab B** [1]

MEETING OBJECTIVE

- Agree on a framework to guide development of risk disclosures through specific projects

BRIEFING MATERIALS

This memo describes the need for a framework, presents a suggested framework, and reviews existing guidance relevant to risk.

Attachments:

1. Statement of Federal Financial Accounting Concepts (SFFAC) 3, *Management's Discussion and Analysis* – Excerpt regarding risk and forward looking information
2. Excerpt from Peace Corps FY2012 Performance and Accountability Report (MD&A's Forward Looking Discussion)

Appendices:

A. SFFAC 5, Elements of Accrual-Basis Financial Statements (excerpts)
B. SFFAC 7, *Measurement of the Elements of Accrual-Basis Financial Statements in Periods after Initial Recording* (excerpts)

Background

Members and staff have noted the overlap of the risk assumed project with other active projects. For example, the reporting entity project proposes disclosures regarding risks posed by disclosure organizations as follows:

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

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Future exposures: A description of financial and non-financial **risks** and potential benefits and, if possible, the amount of the federal government's **exposure to gains and losses from the past or future operations of the disclosure organization**

In addition, the public-private partnership project is developing disclosures relating to the risks arising through public-private partnerships.

Existing standards and concepts also address risk. They do this by guiding recognition of the losses as well as gains resulting from risk and by requiring disclosures that help the reader better understand risk. These established approaches combined with the emerging views in active projects suggest a framework and making that framework clearer will help us make progress in each active project.

To avoid overloading the risk assumed project and delaying progress on other projects but assure that we address risk with some degree of consistency, staff recommends that the Board agree to a working framework for risk disclosures. The primary objective of the risk assumed project is to study the significant risks assumed by the federal government and develop (a) definitions of risk assumed, (b) related recognition and measurement criteria, and (c) disclosure and / or required supplementary information (RSI) guidance that federal agencies can apply consistently in accordance with GAAP. This a broad objective and we adopted a phased approach to facilitate progress. Nonetheless, we continue to confront the concern that risk disclosures will be inconsistent unless all types of risk are addressed in the risk assumed project.

The primary focus of this framework will be disclosures rather than recognition. While recognition is a key decision, our conceptual framework guides recognition decisions. For example, concepts define elements and provide basic recognition criteria. Presently we have general liability standards to guide recognition of liabilities arising from exchange transactions, government-related events, nonexchange transactions, and government-acknowledged events. These standards were established prior to the concepts statements and may be revisited in specific projects.

After reviewing current standards and concepts, staff drafted a disclosure framework for Board discussion. While staff is seeking your input and consensus on the framework, we would **not** be formalizing the framework through full due process. Instead, staff and members would use the working framework to guide relevant projects. By using a consistent framework, we can address the risk inherent in activities through each project more quickly without sacrificing consistency. This approach will also allow us to advance the risk assumed project more quickly.

If the framework proves useful, we might consider options for including it in formal statements of concepts or standards later.

STAFF ANALYSIS

Recognition Principles

The framework will cover key considerations regarding disclosures. Recognition decisions are to be guided by the concepts statements. Because we are usually most concerned about recognition and measurement considerations, a review of some of the current recognition guidance may be helpful before discussing disclosures. Some key guidance is:

1. Items meeting the definition of an element are candidates for recognition. To be recognized, the item must be measurable - meaning a monetary amount can be determined with reasonable certainty or is reasonably estimable.
2. Risk, including uncertainty,[2] must be considered in developing recognition, measurement, and disclosure guidance. Uncertainty does not prevent recognition but may influence the choice of measurement approach, attribute, and method. (SFFAC 7)
3. Choice of measurement approach and attribute is made in particular standards based on the reporting objectives including the anticipated usefulness to decision makers of one approach versus the other. The measurement approach and attribute selected influence the timing of recognition of gains or losses arising from changes in asset and liability values. An example of these choices is that changes in the value of assets used in providing services may not be viewed as useful to decision makers who will not sell the assets. In contrast, information about changes in the value of assets held for sale may be useful.
4. Because of the above approach (a mixed-attribute model), existing standards vary with regard to the timing of recognition of gains and losses. So, a single recognition point for gains and losses cannot be described. The following examples may be helpful in thinking about recognition:
    a. Gains and losses on non-financial assets held for use (or to maturity) generally are not recognized until they are realized (that is, the asset is sold or disposed of) or a significant impairment occurs.
    b. Gains and losses on direct loans and loan guarantees are recognized when a direct loan or loan guarantee is issued based on expectations (best estimate rather than probability weighted expectations).
    c. Losses on short-term insurance coverage, such as property, are recognized when an insured event occurs and on long-term insurance, such as life-insurance, based on the net present value of expected cash flows.

[2] See page 9 for a discussion of 'uncertainty' as described by SFFAC 5.

d. Gains and losses on employee pensions and other post-employment liabilities are recognized through annual re-estimates (note: changes in discount rate changes are based on a minimum of five-year averages).

e. Gains and losses from long-term orders for specific goods or services are recognized in proportion to the provision of goods or services.

f. When there is uncertainty regarding incurrence of a loss from a past event or transaction, probability is considered. Probable[3] losses should be recognized. Factors that may overcome this include:

    i. An inability to reasonably estimate losses (the losses are not measurable) until a confirming event occurs
    ii. The cost exceeds the benefit of measuring probable losses

g. Losses from government-acknowledged events are recognized:

    i. Consistent with exchange transactions if the government procures goods and services
    ii. When an amount is due and payable to a beneficiary

h. Non-exchange transactions – such as SNAP (food stamps) – are recognized when an amount is due and payable.

The draft disclosure framework is presented on the following page. The draft framework describes treatment of an “item” – most standards will include guidance on aggregation or factors to consider regarding the level of detail appropriate to the item or class of item.

At the December meeting, I hope to receive your suggestions and input on the framework presented on the following page.

[3] “Probable” is “more likely than not.” (Note that an exception exists for losses in litigation where probable means “likely to occur.”)

Draft Risk Disclosure Framework

1. Note that – in addition to disclosures - the most important risks should be discussed in management's discussion and analysis (MD&A).
2. The nature and extent of risk disclosures should vary based on:
    a. The degree of measurement uncertainty[4] which is affected by factors such as:
        i. The length of time required to settle or liquidate the item
        ii. Complexity of the measurement method
        iii. Sensitivity to changes in assumptions
        iv. Potential variability of assumptions
        v. Sensitivity to nonperformance risk
    b. The quantitative and qualitative significance of the item
3. For items qualifying for recognition where there is significant measurement uncertainty disclosures[5] should provide:[6]
    a. If the item would be recognized but the amount to be recognized is not measurable, state that the amount cannot be estimated and is therefore not recognized. Also, describe the nature of the uncertainty/risk and the basis for determining that the amount is not estimable.
    b. For recognized items:
        i. The nature of the uncertainty/risk
        ii. If the estimate is a range of amounts rather than a specific amount, disclose the range and the relationship of the recognized amount to the range (for example, whether the recognized amount is a better estimate than the other amounts in the range or represents the minimum amount of the range)
    c. If necessary to understand the nature and magnitude of the risk:
        i. Specific risk factors[7] that may influence the (gain) loss, or the range of (gain) loss
        ii. A description of the method used to estimate the amount, including key assumptions
        iii. A range of possible amounts, if determinable,
        iv. Key terms of related contracts or agreements
        v. A sensitivity analysis, if feasible
        vi. Alternative measures of risk, such as fair value or the projection or timing of cash flows

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[4] The degree of measurement uncertainty is the likelihood that a potential event or change in condition can materially affect measurement.

[5] Disclosure of the basis of accounting may provide certain of this information in addition to other information that may help the reader to understand the nature and extent of further risk. In setting individual standards, the Board will consider specific needs that may go beyond current practices regarding the summary of significant accounting policies.

[6] Note that some of this information may be otherwise required by existing standards. Guidance regarding integration of disclosures (or appropriate modifications) will be considered in each specific standard. Specific standards also may include requirements for other disclosures beyond these risk disclosures to address unusual cases.

[7] "Risk factors" refer to the factors creating risk and those to which the ultimate outcome is sensitive.

vii. Maximum risk exposure, with appropriate narrative that aids in avoiding the misleading inference that there is more than a remote likelihood of a loss or gain of that amount

4. For items that do not meet the recognition criteria (without considering measurability) established in standards, but are contingencies where a past event or exchange transaction has occurred and the likelihood of further gains or losses is reasonably possible[8] (more than remote but less than probable), risk disclosures should provide[9]:
   a. The nature of the contingency and any relationship to recognized items (e.g., assets, liabilities, expenses, revenues)
   b. A reasonable estimate of the gain or loss exposure, range of gain or loss exposure, or a statement that the amount is not estimable.
   c. If necessary to understand the nature and magnitude of the risk:
      i. Specific risk factors, including financial and non-financial risks that may result in a gain or loss. Note that general risks common to most activities need not be addressed. For example, the risk of recessions or other broad economic cycles influencing outcomes should not be discussed.
      ii. an indication of the maximum risk exposure, with appropriate narrative that aids in avoiding the misleading inference that there is more than a remote likelihood of a loss or gain of that amount.

5. Certain exchange programs may be required or designed to be self-supporting and financed exclusively or principally[10] through revenues from non-federal sources and not through general revenues. For such programs, there may be a significant risk, based on known factors and trends, that future revenues will be insufficient to settle future program obligations. In such instances, disclosures should include information necessary to understand the nature and magnitude of the risk, and if known, potential measures to address the risk (such as through availability of loans).

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[8] These criteria are intended to be consistent with current disclosure requirements of reasonably possible contingent losses in SFFAS 5, but would enhance related risk disclosures from those presently in SFFAS 5. SFFAS 5 defines a past event or exchange transaction as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. An important distinction is that the uncertainty considered for contingencies relates to a loss that has already occurred (a past event such as an accident); not to a loss that may occur in the future (a future event such as a natural disaster that has not yet occurred).

[9] Such disclosures may relate to items where related amounts are recognized in the financial statements. For example, certain litigation contingencies may be recognized while others nay be only disclosed.

[10] Such programs may invest excess receipts in federal securities and receive intragovernmental interest revenue.

This general framework would be applied to individual projects. The individual projects would be expected to address questions such as:

1. When should recognition of the asset or liability occur?
2. What measurement approach, attribute, and methods are best suited to the particular circumstances? Recognition and measurement guidance tailored to the circumstances is needed.
3. Are amounts measurable in these circumstances?
4. Is it cost-beneficial to measure amounts?
5. Can specific guidance focus disclosures on the most important information? (for example, by excluding less risky arrangements, prevalent relationships (such as with state governments), or other broad risks)
6. Are different disclosure elements needed due to unique risk exposures?

Questions for the Board:

1. **Would you find a risk disclosure framework useful?**

2. **What suggestions do you have for enhancing the framework?**
    a. **Are there areas that should be clarified?**
    b. **Are there additions/deletions you would recommend?**

The following section reviews relevant standards and concepts. The material below informed the development of the draft framework and may be helpful as you consider the above questions.

Relevant Standards

Management's Discussion and Analysis

Statement of Federal Financial Accounting Standards 15, *Management's Discussion and Analysis* requires risk information:

> 3. MD&A should include forward-looking information regarding the possible future effects of the most important existing, currently-known demands, risks, uncertainties, events, conditions and trends. MD&A may also include forward-looking information about the possible effects of anticipated future demands, events, conditions, and trends. Forward looking information may comprise a separate section of MD&A or may be incorporated with the sections listed above.

SFFAC 3 describes more completely the purpose of the above requirement. Attachment 1 presents the related SFFAC 3 guidance and attachment 2 presents an excerpt from the Peace Corps' FY2012 Performance and Accountability Report (PAR). The Association of Government Accountant's Certificate of Excellence in Accountability Reporting (CEAR) program recognized the Peace Corps for having the "Most Comprehensive and Candid Presentation of Forward-Looking Information."

While management must discuss risks and uncertainties in MD&A, the financial statements, notes, and required supplementary information (RSI) also present information relevant to users in understanding risk. For example, the explanation of significant accounting policies discusses the use of estimates and other notes generally provide information – such as key assumptions – that may help the user assess uncertainties and reach conclusions about risk.

Contingencies

Risk of loss was addressed in SFFAS 5, *Accounting for Liabilities of the Federal Government*, regarding contingencies.

A **contingency** is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. An important distinction is that the uncertainty considered for contingencies relates to a loss that has already occurred (a past event such as an accident); not to a loss that may occur in the future (a future event such as a natural disaster that has not yet occurred).

SFFAS 5 provides for recognition of contingent liabilities and losses if all of these three conditions are met:

- A past event or exchange transaction has occurred (e.g., a federal entity has breached a contract with a nonfederal entity).
- A future outflow or other sacrifice of resources is probable (e.g., the nonfederal entity has filed a legal claim against a federal entity for breach of contract and the federal entity's management believes the claim is likely to be settled in favor of the claimant).
- The future outflow or sacrifice of resources is measurable (e.g., the federal entity's management determines an estimated settlement amount).

Further, SFFAS 5 requires certain disclosures regarding contingencies that are not probable (not recognized):

> 40. A contingent liability should be disclosed if any of the conditions for liability recognition are not met and there is at least a reasonable possibility that a loss or an additional loss may have been incurred. "Disclosure" in this context refers to reporting information in notes regarded as an integral part of the basic financial statements.

41. Disclosure should include the nature of the contingency and an estimate of the possible liability, an estimate of the range of the possible liability, or a statement that such an estimate cannot be made.

42. In some cases, contingencies may be identified but the degree of uncertainty is so great that no reporting (i.e., recognition or disclosure) is necessary in the general purpose federal financial reports. Specifically, contingencies classified as remote need not be reported in general purpose federal financial reports, though law may require such disclosures in special purpose reports. If information about remote contingencies or related to remote contingencies is included in general purpose federal financial reports (e.g., the total face amount of insurance and guarantees in force), it should be labeled in such a way to avoid the misleading inference that there is more than a remote chance of a loss of that amount.

For loss contingencies arising in pending or threatened litigation and unasserted claims, a contingent liability should be recognized when a future outflow or other sacrifice of resources is "likely to occur," a past event or exchange transaction has occurred, and the future outflow or sacrifice of resources is measurable. SFFAS 12 amended SFAFS 5 to provide this exception to the "more likely than not" threshold for recognition.

Direct Loans and Loan Guarantees

For both direct loans and loan guarantees, SFFAS 2 requires recognition of the present value of estimated net cash flows. The result is that losses (and gains) are recognized based on expectations at inception with periodic revisions rather than upon the occurrence of a credit event.

The full amount of direct loans and the face amount of loans guaranteed are disclosed. These represent the maximum exposure to loss but are generally considered remote.

Losses on Goods Made to Order or Specific Services (Exchange Transactions)

SFFAS 7, *Accounting for Revenues and Other Financing Sources,* provides guidance regarding losses on contracts for specific goods or services. In this case, losses are also based on expectations but losses are recognized over the life of a contract rather than at inception. SFFAS 7 provides:

36. Revenue from specific types of exchange transactions should be recognized as follows:
…
(b) When specific goods are made to order under a contract (either short- or long-term), or specific services are produced to order under a contract (either short- or long-term), revenue should be recognized in proportion to estimated total cost when goods and services are acquired to fulfill the contract. **If a loss is probable (more likely than not), revenue should continue to be recognized in proportion to the estimated total cost and costs should continue to be recognized when goods and services are acquired to fulfill the contract. Thus, the loss should be recognized in proportion to total cost over the life of the contract.** 5 [footnote 5 - This standard is an exception to the general principle of SFFAS No. 5, Accounting for Liabilities of the Federal

> Government, which, but for this exception, would require a loss on a contract to be recognized at the time when expected costs exceeded expected revenue. However, the expected loss must be disclosed: see the disclosure requirement in paragraph (d) below.]
> …
>
> 46 (d) the full amount of the expected loss when specific goods are made to order under a contract, or specific services are produced to order under a contract, and a loss on the contract is probable (more likely than not) and measurable (reasonably estimable).

The Board explained this exception as follows:

> The Board believes this exception is appropriate, because it provides a more accurate measure of the entity's net cost of operations during each reporting period than if the entire estimated loss were recognized in the single period when it was concluded that the loss was probable and measurable. The entire estimated loss, however, would be disclosed. (par. 152)

Social Insurance and Risk Assumed

In addition to loss recognition guidance, lessons may be drawn regarding uncertainty from the prospective information required regarding social insurance programs. SFFAS 17, Accounting for Social Insurance, explains the need to provide information helpful in assessing the ability "to raise resources from future program participants to pay for benefits proposed to present participants." Long-term projections are required but the uncertainty inherent in such projections led the Board to require that:

> All programs should provide sensitivity analysis appropriate for their particular circumstances. The objective of sensitivity analysis is **to illustrate how an estimate or projection would change if** assumptions, data, methodologies or other inputs change.

SFFAS 5 discusses the likelihood that federal insurance programs are generally designed to break even and the need to report, as "risk assumed," the present value of unpaid expected losses net of associated premiums, based on the risk inherent in the insurance or guarantee coverage in force." (par. 105) (Note that earlier reviews of insurance reporting showed that the SFFAS 5 vision has not been realized. The net expected losses currently are not reported for major insurance programs.)

Relevant Concepts

Definition and Recognition of Elements

Statement of Federal Financial Accounting Concepts (SFFAC) 5, *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements,* provides definitions of the elements of accrual-basis financial statements, basic recognition criteria, and discusses the effects of uncertainty. Portions of SFFAC 5 are presented as Appendix A to this memo for ease of reference.

SFFAC 5 defines five elements as follows:

> An **asset** is a resource that embodies economic benefits or services that the federal government controls.
>
> A **liability** is a present obligation of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.
>
> **Net position** or its equivalent, net assets, is the arithmetic difference between the total assets and total liabilities recognized in the federal government's or a component entity's balance sheet. Net position may be positive (assets greater than liabilities) or negative (assets less than liabilities).
>
> A **revenue** is an inflow of or other increase in assets, a decrease in liabilities, or a combination of both that results in an increase in the government's net position during the reporting period.
>
> An **expense** is an outflow of or other decrease in assets, an increase in liabilities, or a combination of both that results in a decrease in the government's net position during the reporting period.

The two basic recognition criteria are:

(1) the item must meet the definition of an element and
(2) the item must be measurable.

Measurable means a monetary amount can be determined with reasonable certainty or is reasonably estimable. An item that meets the definition of an element but is not measurable is a candidate for disclosure in the notes to financial statements or as supplementary information.

SFFAC 5 also discusses uncertainty:

> 57. Uncertainty about economic activities and results is pervasive. Uncertainty about whether a transaction or other event gives rise to the existence of an element means that judgment often is required as to whether the item possesses the essential characteristics of an element and therefore meets the relevant definition. Items that are judged to meet the definition of an element are candidates for recognition provided they are measurable—that is a monetary amount can be determined with reasonable certainty or is reasonably estimable. Items that, because of uncertainty, do not meet the basic recognition criteria may be candidates for disclosure.
>
> 58. In addition to the basic recognition criteria, decisions whether to recognize or disclose an item take into account considerations that also include uncertainties. These considerations are measurement of an appropriate attribute, which may include an assessment of the probability of future flows of economic benefits or services, and assessments of the materiality of the item and the benefit versus the cost of recognizing it. [Footnote 10 - As discussed in paragraph 7, measurement issues, probability

> assessments, and other considerations for recognition decisions beyond the basic recognition criteria are not addressed in this Statement. The Board intends to address those issues in future pronouncements. In the meantime, existing standards for those issues continue to apply.
>
> 59. Uncertainty increases the costs of financial reporting, particularly the costs of recognition and measurement. Also, reassessments and restatements may be required if items previously reported as expenses or revenues, or not reported, are later found with benefit of hindsight to have the essential characteristics of assets or liabilities. [Footnote 11 - This Statement does not change existing standards concerning whether new information should result in restatement of previously reported information or should be treated prospectively as a change in estimate.] It may be possible to reduce uncertainty by exerting greater effort or spending more money, but it also may not be worth the added cost. As discussed in paragraph 6, the exercise of judgment may be necessary, but this Statement does not require certainty.

Measurement

Choices regarding measurement approach – initial or remeasured amounts – and measurement attribute affect the timing of loss recognition as well. SFFAC 7, *Measurement of the Elements of Accrual-Basis Financial Statements in Periods After Initial Recording*, describes these two approaches and defines several measurement attributes. Two measurement attributes are most relevant to consideration of loss recognition:

> Fair value is the amount at which an asset or liability could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.
>
> Settlement amount is the amount at which an asset can be realized or a liability can be liquidated.

Current federal standards for loss recognition focus more heavily on settlement amounts than on fair value. For example, SFFAS 2 requires estimated cash flows to be discounted at the risk-free rather than the market rate.

Questions for the Board:

1. **Would you find a risk-reporting framework useful?**

2. **What suggestions do you have for enhancing the framework?**
   a. **Are there areas that should be clarified?**
   b. **Are there additions/deletions you would recommend?**

30. Use of Estimates—MD&A should concisely explain the use of estimates where that is important to understand issues discussed in MD&A, such as the major risks and uncertainties mentioned in paragraph 31 or the key forward-looking information discussed in paragraph 32. For example, the future expenses and the long term obligations[11] associated with major social insurance programs such as Social Security and Medicare should be discussed in MD&A of the financial report of the relevant reporting entities. These estimates are inherently imprecise and sensitive to several assumptions. Such factors would, therefore, be worthy of discussion in MD&A.

31. Current Demands, Risks, Uncertainties, Events, Conditions, and Trends—MD&A should describe important existing, currently-known demands, risks, uncertainties, events, conditions and trends--both favorable and unfavorable--that affect the amounts reported in the financial statements and supplementary information. The information called for by this paragraph and paragraph 32 is closely related. Preparers should combine the presentation of this information in whatever fashion is appropriate under the circumstances that apply to the reporting entity.

32. Future Effects of Current Demands, Risks, Uncertainties, Events, Conditions and Trends—The discussion of these current factors should go beyond a mere description of existing conditions, such as demographic characteristics, claims, deferred maintenance, commitments[12] undertaken, and major unfunded liabilities, to include a discussion of the possible future effect of those factors. (This discussion of possible future effect of existing, currently-known factors is required pursuant to the standards in *Standards for Management's Discussion and Analysis*.)

33. Future Effects of Anticipated Future Events, Conditions, and Trends—To the extent feasible and appropriate, the discussion should also encompass the possible future effects of anticipated future events, conditions, and trends, although this additional information is not required by the standards for MD&A.[13] For example, MD&A might discuss the possible future effect of anticipated trends in the cost of inputs that may significantly affect future output costs. Other examples include the future effect of anticipated demographic trends, such as declining mortality rates, and the future effects of potential changes in behavior that may be caused by changes in Government programs. Such behavioral changes can greatly affect the future cost of some Governmental programs. For example, such effects can arise if subsidized insurance encourages the people or entities most at risk to participate in insurance programs ("adverse selection") or encourages risky behavior ("moral hazard").

34. An anticipated condition such as a prospective demographic trend or potential behavioral change may not, in itself, constitute a contingency or assumed risk that must be recognized, disclosed, or reported pursuant to SFFAS 5. Likewise, it may not be something that must be discussed in MD&A pursuant to the *Standards for Management's Discussion and Analysis*. Even so, if there is a reasonable prospect of a major effect on the reporting entity due to the anticipated condition, then MD&A should include this information to the extent feasible.

35. Where appropriate, the description of possible future effects of both existing and anticipated factors should include quantitative forecasts* or projections[*]. Such forecasts or projections can show the implications of existing policies and conditions in light of anticipated or reasonably possible future conditions. For example, for MD&A of the Government-wide financial statements, long-term projections of the deficit or surplus may be important indicators of financial condition and sustainability. For insurance programs, this kind of projection—which

actuaries sometimes call "dynamic analysis"—would consider possible interactions among current assets, reserves, policies in force, expected future business or populations covered by the insurance, and potential behavioral changes such as adverse selection and moral hazard, if appropriate. Some programs are inter-related among themselves and/or with conditions in the private sector. For example, flood insurance programs and disaster assistance programs may be related to such an extent that analysis of programs individually would not provide a good idea of their potential impact on the Government. To the extent feasible, projections should consider the potential implications of such relationships.

36. The future implications of current or anticipated factors often can better be expressed as a range of possible outcomes and associated probabilities than as a single point estimate. Sometimes the implications may best be discussed in nonfinancial as well as financial terms. Forward-looking information can be highly useful, but management should avoid turning this part of MD&A into mere "lobbying" for more budgetary authority.

37. Understanding Financial Reporting—MD&A should make federal financial statements understandable to a wide audience, not just to users who are specialized analysts or members of the entity's management. There may be many potential sources of misunderstanding. Management should try to identify those sources of misunderstanding that may be important and deal with them in MD&A. Some of these are general and pervasive, such as those that may arise in the minds of new users of federal financial statements. New users may have been budget-oriented rather than accrual-accounting oriented, or may be accustomed to seeing financial statements prepared on the basis of private sector accounting standards. A general discussion and reference to the Statement of Financing and the basis of accounting footnote may be sufficient for such users, although more specific treatment may be appropriate where the resulting differences in the reported amounts may be important to the understanding of users.

38. Emphasis that may be given in the financial statements to the costs of suborganizations and programs may require cautionary discussion of the relevance and utility of cost information. When MD&A itself discusses the cost of program outcomes, the problems of associating costs with outcomes may need to be discussed. In addition, the possible imprecision of cost information should be mentioned when it could be relevant to users' understanding. Similarly, any account-level discussion in MD&A of variations, balances, and amounts in the basic and stewardship information made in response to paragraphs 26 and 27 may require mention of the imprecision of amounts cited.

39. Exceptions and disclaimers in the auditor's report should be mentioned in MD&A, and management should respect the auditor's professional judgment if management expresses disagreement with auditor's findings. (This does not mean that management must refrain from stating views that differ from the auditor's; e.g., different views as to whether a weakness in control is material.) There may be other sources of misunderstanding. Management should be sensitive to them and guide the user to a better understanding when the problem could significantly affect the conclusions and judgments of substantial numbers of users.

Endnotes

[11]The term "obligations" is used here in the customary sense, not as it is used in budgetary accounting.

[12]The term "commitments" is used here in the customary sense, not as it is used in budgetary accounting.

[13]Some projections that could involve consideration of anticipated factors would be presented as required supplementary stewardship information pursuant to the standards exposed for comment in FASAB's exposure draft Accounting for Social Insurance, February, 1998.

Looking Forward

Throughout its history, the Peace Corps has adapted and responded to emerging issues, while remaining focused on its mission and core goals. The agency regularly reviews and modifies its operations to proactively address the changing conditions in which Volunteers operate through innovative and new approaches. The agency utilizes its performance management framework to sustain the gains it has made to build a stronger Peace Corps that is well-equipped to respond to the challenges of the 21st century.

Safety and Security of Volunteers

The economic, political, and environmental conditions in many of the countries where the Peace Corps operates can be fragile. Improving local conditions through development is central to the agency's mission and as Volunteers work to achieve that mission, they often serve in communities where the potential for crime or conflict exists.

The safety and security of Volunteers is the agency's highest priority. Volunteers commit themselves to serving their communities; in turn, the agency is committed to maximizing Volunteers' well-being, allowing them to focus on their assignments and ensuring that they return home safely. A safe and productive service for every Volunteer is central to Peace Corps' ongoing success.

Peace Corps' approach to Volunteer safety and security is multi-faceted. Responsibility is shared among staff, Volunteers, and local communities. The agency ensures the safety and security of Volunteers through prevention and response strategies, including conducting thorough site development and monitoring; providing in-depth Volunteer training; regularly reviewing and improving safety and security systems; implementing effective incident response and emergency action procedures; collecting and reporting incident data in a timely fashion; and maintaining an active awareness of the local security environment.

As local security environments continue to evolve, the agency will work closely with embassy staff and the governments of host countries to identify threats to Volunteers and respond appropriately. As situations change, the agency will adjust its safety and security strategies to best protect its Volunteers.

The agency has taken decisive action in a number of instances to aggressively and quickly respond to changing security circumstances. For example, despite the high need in the Sahel region of Africa for the services provided by Volunteers, programs have been closed (Mauritania) and suspended (Mali and Niger) in recent years due to political instability and a deteriorating environment for development workers. In FY 2012, operations in the Northern Triangle of Central America (El Salvador, Guatemala, and Honduras) were realigned as a result of an increasingly insecure environment indicated by crime incident data and feedback from Volunteers in the area. Other organizations in the area followed Peace Corps' lead in reconsidering their safety and security systems, particularly in Honduras. Volunteer activities are currently suspended in Honduras, and the agency has implemented measures in El Salvador and Guatemala to help reduce the risk for crime for Volunteers, including: requiring Volunteers to live with host families for their full term of service; creating regional offices; appointing regional Volunteer leaders; and providing Volunteers with safer modes of transportation.

With the passage of the Kate Puzey Peace Corps Volunteer Protection Act of 2011, a number of the reforms the Peace Corps has put into place over recent years to better protect and support Volunteers have been codified into law. Continuing to implement the law will be a primary focus for the agency in the coming years.

Changing Conditions in Host Countries

Volunteer projects are reviewed regularly by the agency and host country partners in order to address changing local needs within the context of evolving local and global trends.

Increasingly the Peace Corps is addressing food insecurity, a critical global concern. The increased need for basic resources, resulting from the pressures of an expanding world population and climate change, is and will remain a major development challenge. The impoverished individuals and communities that rely on the land through rain-fed agriculture, herding, and other subsistence activities are particularly affected by a changing environment. As a result of diminished agricultural productivity, communities face poverty, hunger, and malnutrition, which exacerbate other development issues, including poor health, low education, and urban migration.

Volunteer activities in support of increased food security are expanding to address this critical development challenge. Across the world, Volunteers are promoting sustainable methods for local people to increase agricultural productivity, address water shortages, and feed their families. In support of the President's Feed the Future initiative (www.feedthefuture.gov) and in partnership with the U. S. Agency for International Development, the Peace Corps will equip more than 1,000 Volunteers to address food security needs across the world and properly support, monitor, and evaluate their contributions to this initiative.

The new program in Nepal is a prime example of the agency's work to increase food security in vulnerable populations. In collaboration with the President's Feed the Future initiative and the U.S. Agency for International Development, food security Volunteers in Nepal will target the needs of the most marginalized groups in the country, including rural women and children, religious and ethnic minorities, and members of lower castes, to improve food security.

Competition for Talented Americans

The Peace Corps is a premier service opportunity for Americans who want to make a difference in the world—attracting the best and the brightest to serve in challenging conditions to introduce tangible and sustainable improvements in lives of those with whom they live and work and to promote mutual understanding around the world. In return, Volunteers gain skills and experiences that enrich their lives by increasing their competitiveness in the global marketplace and providing them with lifelong friendships both with other Volunteers and with local counterparts, beneficiaries, and host families. With over 210,000 individuals having served as Volunteers since 1961, many Americans have a relative, teacher, doctor, or friend who served. A significant number of international development and foreign policy specialists received their initial overseas training in the field as Peace Corps Volunteers.

The application process to become a Volunteer is competitive. The agency aggressively recruits Volunteers who have the skills, experience, and maturity to successfully meet the skill needs of local communities.

While the Peace Corps remains a top service choice, international and domestic service opportunities have expanded considerably in recent years, increasing the competition for talented Americans. Service-minded individuals now have several alternatives from which to choose, including those requiring a shorter time commitment. The challenge is most acute in recruiting individuals with highly technical skills and multiple years of work experience. The two-year time commitment, limited financial benefits, and challenging living conditions of Peace Corps service can make other volunteer and employment opportunities more attractive to some.

The agency will continue to address this challenge by promoting the unique benefits of Peace Corps service to targeted groups and experimenting with the service delivery model to make the agency more competitive.

The Peace Corps Response (PCR) program is one example of agency innovation. The PCR program (www.peacecorps.gov/response) offers seasoned professionals the opportunity to undertake short-term, high-impact assignments in various programs around the world. Positions average six months in length and are designed to address development needs as identified by the host country. While PCR historically was only available to eligible returned Volunteers, in FY 2012, the agency piloted an expansion of the program to all Americans with at least 10 years of work experience. This change in the PCR program will make the agency a more competitive option for experienced Americans interested in Peace Corps service.

> Life in the Peace Corps will not be easy. There will be no salary and allowances will be at a level sufficient only to maintain health and meet basic needs. Men and women will be expected to work and live alongside the nationals of the country in which they are stationed—doing the same work, eating the same food, talking the same language.
> But if the life will not be easy, it will be rich and satisfying. For every young American who participates in the Peace Corps—who works in a foreign land—will know that he or she is sharing in the great common task of bringing to man that decent way of life which is the foundation of freedom and a condition of peace.
>
> *—President John F. Kennedy*

Demonstrating Impact

Every day, Volunteers improve the lives of local people and promote peace and friendship between America and host communities. The positive impact of Volunteers can be seen by visiting any Volunteer site. However, demonstrating the aggregate impact of Volunteers over the years has been challenging, particularly in the complex social and economic environments where Volunteers live and work. Large-scale data collection is complicated and costly, and baseline data is rarely collected due, in part, to resource constraints.

Demonstrating the impact of the work of Volunteers has gained significant momentum over the last few years. The agency is strengthening its monitoring and evaluation (M&E) systems to improve Volunteer programs and better articulate the value of the Peace Corps to our overseas partners and the American public. Considerable progress in building an M&E culture was made in FY 2012, and several improvements are planned for future years. Through the Focus In/Train Up strategy, for example, Volunteers will be reporting on standard sector indicators beginning in FY 2013, and the results will be aggregated in summary reports on the activities of Volunteers worldwide.

A new agencywide evaluation framework that will guide the agency's evaluation work will be completed in FY 2013. The framework codifies the agency's current best practices and adds new elements to set the direction for the future. The framework successfully connects the evaluation work being conducted in disparate offices throughout the agency into one coherent system with a clear delineation of the roles and responsibilities of both headquarters offices and overseas posts. Host Country Impact Studies—which provide impact information directly from host country counterparts and beneficiaries on previous Volunteer work—will continue to be a critical component of agency efforts to demonstrate impact. A new counterpart survey will be piloted in FY 2013 to directly collect viewpoints from the local partners with whom Volunteers work. Baseline data collection has also been included in the new country entry guidance.

These planned activities to strengthen M&E are supported by the agency's existing structures for data-driven decision making. The agency holds quarterly performance review sessions to monitor progress on agency goals, identify opportunities for improvement, and share best practices. The Annual Volunteer Survey provides rich information on Volunteer satisfaction and perceptions, and the agency analyzes results to improve operations. The annual Country Portfolio Review also includes impact data and informs the countries where Volunteers serve.

Redevelopment of Legacy Technologies

As the Peace Corps builds on its performance management culture, there has never been more demand for high-quality data to inform decision making. At the same time, the agency currently maintains several legacy applications to manage information at headquarters and overseas posts that do not fully meet the evolving needs of the Peace Corps. Notably, the agency does not have a centralized data warehouse to store and report on critical current and historical programmatic data, reducing its utility to key decision makers. Additionally, as a small federal agency, the Peace Corps does not always benefit from economies of scale in the procurement of major technologies, and new acquisitions take up a disproportionate share of the budget.

The maintenance of aging systems will be a challenge in the future, and the agency is working to modernize both its core systems and reporting applications. The agency is moving increasingly toward externally hosted solutions, common platforms for core systems, and open-source software to retire legacy systems and support the evolving data needs of the agency. The redesign and modernization of the Volunteer Reporting Tool is one major agency effort to modernize a core system. Work on the project commenced in FY 2012 and will be completed by FY 2014. The redesigned reporting tool will run on a common platform, provide centralized storage for Volunteer project data, and allow for more standardized reporting on Volunteer activities. These enhancements will save significant time in report preparation on the part of Volunteers and staff and will improve the accuracy of information on the activities of Volunteers.

Collaboration with Other Government Agencies and Strategic Partners

The Peace Corps collaborates with other U.S. government agencies and strategic partners to promote shared development efforts and enhance the impact of Volunteers. Notably, the agency has worked closely with the President's Emergency Plan for AIDS Relief (PEPFAR), the U.S. Agency for International Development in support of Feed the Future, and various international nongovernmental organizations. Through these strategic partnerships, the Peace Corps leverages training and programmatic resources and Volunteers expand the reach of partners' development efforts to the local level. As the development community continues to engage strategic partners to address difficult development challenges, the agency will continue to search out mutually beneficial relationships with a broad range of development actors.

Collaboration with strategic partners in development is a key opportunity for the agency moving forward—helping to leverage the taxpayers' dollars to achieve the greatest impact. At the same time, maintaining the agency's independence in shared development endeavors remains critical. While collaborating closely with others to achieve the Peace Corps mission, the agency will maintain its independence to ensure that its unique people-to-people approach to development flourishes.

Global Health Service Partnership: Boosting Training for Health Professionals in Host Countries

The Peace Corps, the President's Emergency Plan for AIDS Relief (PEPFAR), and the Global Health Service Corps launched the Global Health Service Partnership, a public-private partnership to place nurses, physicians, and other health professionals as adjunct faculty in medical and nursing schools in host countries.

This partnership will build capacity in host country medical and nursing education programs to address health professional shortages. Under the new partnership, American medical professionals will serve one-year terms as Peace Corps Response Volunteers. Volunteers will primarily function as medical or nursing educators, working alongside local faculty counterparts to teach and transfer clinical skills. Volunteers will also participate in direct medical care in the process of educating and mentoring local students and practitioners.

The first Volunteers are expected to begin service in FY 2013.

Development of the FY 2015-2018 Strategic Plan

The development of the agency's strategic plan for FY 2015-2018 represents a major opportunity to set the agency's performance improvement agenda for the next several years. The development of the new plan commenced this year, and the agency will engage the Peace Corps community (headquarters and overseas staff, Volunteers, constituency groups, returned Volunteers, and partners), the White House, Congress, and the public at large in discussions over the agency's future strategic direction. The new plan will fully comply with the GPRA Modernization Act of 2010 (GPRA-MA) and will be finalized in February 2014.

The Peace Corps is actively involved in a variety of forums to discuss implementation of GPRA-MA and share best practices, including the Performance Improvement Council and the Small Agency Council's Performance Improvement Committee. The agency will continue to work closely with the Office of Management and Budget (OMB) and the broader performance management community to discuss how best to advance implementation of GPRA-MA.

To learn more about the Peace Corps, please visit our website: www.peacecorps.gov

Statement of Federal Financial Accounting Concepts 5: Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements

Summary - Objective of this Statement

Elements of financial statements result from an entity's transactions or other events that affect the entity. Elements are the "building blocks" of financial statements-the broad classes of items from which the statements are constructed. This Statement defines five elements of accrual-basis financial statements of the federal government. Items that meet the definitions also are elements of accrual-basis financial statements of the relevant component entity. The elements are defined as follows:

An ***asset*** is a resource that embodies economic benefits or services that the federal government controls.

A ***liability*** is a present obligation of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

Net position or its equivalent, net assets, is the arithmetic difference between the total assets and total liabilities recognized in the federal government's or a component entity's balance sheet. Net position may be positive (assets greater than liabilities) or negative (assets less than liabilities).

A ***revenue*** is an inflow of or other increase in assets, a decrease in liabilities, or a combination of both that results in an increase in the government's net position during the reporting period.

An ***expense*** is an outflow of or other decrease in assets, an increase in liabilities, or a combination of both that results in a decrease in the government's net position during the reporting period.

This Statement establishes two basic recognition criteria that an item must meet to be a candidate for recognition in the body of a financial statement: (1) the item must meet the definition of an element and (2) the item must be measurable, meaning a monetary amount can be determined with reasonable certainty or is reasonably estimable. An item that meets the definition of an element but is not measurable is a candidate for disclosure in the notes to financial statements or as supplementary information.

Meeting the basic recognition criteria is a necessary but not a sufficient condition for recognition. Additional considerations for a recognition decision are measurement of the candidate for recognition and assessments of the materiality and benefit versus cost of the amount measured. Measurement entails selection of an appropriate attribute, such as historical cost, fair value, or expected value, and application of a measurement method. Measurement may require the use of estimates or approximations and, for items that meet the definition of an asset or a liability, an assessment of the probability that future inflows or outflows of economic benefits or services will result from the item.

This Statement includes a discussion of the effects of uncertainty on financial reporting but does not otherwise address the assessment of probabilities or other measurement issues. The Board intends to address those considerations for recognition decisions in future pronouncements. In the meantime, this Statement does not change existing standards for assessing probabilities or for selecting the appropriate measurement attribute, which the Board expects will continue to be based on the reporting objectives, qualitative characteristics, and cost-benefit constraints applicable to financial information.

Elements and Recognition

2. The term *elements* refers to broad classes of items, such as **assets** and **liabilities**, that comprise the building blocks of financial statements. Components of those broad classes, such as cash, investments, and debt instruments, may meet the definitions of elements but are not elements as the term is used in this Statement. Instead, they are called *items* or by descriptive names. This Statement focuses on the broad classes and their characteristics instead of defining particular assets, liabilities, or other items. Notes to financial statements generally are considered an integral part of financial statements, but they are not elements. They serve different functions, including amplifying or complementing information about items reported in the body of financial statements.

3. The elements of accrual-basis financial statements defined in this Statement (paragraphs 18 through 56) are assets, liabilities, **net position**, **revenues**, and **expenses**. The definitions of assets and liabilities derive from the essential characteristics of those elements. The definitions of net position, revenues, and expenses derive from the definitions of assets and liabilities.

4. The terms ***recognition*** and *recognize* refer to the process of formally recording or incorporating an element into the financial statements of an entity. Recognition comprises depiction of an element in both words and numbers, with the amount included in the totals of the financial statements. For an asset or liability, recognition involves recording not only acquisition or incurrence of the item but also later changes in it, including changes that result in removal from the financial statements.

Concepts

Recognition

Basic Recognition Criteria

5. Basic recognition criteria are the conditions an item should meet in order to be a candidate for recognition in the financial statements. The basic recognition criteria established in this Statement are (a) the item meets the definition of an element of financial statements and (b) the item is **measurable**. As used in this Statement, the term *measurable* means that a monetary amount can be determined with reasonable certainty or is reasonably estimable.

6. The existence or measurability (or both) of many assets, liabilities, and other elements may not be certain, but this Statement does not require certainty. Uncertainty and its effects on financial reporting are discussed in paragraphs 57 through 59. Conclusions about whether an element exists and is measurable may require judgment based on the available evidence.

Additional Considerations for Recognition Decisions

7. Meeting both of the basic recognition criteria established in paragraph 5 is a necessary but not a sufficient condition for recognition. Additional steps are necessary before a recognition decision can be made. For example, a candidate for recognition needs to be measured. **Measurement** of an item entails the selection of an appropriate attribute to be measured, such as historical cost, fair value, or expected value, and application of a measurement method. Measurement may require the use of estimates and approximations as well as an assessment, in a manner consistent with the attribute being measured, of the probability that future inflows or outflows of economic benefits or services will result from the item. Recognition decisions also incorporate the results of assessments of the materiality and benefit versus cost of recognizing the item measured. Thus, it is possible that an item that meets the basic recognition criteria would not be recognized due to measurement, materiality, or cost-benefit considerations.

8. This Statement establishes the basic recognition criteria for elements but does not address these additional considerations for recognition decisions. The Board intends to establish concepts and standards for these additional considerations in future pronouncements. In the meantime, this Statement does not change existing standards for measurement or for assessing probabilities. The Board expects that the selection of an appropriate measurement attribute in specific circumstances will continue to be based on the reporting objectives, **qualitative characteristics**, and cost-benefit constraints applicable to financial information.

9. An item that meets the appropriate definition of an element is an asset, liability, revenue, or expense, even if it is not recognized in the accrual-basis financial statements because, for example, it is not measurable or its amount is not material. Unrecognized elements are candidates for disclosure in the notes to financial statements or as supplementary information.

Definitions Of Elements

Applicability of Current Conditions, Including Current Law

17. Assessments of whether an item meets the definition of an asset, liability, revenue, or expense are based on conditions that exist at the reporting date, including current law, because all elements of accrual-basis financial statements are based on transactions or events that already have occurred. Therefore, if an item meets (or does not meet) the definition of an element under the conditions in effect at the reporting date, the power of the government to subsequently change those conditions does not eliminate (or create) an element at the reporting date. For example, if an item meets the definition of a liability at the reporting date, the power of the government to subsequently change the law so that the item no longer meets the definition does not eliminate the existence of the liability at the reporting date.

Assets

Definition of an Asset

18. An asset is a resource that embodies economic benefits or services that the federal government controls.

19. The definition of an asset addresses only whether an asset exists. It does not address whether the asset is measurable and, if so, how it should be measured or whether or when it should be recognized in the federal government's or a component entity's balance sheet. Nor does the definition address whether or when the economic benefits or services embodied in an asset will be used. Basic recognition criteria for all elements of accrual-basis financial statements are set forth and discussed in paragraphs 5 through 9. Those paragraphs also indicate that measurement issues and other considerations for recognition decisions will be addressed in future pronouncements. In addition, paragraph 6 acknowledges the possibility of uncertainty about whether an item meets the definition of an element and the need for judgment based on the available evidence. However, this Statement does not establish a threshold to be assumed in applying judgment.

20. The definition of an asset derives from the nature of assets-that is, their **essential characteristics**. An essential characteristic of an asset is one that is inherent to all assets and, therefore, without it an asset would not exist. Paragraphs 21 through 35 highlight and discuss those characteristics. Also discussed are certain characteristics that are common to many assets but not to all assets. As such, those characteristics are not essential, but they may provide additional evidence that an asset exists.

Essential Characteristics of Assets

21. The federal government needs financial, economic, human, and other resources to help it achieve its mission. In this context, the term *resource* means "a useful or valuable possession or quality of a country, organization or person" [4] or a "means of supplying a want." [5] The government has numerous resources. However, those resources are not assets unless they have the essential characteristics of assets and, therefore, meet the definition of assets in paragraph 18.

22. To be an asset of the federal government, a resource must possess two characteristics. First, it embodies economic benefits or services that can be used in the future. Second, the government controls access to the economic benefits or services and, therefore, can obtain them and deny or regulate the access of other entities.

23. To illustrate the distinction between a resource that is an asset and one that is not, the federal government may obtain economic benefits or services from a resource but be unable to deny or regulate the access of other entities to those benefits or services. If so, the resource is not an asset of the federal government. For example, outer space is a natural resource from which the federal government can obtain economic benefits. However, outer space is not an asset of the federal government because the government cannot deny or regulate the access of others. In contrast, natural resources under federal lands qualify as federal government assets because the government can obtain the economic benefits and regulate the access of other entities as provided under federal law. Such natural resources are assets of the federal government even if they are not measurable and therefore are not candidates for recognition in the financial statements.

24. In addition to the two essential characteristics identified in paragraph 22, many resources have other features that help identify them as assets. For example, they may be acquired at a cost and owned by the federal government. However, those features are not characteristics of all assets. Whereas access to economic benefits or services often is obtained through legal ownership of the underlying item of property, legal rights to economic benefits or services can be obtained without ownership of the property-for example, under certain lease arrangements.

25. The federal government's resources often are tangible and exchangeable, and the government

often has legally enforceable rights of access to the resulting benefits. But the absence of those features is not sufficient to preclude an item from qualifying as an asset. For example, an intangible resource, such as an easement on property, is an asset if the federal government can benefit from it and regulate or deny the access of other entities. A resource may embody economic benefits even though the federal government cannot exchange it or sell it-for example a machine that continues to provide a needed service even though there is no market for the machine. Similarly, the fact that the government's ability to access or use a resource is not legally enforceable does not mean that the resource is not an asset, if the government nevertheless can obtain the economic benefits or services it embodies and deny or regulate other entities' access to or use of those economic benefits or services.

Economic Benefits or Services

26. A characteristic possessed by all assets is the ability to provide economic benefits or services. Some sources use the terms *economic benefits* and *services* (or *service potential*) interchangeably. However, as used in this Statement, economic benefits may result in inflows of cash, cash equivalents, goods, or services to the federal government, whereas the services embodied in an asset may benefit the government in other ways. For example, assets such as public parks, museums, and art galleries often provide recreational, educational, and research opportunities to the public at no charge or for a reduced fee or voluntary contribution, thereby assisting the federal government to achieve its objectives and meet its mission to provide public services.

27. The economic benefits or services that a property can provide can be distinguished from the property itself, whether it is tangible or intangible, such as a right. Not all properties embody economic benefits or services and the assumption that a particular type of property will always be an asset is not justified. For example, whereas equipment normally is expected to provide economic benefits or services, sometimes it has become unusable and has no scrap value. If so, it no longer embodies economic benefits or services and does not meet the definition of an asset.

28. The economic benefits or services embodied in resources may be shared by the government and another entity through specific arrangements. For example, the government and another entity may enter into a joint venture and share an interest in the resources committed to the joint venture. If so, each party may possess assets comprising its respective share of the benefits or services. Similarly, lease agreements unbundle the economic benefits or services embodied in leased property and may, for example, give the lessee the right to hold and use the property and the lessor the right to receive rentals and any residual value. Thus, both parties may have assets corresponding to their respective rights.

Control by the Federal Government

29. The second essential characteristic of an asset is control, which refers to the *ability* of the federal government to obtain the economic benefits or services embodied in a resource and to deny or regulate the access of others. It is possible that the government does not actively *exercise* control. Nevertheless, as long as the government currently has the ability to exercise control, the item is an asset of the government. In exercising control of the economic benefits or services, the government may, depending on the nature of the resource, hold the resource; exchange it; use it to obtain cash, cash equivalents, goods, or services; exact a price for other entities' use of the economic benefits or

services; or use it to settle liabilities. Many resources are subject to certain legal or other external constraints, such as public land subject to preservation requirements. Such restrictions on the use of a resource do not negate the government's control of the economic benefits or services embodied in the resource.

30. The ability of the federal government to control access to the economic benefits or services embodied in a resource normally stems from legal rights and may be evidenced by title deeds, contractual agreements, possession, or other devices that protect the government's interests. However, legal enforceability of a right is not a prerequisite to the establishment of control of access to economic benefits or services, because the government may be able to exercise control in some other way.

31. Possession or ownership of a resource normally entails control of access to the economic benefits or services embodied in it, but that is not always the case. Whereas control of access is an essential characteristic of an asset, possession or ownership is not. For example, the government may grant another entity, acting as an agent of the government, physical possession of goods for sale and retain the right to receive the proceeds of sale. The goods are assets of the government because it controls access to the economic benefits embodied in the goods. The agent has physical possession of the goods, but they are not the agent's assets because it does not control access to the economic benefits. Also, as discussed in paragraph 27, through a lease arrangement the government may control access to the economic benefits or services embodied in a resource that it does not own.

32. Sometimes the federal government cannot control the economic benefits or services that it obtains from a resource because it cannot deny or regulate the access of other entities. In those circumstances, the resource does not meet the definition of an asset of the federal government. Public goods are an example. Public highways provide economic benefits to the entities that use them. However, they are assets only of the entity that has the capacity to control their use or regulate other entities' access to them by, for example, the use of tolls or other restrictions. Similarly, natural resources, such as air and water do not qualify as assets of the federal government when it has only general access to them along with all other entities, even if the government has incurred costs to help clean the environment.

33. The federal government obtains most of its resources from cash or credit transactions. The government may acquire resources in exchange for other resources or for an obligation to transfer resources or provide services in the future, or resources may result from the exercise of the government's powers, such as, for example, the imposition of taxes, penalties, fines, and forfeitures. Government resources also may result from events such as accretion and discovery.

34. Implicit in the definition and essential characteristics of assets is that the event giving rise to the government's ability to control access to the economic benefits or services embodied in a resource must have occurred. The government's intent or ability to acquire a resource in the future does not create an asset. For the resource to qualify as an asset, the government already must have acquired the resource or otherwise obtained access to the economic benefits or services it embodies to the exclusion of other entities. For example, the mere existence of the government's power to tax is not an asset because, until the government has exercised that power by imposing a tax and has access to benefits by virtue of completion of a taxable event, no event has occurred to generate resources and there are no resulting economic benefits that the government can control and use in providing programs and services.

35. Once acquired, a resource that meets the definition of an asset continues to be an asset until the

government transfers it to another entity or uses it up, or until some other event or circumstance destroys the economic benefits or services previously embodied in the resource or removes the government's ability to obtain them and deny or regulate the access of other entities.

Liabilities

Legal Framework

36. The federal government is governed by and operates within a framework of laws. Thus, a federal liability must have its foundation in law. Some federal liabilities result from discrete actions of the government that are authorized by law but are not explicitly required by law. Examples are liabilities that result from contractual arrangements, including amounts borrowed, amounts owed for purchased goods and services, and liabilities for providing goods or services to entities that have paid for them in advance. Other liabilities flow directly from a law and its implementing regulation that specifically require the federal government to provide assets to another entity. Examples include formula grants and subsidies, claims owed under workers' compensation, and amounts owed for environmental clean-up.

37. Although all federal liabilities have their foundation in law, some liabilities are construed from the totality of the conditions and facts of a particular situation, rather than from specific legal or regulatory requirements. In those circumstances, the government should weigh the totality of the facts of the situation against the definition and essential characteristics of liabilities (discussed in paragraphs 41 through 48) and make an informed judgment as to whether or when a liability has been incurred. Factors that may affect that conclusion include relevant aspects of the legal framework within which the government is constituted, whether the government has an agreement or understanding with another entity concerning the nature and amount of the government's obligation and the timing of settlement, and decisions or actions in previous situations that are relevant precedents.

38. Settlement of a federal liability often is legally enforceable, as is the case, for example, with contracts. However, laws that create or support federal liabilities do not always confer legally enforceable rights on recipient entities. Legal enforceability may provide additional evidence that a liability exists, but it is not a prerequisite.

Definition of a Liability

39. A liability is a present obligation [6] of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

40. The definition of a liability addresses only whether a liability exists and not how it should be measured or whether or when it should be recognized. Basic recognition criteria for all elements of accrual-basis financial statements are set forth and discussed in paragraphs 5 through 9. Those paragraphs also indicate that measurement issues and other considerations for recognition decisions will be addressed in future pronouncements. In addition, paragraph 6 acknowledges the possibility of uncertainty about whether an item meets the definition of an element and the need for judgment based on the available evidence. However, this Statement does not establish a threshold to be assumed in applying judgment.

Essential Characteristics of Liabilities

41. Similar to the definition of an asset, the definition of a liability is derived from the nature of liabilities-that is, the essential characteristics without which a liability would not exist. A liability of the federal government has two essential characteristics, which are discussed in paragraphs 42 through 48. First, a liability constitutes a present obligation to provide assets or services to another entity. Second, either a law or an agreement or understanding between the government and another entity identifies conditions or events that will determine when the obligation will be settled.

Present Obligation

42. As the term is used in this Statement, an obligation is a duty or responsibility to act in a certain way. To have a *present* obligation means that the obligation arose as a result of a past transaction or other event and has not yet been settled. Thus, a present obligation should be distinguished from a mere expression of future intent, such as the government's announcement that it intends to acquire equipment. A present obligation is incurred when the government takes a specific action or an event occurs that commits or binds the government.

43. To meet the first essential characteristic of a liability, a present obligation must entail the provision of assets (cash, cash equivalents, or goods) or services to another entity in the future. For example, the government may have received from another entity goods or services that it has agreed to purchase but has not yet paid for, or it may have agreed to provide assets or services to another entity under certain conditions and those conditions have been met. In these situations the government has a present obligation to fulfill its commitments, even if the actual provision of assets or services is not required until a later date.

44. As indicated in the previous paragraph, for a present obligation to qualify as a liability of the Federal government, two separate entities must be involved. [7] Separate entities must be involved because the same entity cannot be both the recipient of settlement of a liability and the entity with the duty to settle. For example, when the government operates machinery, the government may have an obligation to maintain it. However, the obligation does not qualify as a liability for maintenance because the government cannot have a liability to itself. In contrast, if the government contracts for maintenance from another entity, it may have a liability to that other entity for the price of the maintenance services it has received.

Settlement of the Obligation

45. The second essential characteristic of a liability is that either a law or an agreement or understanding between the government and another entity identifies conditions or events that will determine when the obligation will be settled. The timing of settlement often is expressed in contracts and other agreements as a specific or determinable date. However, in some cases the parties agree that settlement will be triggered by a specific event or by the demand of the recipient of the assets or services, the timing of which may be uncertain. If, at the reporting date, the government and the other entity do not have an agreement or understanding concerning settlement and the government is free to decide whether and when to settle its obligation, the obligation does not meet the definition of a liability.

46. In addition to uncertainty as to the timing of settlement, many present obligations involve uncertainty regarding the amount of settlement. For example, the amount required to settle the obligation may

be contingent on the occurrence or non-occurrence of a future event, such as a decline in market prices. The government nevertheless is obligated to fulfill its obligation upon resolution of any contingencies affecting the timing and amount of settlement. Uncertainty regarding the amount or timing of settlement is addressed through measurement of the liability.

47. Frequently, the federal government knows before settlement is due which specific entities or individuals will receive settlement. However, such advance identification of specific recipients is not an essential characteristic of a liability. For example, the government may have a long-term disability agreement with federal employees without knowing the identity of each of the employees who ultimately will qualify for payment. The obligation qualifies as a liability if both of the essential characteristics of a liability are present.

48. Once incurred, a liability of the federal government continues as a liability until the government settles it or another event or circumstance discharges it or removes the government's responsibility to settle it.

Net Position, Revenues, and Expenses

49. Whereas the definitions of assets and liabilities derive from the essential characteristics of those items, the definitions of net position, revenues, and expenses derive from the definitions of assets and liabilities. Thus, in assessing whether items meet the definitions of net position, revenues, and expenses, reference should be made to the definitions of their underlying assets or liabilities.

Definition of Net Position

50. Net position or its equivalent, net assets, is the arithmetic difference between the total assets and total liabilities recognized in the federal government's or a component entity's balance sheet. Net position may be positive (assets greater than liabilities) or negative (assets less than liabilities).

51. Entities often subdivide net position in financial reports to provide information about its composition. However, the reported composition and intended interpretation of net position depend on the particular financial reporting model applied and resulting display requirements. As such, a discussion of the meaning of the government's or a component entity's reported net position is beyond the scope of this Statement.

Definitions of Revenue and Expense

52. A revenue is an inflow of or other increase in assets, a decrease in liabilities, or a combination of both that results in an increase in the government's net position during the reporting period.

53. An expense is an outflow of or other decrease in assets, an increase in liabilities, or a combination of both that results in a decrease in the government's net position during the reporting period.

54. Common sources of revenues are charges and fees to other entities for goods or services; tax levies and other impositions; and donations. Expenses generally result from the provision of cash, cash equivalents, goods, and services to other entities. Transactions that are in substance adjustments or completions of previous transactions rather than new transactions involve the same

elements as the original transaction. For example, a tax refund is considered a revenue reduction and not an expense, and reimbursement of one agency's expense by another agency is considered a reduction of an expense, not a revenue, to the recipient agency and an expense to the reimbursing agency. The definitions of revenue and expense address only whether those elements exist. The definitions do not address how a revenue or expense should be measured or whether or when it should be recognized in the federal government's or a component entity's financial statements. Basic recognition criteria for all elements of accrual-basis financial statements are set forth and discussed in paragraphs 5 through 9. Those paragraphs also indicate that measurement issues and other considerations for recognition decisions will be addressed in future pronouncements. In addition, paragraph 6 acknowledges the possibility of uncertainty about whether an item meets the definition of an element and the need for judgment based on the available evidence. However, this Statement does not establish a threshold to be assumed in applying judgment.

55. Existing standards or established practice may indicate that certain increases and decreases in assets should be reported as gains and losses, rather than revenues and expenses. Use of the terms *gains* and *losses* generally serves to highlight particular features of certain revenues and expenses, such as their unusual or non-recurring nature [8] or their having resulted from peripheral or incidental activities of an entity. [9]

56. The definitions of revenue and expense in this Statement include items that might be reported as gains and losses. Gains and losses are considered subsets of revenues and expenses, rather than distinct elements, just as capital assets and financial assets are considered subsets of assets. Whether certain kinds of revenues and expenses should be reported as gains and losses and, if so, under what circumstances, is beyond the scope of this Statement.

Effects Of Uncertainty

57. Uncertainty about economic activities and results is pervasive. Uncertainty about whether a transaction or other event gives rise to the existence of an element means that judgment often is required as to whether the item possesses the essential characteristics of an element and therefore meets the relevant definition. Items that are judged to meet the definition of an element are candidates for recognition provided they are measurable-that is a monetary amount can be determined with reasonable certainty or is reasonably estimable. Items that, because of uncertainty, do not meet the basic recognition criteria may be candidates for disclosure.

58. In addition to the basic recognition criteria, decisions whether to recognize or disclose an item take into account considerations that also include uncertainties. These considerations are measurement of an appropriate attribute, which may include an assessment of the probability of future flows of economic benefits or services, and assessments of the materiality of the item and the benefit versus the cost of recognizing it. [10]

59. Uncertainty increases the costs of financial reporting, particularly the costs of recognition and measurement. Also, reassessments and restatements may be required if items previously reported as expenses or revenues, or not reported, are later found with benefit of hindsight to have the essential characteristics of assets or liabilities. [11] It may be possible to reduce uncertainty by exerting greater effort or spending more money, but it also may not be worth the added cost. As

discussed in paragraph 6, the exercise of judgment may be necessary, but this Statement does not require certainty.

Footnotes

[4] *American Heritage Dictionary of the English Language*, Fourth Edition (Houghton Mifflin Company, 2000)

[5] *The Concise Oxford Dictionary* Oxford, U.K.: Oxford University Press, 1964.

[6] The term *obligation* is used in this Statement with its general meaning of a duty or responsibility to act in a certain way. It does not mean that an obligation of budgetary resources is required for a liability to exist in accounting or financial reporting or that a liability in accounting or financial reporting is required to exist for budgetary resources to be obligated.

[7] As indicated in paragraph 16, for a component entity the other entity could be another component entity. When component entities transact with each other, they are external to each other. Paragraph 14 explains that some items meet the definitions of elements from a component entity's perspective but not from the federal government's perspective. Such items would be reported in the accrual-basis financial statements of the relevant component entities but would be eliminated in consolidation and therefore would not be reported in the consolidated financial statements of the federal government.

[8] See, for example, Statement of Federal Financial Accounting Standards 7, *Accounting for Revenue and OtherFinancing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, par. 35 (FASAB, 1996).

[9] The latter distinction is included in FASB Concepts Statement 6, *Elements of Financial Statements,* par. 87 (FASB,1985).

[10] As discussed in paragraph 7, measurement issues, probability assessments, and other considerations for recognition decisions beyond the basic recognition criteria are not addressed in this Statement. The Board intends to address those issues in future pronouncements. In the meantime, existing standards for those issues continue to apply.

Statement of Federal Financial Accounting Concepts 7: Measurement of the Elements of Accrual-Basis Financial Statements in Periods after Initial Recording

Focus on Assets and Liabilities

3. The measurement concepts in this Statement focus on assets and liabilities because remeasuring elements after their initial recording is directly applicable only to assets and liabilities, insofar as the other elements are derived from them. [3] That is, balance sheets and operating statements articulate and, therefore, the measurement and recognition of changes in assets and liabilities affect reported revenues and expenses.

4. Expenses for a reporting period result from consuming assets and incurring liabilities, as well as from accounting adjustments that increase existing liabilities or decrease existing assets. Revenues result from acquiring assets and from accounting adjustments that increase existing assets or decrease existing liabilities. Consequently, expenses and revenues arise either from current-period transactions in which the resulting initial and remeasured amounts are the same (e.g., salaries expense and tax revenue), or from adjustments to existing assets and liabilities, such as for changes in the applicable discount rate (e.g., increases in pension liabilities), or for decreases in liabilities due to recognizing revenues for amounts previously reported as deferred revenues.

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Measurement Approaches and Attributes

7. The questions surrounding the measurement of assets and liabilities in accrual-basis financial statements can be grouped into two broad areas of consideration:

   a. **Measurement Approach**

The *measurement approach* is how an asset or liability is measured in periods after initial recording-i.e., at the historical cost or initial transaction amount (with subsequent adjustments for amortization, depreciation, or depletion, if applicable) or at an amount, such as fair value, measured at each financial statement date. A different measurement approach may be appropriate for different assets and liabilities. This Statement refers to the amount initially recorded as the "initial amount" and to amounts measured at each subsequent financial statement date as "remeasured amounts."

b. **Measurement Attribute and Method**

The *measurement attribute* (or measurement basis) [5] is a measurable characteristic of an asset or liability, such as its fair value or settlement amount. [6] Major questions are: Which attributes result in more useful information for decision making, and what factors and circumstances may contribute to that result, such as the class of asset or liability, the type of transaction, and variations in users' decision-making needs? Also, the selection of a measurement attribute often entails the selection of a *measurement method*. For example, if the measurement approach for a particular asset is to report a remeasured amount and the measurement attribute selected is fair value, possible measurement methods could be to research quoted market prices, if available, or to obtain a professional appraisal. Different measurement attributes and methods may be used for different assets and liabilities, and the selections made can affect the usefulness of reported information for decision making.

8. The next section discusses different measurement approaches with reference to the financial reporting objectives. A later section discusses measurement attributes and methods with reference to the qualitative characteristics.

Measurement Approaches

9. The most basic accounting and financial reporting questions relate to recognition and measurement. When should a government measure the existence of, or changes in, the value of an asset or liability? When and how should revenues and expenses resulting from these changes be measured and recognized? Should a government record changes in economic values that have occurred, even though no transaction by the government has taken place? Would the reliability of financial statements suffer if such changes were accounted for as they occur, or would the failure to account

for them reduce the decision-usefulness and representational faithfulness of financial statements? Financial reporting standards traditionally have permitted or required recognition of value changes for some assets and liabilities but not for others. The issues are complicated because value changes may be due to changes in interest rates or service potential, or to different types of price changes.

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16. The analysis in this Statement addresses assets and liabilities in general. However, a particular financial reporting standard may permit or require the reporting of initial amounts for some assets and liabilities and remeasured amounts for others, based on the anticipated usefulness to decision makers of one approach versus the other for the reporting issues addressed in the standard.

Initial Amounts, Remeasured Amounts, and the Financial Reporting Objectives

17. This section discusses initial amounts and remeasured amounts in general and the extent to which each measurement approach helps achieve the federal financial reporting objectives. Different measurement attributes are discussed in a later section on "Measurement Attributes and Qualitative Characteristics."

Initial Amounts Versus Remeasured Amounts

18. Traditionally, the amount at which a transaction is reported has been determined in a manner appropriate to the nature of the transaction. For example, assets acquired by purchase are initially reported at the amount of the consideration surrendered by the purchaser (plus any additional costs incurred to bring the asset to a serviceable condition). Assets acquired through donation are reported at their fair value at the date of donation. Accounts receivable and payable are reported at their anticipated net settlement amounts, which are future exit values. [8] Examples include reporting accounts receivable at net realizable value and reporting accounts payable at invoice amount less any discounts (e.g., for prompt payment). Once recorded, the amounts initially determined are often

referred to as the "historical cost" of an asset or "historical proceeds" of a liability, regardless of how they were determined. In this Statement they are referred to as *initial amounts*.

19. Certain features of a transaction may make identification of an initial amount more difficult. For example, transactions may have associated costs, such as legal fees, which generally are reported as part of the initial amount. A single transaction may involve more than one asset or liability, requiring the total transaction amount to be allocated to the components. Indirect costs, such as certain labor costs, may need to be allocated to constructed assets through cost accounting procedures. Initial amounts for longer lived assets and liabilities generally are allocated to reporting periods. For example, capital assets are depreciated or amortized over their estimated useful lives. Discounts or premiums from issuance of debt are amortized or accreted over the term of the debt. Many of these features present practical questions to be resolved when setting standards.

20. Remeasured amounts of assets and liabilities are determined using one of several possible measurement attributes that reflect economic conditions at the financial statement date, including, for example, fair value or settlement amount. Remeasurement updates a previously determined carrying amount to reflect a change in the economic value of an asset or liability that has occurred since the previous financial statement date. A remeasured amount thus differs from an adjustment to an initial amount that does not reflect a change in value. For example, an increase in the accumulated depreciation balance on a building does not change the economic value of the building and does not constitute remeasurement of its carrying amount. Unless the value of the building itself is remeasured at, for example, its fair value, the reported amount will continue to be considered the initial amount. In contrast, an adjustment to an allowance for uncollectible accounts receivable due to an increased risk of noncollection constitutes remeasurement of the carrying amount, even when the gross amount of receivables is not remeasured, because the adjustment reflects a change in the economic value of the receivables-the anticipated net settlement amount.

Achieving the Financial Reporting Objectives

21. Assessments of which nominal-dollar measurement approach-initial amounts or remeasured amounts-better enables achievement of one or more of the financial reporting objectives vary according to the kinds of information users need and the decisions to be made. [9] In practice, federal financial statements traditionally have followed a "mixed-attribute" model. That is, some assets and liabilities, such as general property, plant, and equipment, have been reported at initial amounts (adjusted for depreciation, depletion, or amortization, if applicable), and others, such as direct loans and loan guarantees, have been reported at remeasured amounts.

22. Given the objective of reporting information that is useful for accountability and users' decision-making needs and the range of different users and information needs to be addressed, it is likely that federal financial statements will continue to include both measurement approaches as well as different measurement attributes and measurement methods under each approach. Consequently, this Concepts Statement identifies advantages and disadvantages of reporting initial amounts and remeasured amounts and of applying different measurement attributes, but no conclusions are drawn as to which measurement approach or attribute may be preferable either in general or in particular circumstances. Such conclusions are the province of the standard- setting process, in the course of which the concepts in this Statement will be considered on a project-by-project basis, along with cost-benefit considerations and other practical reporting concerns that may arise under different alternatives.

23. Continuing to report assets and liabilities at their initially recorded amounts in periods following their acquisition or incurrence is a long-established approach to financial reporting and users are accustomed to that approach. Initial amounts generally are reliable and objective, based on documented evidence, although subjectivity subsequently may be introduced through the assumptions or methods adopted for calculating depreciation or amortization, such as depreciable lives and salvage values, or, as previously indicated, through the allocation of indirect costs. Initial amounts establish a historical record of transactions that have occurred that facilitates the control and safeguarding of resources.

24. Proponents cite these advantages in support of reporting at their initial amounts the costs of inventory and capital assets and the resultant costs of providing programs and activities (referred to in the operating performance objective). These proponents believe that it is not useful to remeasure and report assets at their potential sales prices or settlement amounts when they are being held to

provide services, rather than for sale. In this view, assets held to provide services should be reported at the amounts paid for them (or other initial amounts), and the reported cost of using them each period should be a function of that amount. With this approach, the initial amounts of assets will be allocated to service costs over the periods when the assets are used to provide services, based on the prices paid for the assets.

25. Many also support reporting initial amounts for assets used to provide services because they believe that the adequacy of taxes and other revenues should be assessed based on the amounts actually expended to acquire existing assets, rather than on the current-period costs of equivalent assets or service potential. These proponents suggest that reporting program and activity costs based on the initial amounts facilitates users' ability to assess how the use of budgetary resources relates to the costs of operations (budgetary integrity objective), whereas reporting costs each period at remeasured amounts does not. Initial amounts also may be advocated when there are significant barriers to the realization or settlement of a remeasured amount.

26. Proponents of reporting initial amounts hold that the reliability and objectivity of initial amounts is critical for users' decisions. Reporting remeasured amounts may introduce significant uncertainties and subjectivity into the information provided to users because of the extent of judgment involved in developing these estimates. Those who hold these views point out that remeasured information may reduce the reliability of financial statements. Further, they note that information that is not reliable is rarely relevant.

27. Supporters of remeasurement believe that users require up-to-date information about the price of assets held for sale or to generate future cash inflows. Further, they believe that users also need information about the costs of programs and other ongoing activities based on the current costs of the underlying assets, particularly infrastructure and other capital assets that likely were acquired many years ago. In this view, a comparison of current-period taxes and other revenues with remeasured (current) costs of the resources consumed in providing goods and services is more relevant for assessing operating performance, stewardship, and the sustainability of services than is a comparison with initial amounts that are no longer current. To provide up-to- date information on the costs of services, the underlying assets need to be reported at a remeasured amount, such as

replacement cost.

28. Similarly, supporters of remeasurement believe that remeasured amounts of assets and liabilities, especially for assets acquired many years ago, are more relevant than initial amounts for assessing an entity's current financial position, service potential, and ability to meet obligations when due, as well as the magnitude of the entity's current and probable future resource needs. Over time, critical factors, such as prices and interest rates, change, yet initial amounts reflect the prices and interest rates in effect at the various transaction dates, not at the reporting date. For example, it is possible for assets acquired at different dates to be reported at different amounts, even though they have the same service potential. Similarly, it is possible for liabilities incurred at different dates to be reported at the same initial amount, even though they do not represent equivalent economic claims on the entity's resources, because they bear different interest rates.

29. The contrasting views about the usefulness of initial amounts versus remeasured amounts suggest that an important consideration is whether the reporting objectives generally are more concerned with informing users about how efficiently and effectively budgetary resources were ultimately used to deliver goods and services, or about how all economic resources were used. The principal difference between the two goals is the treatment of the effects of price changes (unrealized or "holding" gains and losses) on reported assets and liabilities and related operating costs. The different treatments provide different information to users of the financial statements.

30. If an entity reports initial amounts, the statement of net cost reports the expiring benefits from previously expended budgetary resources only when the underlying assets are consumed or sold. The statement of net cost does not provide information about changes that occur in resource prices or the values of existing assets in the intervening periods. In contrast, if the entity reports remeasured amounts, the information reflects the capacity of the underlying assets to provide goods and services in changing circumstances. The statement of net cost captures the period-to-period changes in asset amounts (holding gains and losses) in the periods in which they occur and reports the resources consumed at current amounts, information that can help users assess stewardship and operating results each period.

31. The reporting of holding gains and losses can help fulfill the financial reporting objectives by providing information about management's performance that is useful to agency and program

managers as well as to taxpayers and other users of financial reports, including, for example, the economic results of decisions to hold rather than to sell assets. This information may enhance understanding of the costs of programs and activities based on current costs, how costs are changing, the sufficiency of current resources, and future resource needs. The information also may help users assess the efficiency and effectiveness of the management of the entity's assets and liabilities, including whether a change in financial position resulted from management's operating decisions or from changes in prices beyond management's control. These kinds of information are available from the financial statements when holding gains and losses are separately displayed in the statement of net cost. Reporting initial amounts without adjustment for holding gains and losses (and excluding amortization, depreciation, and depletion) may help users compare the resources consumed for goods and services with the resources provided for those purposes. On the other hand, without information about current prices it is difficult for users to assess future resource needs and whether the entity's financial position has improved or deteriorated.

32. The expenses related to capital assets that are reported in a resource flows statement are a component of the cost of current-year services. Initial amounts may be more useful than remeasured amounts for reporting certain costs of services when the objective is to enable tracking of budgetary resources expended. For example, costs, such as amortization or depreciation of capital assets, may be viewed as the expiration of benefits derived from prior expenditures of budgetary resources. Remeasured amounts may be more useful than initial amounts for assessing operating performance when the objective is to consider the economic costs of providing specific programs and activities and to compare costs with accomplishments. Remeasured amounts also may be more useful for assessing stewardship, including whether the entity's financial position improved or deteriorated over the period, whether public services are sustainable, whether obligations can be met as they come due, and for assessing future resource needs.

33. The previous discussion suggests that there are different views and factors to be considered concerning whether the financial reporting objectives are better achieved by reporting initial amounts or remeasured amounts. Also, some individuals believe that a mixed measurement approach, whereby some assets or liabilities are reported at initial amounts and others at remeasured amounts, serves a wider range of decision-making needs than either of the two measurement approaches alone. [10] Ultimately, which measurement approach is more useful

depends on the types of transactions and other events that have occurred and the information needed for the decisions to be made. Requiring the same measurement approach for all assets and/or liabilities and related costs is unlikely to be conceptually appropriate or useful for decision makers. Rather, when the goal is to help ensure that reported information meets several financial reporting objectives in response to the various decision-making needs of a range of users, it is necessary to accept that different measurement approaches, measurement attributes, and measurement methods may be appropriate to convey useful information about different transactions and underlying events.

Measurement Attributes and Qualitative Characteristics

34. The previous section evaluates two measurement approaches-reporting initial amounts and reporting remeasured amounts-in relation to the financial reporting objectives. This section examines initial and remeasured amounts in relation to the qualitative characteristics that information in financial reports should demonstrate. [11]

35. Initial amounts are referred to in general terms because they are not changed from period to period (except for appropriate adjustments for amortization, depreciation, or depletion). Remeasured amounts are discussed with reference to the attribute measured because the attribute selected may affect the degree to which a particular qualitative characteristic is met. Also, different attributes may be selected for different assets and liabilities and, because the amounts are remeasured each period, it is possible to change the attribute, if appropriate to achieve the financial reporting objectives under changed circumstances.

36. The measurement attributes discussed are those most commonly applied or available for use: *fair value, settlement amount, replacement cost, value in use,* and *fulfillment cost*. Additional measurement attributes may be developed in the future. Fair value and settlement amount may be used to determine either the initial amount (historical cost or historical proceeds) or the remeasured amount of an asset or liability. Replacement cost and value in use (for assets) and fulfillment cost (for liabilities) are not applicable for assessing initial amounts because they are attributes of assets

and liabilities that an entity already has recorded. These attributes may be used to remeasure recorded amounts at subsequent financial statement dates.

37. Different measurement methods, with varying degrees of precision, may be used in applying measurement attributes. For example, fair value may be measured by selecting a market price from applicable quotations, by estimating the present value of future resource flows, through a professional appraisal, or by applying a variety of other estimation techniques. The methods used may introduce different degrees of uncertainty in the resultant amounts and may, therefore, affect the degree to which the qualitative characteristics are met.

Fair Value

38. *Fair value is the amount at which an asset or liability could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.*

39. The fair value of an asset or liability may be measured at the market value in established markets, such as those for certain investment or debt securities, or it may be estimated when there is no active market. Estimated fair value is commonly used for the initial amounts of assets acquired through donation or other types of nonexchange transactions.

40. The fair value may be an entry (purchase) value or an exit (selling or settlement) value. For exchanges in established markets, the entry and exit values for the same item should be the same except for transaction costs and differences attributable to the value of services provided by the seller of an asset (e.g., a merchandise vendor) to the buyer. [12] When there is no established market for the exchange, differences between entry and exit prices may arise due to the use of different assumptions in arriving at an estimate of market value. Also, when a federal entity acquires or constructs an asset for a specific public purpose, the exit value may be lower than the entry value if, for example, a potential purchaser would expect to pay a reduced price to allow for the cost of adapting the asset to an alternative use.

41. Methods used to measure fair value include calculating the present value of estimated future cash flows and estimating the fair value by reference to the current purchase or selling prices or other settlement amounts of similar assets or liabilities. A present value measurement that fully captures

the economic differences among different assets and liabilities would most often include the following factors:

a. An estimate of the future cash flow, or in more complex cases, series of future cash flows at different times

b. Expectations about possible variations in the amount or timing of those cash flows

c. The time value of money, represented by the risk-free rate of interest

d. The price for bearing the uncertainty inherent in the asset or liability

e. Other, sometimes unidentifiable, factors including illiquidity and market imperfections. [13]

42. When fair value is used to measure and report an initial transaction, the amount becomes the historical cost or historical proceeds of the resultant asset or liability. The relevance, reliability, understandability, and comparability across entities of the reported amount are high in the initial reporting period, but they may decline with each successive period when compared with remeasured amounts. When market values can be used, amounts that are remeasured at fair value generally are high in relevance, reliability, and understandability, and in their comparability to equivalent amounts reported by other entities and their contribution to timely reporting. When fair values must be estimated, the degree to which the qualitative characteristics are met may vary depending on the availability of information about similar assets and liabilities and the degree of estimation required.

Settlement Amount

43. *Settlement amount is the amount at which an asset can be realized or a liability can be liquidated.*

44. Settlement amounts are exit values that are based on transactions and may be adjusted by the reporting entity for expectations regarding circumstances that may influence future settlement. When used to report receivables, the settlement amount is often referred to as the net realizable value. For example, the settlement amount or net realizable value for a receivable would be the invoiced amount adjusted for expectations regarding credit losses. For accounts payable, the

settlement amount is the amount that the creditor will accept in settlement of its claim for compensation for goods or services provided. For long-term liabilities, the settlement amount is often calculated by applying net present value techniques to expected future cash flows. For example, the settlement amount for loan guarantees may be measured by projecting defaults, and subsequent recoveries, on guaranteed loans and applying an entity-specific discount rate to the resultant cash flows. The resultant measure represents the amount of cash that would need to be invested at the stated interest rate (i.e., the discount rate) to provide cash flows equal to the expected future cash payments required to settle the guaranteed loans. In contrast to fair value, the settlement amount would not take into account the price that the market would charge for bearing the risk or uncertainty associated with the asset or liability.

45. When used for initially recording and reporting short-term assets and liabilities, the degree of relevance, reliability, and understandability of settlement amounts could be similar to that afforded by fair values. However, the relevance of initial amounts for longer term assets and liabilities would decline in subsequent periods. Remeasured settlement amounts would seem to be more appropriate because their relevance and reliability would be maintained or enhanced as the reporting dates approached the final settlement date. For some long-term liabilities, remeasurement may require the professional expertise of disciplines such as, for example, that of actuaries with respect to pension liabilities.

Replacement Cost

46. *Replacement cost is the amount required for an entity to replace the remaining service potential of an existing asset in a current transaction at the reporting date, including the amount that the entity would receive from disposing of the asset at the end of its useful life.*

47. Replacement cost is a remeasured amount, an entry value that is often advocated for assets used in providing services, such as capital assets and inventory not held for sale. Replacing the remaining service potential of an existing asset is not the same as acquiring an identical asset. However, in practice, it may be difficult to measure remaining service potential directly. There may be several ways of arriving at an approximation. For example, one way would be to measure the

current cost of a similar asset, reduced by an appropriate amount to allow for the lower service potential of the existing asset due to its age and condition. Thus, the replacement cost of an asset is not the same as the fair value of either an equivalent new asset or the existing asset at the reporting date. For example, to arrive at the replacement cost of a fifty-year-old office building at the mid-point of its expected life, the fair value of an equivalent, newly constructed office building would have to be adjusted for the value of the difference in age or service potential. In addition, the fair value of the existing building may be higher than the replacement cost because the building can be put to alternative uses that produce greater benefits to the owner.

48. The relevance of replacement cost is high, especially for assessments of financial position and future resource needs. The level of understandability, reliability, and comparability across entities of reported replacement cost amounts may vary according to the data used and the complexity of the calculation.

49. Reporting the replacement cost of capital assets used in providing services and related service costs can facilitate comparisons between program and activity costs and accomplishments related to the same period. An objection sometimes raised is that replacement cost is not an attribute of the asset that is actually owned. However, the asset being measured is not the physical asset but the services it can provide.

Value in Use

50. *Value in use is the benefit to be obtained by an entity from the continuing use of an asset and from its disposal at the end of its useful life.*

51. Value in use is a remeasured amount for assets used to provide services. It can be measured at the present value of future cash flows that the entity expects to derive from the asset, including cash flows from use of the asset and eventual disposition. Value in use is entity specific and differs from fair value. Fair value is intended to be an objective, market-based estimate of the exchange price of an asset between willing parties. Value in use is an entity's own estimation of the service potential of an asset that it holds to provide a specific service. Examples include inventory and equipment with a unique design and purpose, and special-purpose buildings, such as prisons. In those cases, the value in use may be greater than the amount the entity could obtain from selling the asset

because the selling price would need to accommodate the purchaser's need to adapt the asset to another purpose.

52. The service potential of an asset may be difficult to assess when the asset is used in combination with other assets and the total assessment must be allocated to the individual assets. In those cases, the reliability, consistency, and understandability of the remeasured amounts may be lower than when a direct assessment can be made of the value in use of each asset. The relevance of value in use is high for assessments of an individual entity, both with regard to the entity's management and for users' evaluations of operating performance, especially the entity's efficiency and effectiveness in managing its assets. However, the entity-specific nature of value in use reduces inter-entity comparability.

Fulfillment Cost

53. *Fulfillment cost includes all costs that an entity will incur in fulfilling the promises that constitute a liability.*

54. Fulfillment cost is a remeasured, entity-specific amount. It is an exit value that includes payments to the counterparty and other costs that arise from fulfilling the promises that constitute a liability assumed by an entity, such as for environmental remediation. The fulfillment cost differs from the settlement amount. The settlement amount is based on a transaction with an external party, potentially adjusted by the entity for circumstances that may affect the payment amount. The fulfillment cost, in contrast, is the value to the entity of the resources that will be used in liquidating the entity's assumed liability and is not necessarily equal to the carrying amount or the fair value of those resources. Thus, the fulfillment cost of an entity's liability is analogous to the value in use of an entity's asset.

55. When the fulfillment cost depends on uncertain future events, possible alternative outcomes need to be considered when developing the estimated cost to reduce the potential for bias in the assessment. When fulfillment requires work to be done-for example, when the liability is for environmental remediation-the relevant costs are those that the entity will incur for either doing the work itself or employing a contractor. The fulfillment costs of long-term liabilities would be discounted to the reporting date, adjusting for risk at the risk-free rate, if appropriate.

56. Fulfillment costs are relevant to assessments of an entity's financial position but, because they are entity specific, they may not be comparable for assessments of other entities. Their reliability and understandability may vary depending on the complexities and uncertainties reflected in their measurement.