



October 14, 2011

Memorandum

To: Members of the Board

From: Melissa L. Loughan, Assistant Director
Wendy M. Payne

Through: Wendy M. Payne, Executive Director

Subj: Federal Entity- **Tab C--Component Entity¹**

MEETING OBJECTIVES

- To consider issues relating to component entities.

The primary objective for Tab C Federal Entity—Component Entity for the October Board meeting is to consider high level issues related to the approach to the component entity phase of the federal entity project. At this time, the members are not asked to respond to specific questions. All comments are welcome, especially any concerns with the approach thus far.

BRIEFING MATERIAL

- ***Staff Issue Paper (beginning at page 3 of this memo)***

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

BACKGROUND

The Board has focused its deliberations on the government-wide entity. This phase of the federal entity project is the component entity phase. The topic was briefly

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.

introduced at the August meeting as well. Staff continues to gather preliminary feedback from the Board on this phase as we wrap up the government-wide portion of the project. Detailed issues will be presented at December, but staff is presenting a brief outline of issues to be addressed in the component reporting entity phase for the Board's consideration.

NEXT STEPS

Detailed options for selected issues will be presented at the December meeting.

MEMBER FEEDBACK

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

Staff Issue Paper October 2011 Board Meeting Component Entity

From FASAB's current pronouncements (see Appendix 1), previous Boards have concluded that the same objectives apply to both component reporting entities and that all costs and liabilities reported in the government-wide must be attributable to a component entity. In addition, there appeared to be a general notion and principle that all costs and liabilities must be reported at the component level before flowing into the consolidated statements.

Staff believes the overall framework for the component entity standards should be the same and generally consistent with what has been established for the government-wide—one based on organization and accountability. Therefore, staff believes providing detailed standards to ensure component entities' reports follow consistent standards for determining which organization should be included in the financial reports. This would allow the Congress and the President to hold management accountable for implementation of public policy decisions and show the risks inherent in agency operations and provide accountability. Stakeholders would want to understand the potential impact of these risks on future operations and programs.

The principles for defining what organizations should be included in the component entity reports should be consistent with those established for the government-wide. Principles and attributes established for core and non-core entities would generally be the same, but would have to be revised to fit the component entity *level* versus government-wide. Naturally, based on materiality, the information presented in consolidated financial statements typically is aggregated and in less detail than in component entity financial statements. Therefore, when considering the entity reports it may mean that certain non-core accountable entities may meet materiality thresholds in component entity reports while not in the government-wide so that disclosures are more extensive in component entity reports.

Conclusion regarding approach:

Staff believes the overall framework for the component entity standards should be accountability and generally consistent with what has been established for the government-wide. That is, with necessary adaptations the standards would provide:

1. principles for identifying organizations to be included in the component entity's GPFFR would be identified
2. core and non-core entity classification consistent with the government-wide classification principles

3. only core entities would be consolidated in a component entity²
4. requirements to report related non-core entities through disclosures would be consistent with government-wide requirements but may be more detailed

Therefore, staff will begin by identifying potential issues that may need to be addressed to apply the government-wide principles at the component entity level.

Identification of Issues regarding Component Entity

The draft ED defines component reporting entity as follows:

Component reporting entity is used broadly to refer to a reporting entity within a larger reporting entity³ that issues GPFFR. Examples of component reporting entities include entities such as executive departments, legislative agencies, federal courts, independent agencies, and government corporations. Component reporting entities would also include sub-components (entities that are part of a larger component reporting entity) that prepare GPFFR. One example is a bureau of a larger department that prepares stand alone financial reports. Other examples include commercial functions, revolving funds, and/or other accounts for which GPFFR are prepared.

When a component of the federal government issues a GPFFR, it must determine what organizations to include. This paper identifies issues to be considered in adapting the government-wide principles to component reporting entity principles. At this time, the members are not asked to respond to the questions. Rather, the list of issues should be evaluated for completeness and relevance. Member comments on the issues are welcome.

Complete Economic Entity

At the last meeting, Mr. Dacey raised the question of the completeness of a component entity. Specifically, he was concerned about whether the financial statements provide a complete representation of the component entity's operations. Because federal components receive support from other components and rely on federal funding, it is often difficult to ensure that financial statements are complete. For example, SFFAS 4 provides that certain unreimbursed costs of goods and services provided by one federal agency to another be recognized to arrive at the full cost of a program. In addition, some question the meaningfulness of net position for a component of the federal government given the power to tax and allocation of resources through the budgetary process.

² The board previously decided not to establish criteria for "reporting entity." This means that any core entity can produce a standalone GPFFR. The GPFFR for that core entity must include the organizations for which the core entity is accountable.

³ The larger reporting entity could be the government-wide reporting entity or another component reporting entity.

Presently, each component entity includes a statement cautioning the reader as follows: 'The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.' Issues to be explored include:

1. Are additional principles needed at the component level to provide a complete representation of the component entity's operations?
2. Is additional explanatory language needed because the component entity GPFFR presents the financial statements of a component of the U.S. Government (e.g., disclosures regarding the nature of the entity)?

Inclusion Principles

The organizations to include in a component reporting entity GPFFR must first be identified. At least two alternative approaches to identifying organizations to be included in a component reporting entity GPFFR will be considered.

One – Component entities would review organizations in question to determine if the organization should be included in the government-wide GPFFR using the government-wide inclusion principles. If so, decide if the organization should be included with the larger component reporting entity or not.

Two - The four inclusion principles for the government-wide entity could be adapted to be applied from the perspective of a component reporting entity.

Under either approach, the four government-wide inclusion principles would serve as the starting point for developing guidance. The following issues would be addressed in developing guidance.

In the Budget –

The Budget of the United States Government: Analytical Perspectives- Supplemental Materials Schedule of Federal Programs by Agency and Account presents budgetary accounts by branch and by agency. For the government-wide GPFFR, with the exception of organizations receiving federal financial assistance, an organization identified in the budget is (1) included in the GPFFR and (2) presumed to be a core entity.

Presently, component entity statements often include in Note 1 (significant accounting policies) statements such as:

"The accompanying financial statements of xxx include the accounts of all funds which have been established and maintained to account for the resources under the control of xxx management. "

1. Is the SFFAC 2 concept that “Any organization, program, or budget account, including off-budget accounts and government corporations, included in that section should be considered part of the U.S. Federal Government, as well as part of the organization with which it appears” (emphasis added) an effective principle for including organizations in component entity reports? Alternatively, should the ‘in the budget’ principle address “all funds which have been established and maintained to account for the resources under the control of entity management” and other principles be established to address separate organizations to be included in a component?”
2. Should the exception for federal financial assistance be repeated at the component entity level?
3. Are there any (other) circumstances in which an organization identified in the budget under a larger agency should not be considered part of the larger organization?
4. Are there budgetary accounts for which guidance on inclusion in a component entity is needed? (e.g., accounts for which multiple agencies have roles and responsibilities)

Majority Ownership

When the federal government holds a majority ownership in an entity it should be included in the government-wide report.⁴ Issues at the component reporting entity level include:

1. When an entity is federally owned, is it clear which, if any, agency should include the “owned” entity in its component GPFFR?
2. Under what circumstances must an “owned” entity be included in a larger component entity GPFFR (rather than simply being included directly in the government-wide GPFFR)?
3. Should there be any differences in principles between “owned” core and non-core entities with regard to inclusion in a larger component entity?

Control with Expected Benefits or Risk of Loss

From the government-wide perspective, control with expected benefits or risk of loss is the power to govern the financial and/or operating policies of another entity with expected benefits or the risk of loss⁵ to the federal reporting entity. In some cases,

⁴ Ownership interest is defined as the possession of substantially all of the benefits and risks incident to ownership, FASAB Glossary FASAB Pronouncements as Amended as of June 30, 2010.

⁵ The expected benefit or risk of loss may be financial or non-financial. For example, a non-financial benefit would be the federal government benefits from a service being provided on its behalf.

control is established in legislation or through the organization's charter, and the benefits and/or risk of loss are associated with a particular agency. Note also that benefits and risks may be non-financial (as in an organization that provides programs in support of an entity's mission).

1. When "control" exists at the government-wide level but does not rest with the component entity that may benefit (or lose) should the component entity include the organization from which it is intended to benefit (or lose)? For example, an organization intended to operate independently but solely to support (benefit) the operations of a component entity.
2. What guidance is needed to aid in applying the indicators of control at the component entity level? For example, a component entity can rarely unilaterally dissolve another organization.
3. If the head of a component entity is designated to chair the governing body of another organization, under what, if any, circumstances should that component entity include the organization in its GPFFR? For example, a departmental secretary having responsibility for international assistance is designated to chair the governing body of an organization established to offer international assistance.

Misleading to Exclude

The Statement requires inclusion of entities in the government-wide report if it would be misleading to exclude them. Does the same principle apply at the component entity level?

Alternative or Additional Principles

In developing the definitions of elements, the Board considered the issue of which entity should report particular assets and liabilities. The principles established for elements may be useful for identifying organizations to include in a component entity's GPFFR if there questions arise about which entity should include an organization.

The following principles were established:

10. All elements defined in this Statement are defined in relation to the U.S. Government ("federal government" or "government"). That is, an item that meets the relevant definition is an asset, liability, net position, revenue, or expense of the federal government. An item that meets the basic recognition criteria established in paragraph 5 and the additional considerations for recognition decisions referred to in paragraph 7 is recognized in the consolidated financial statements of the federal government, except

when it is eliminated in the consolidation process, as discussed in paragraphs 14 and 15.

11. The federal government is composed of component entities that control, manage, or are otherwise accountable for the government's assets and may be authorized to incur liabilities. Component entities include departments, independent agencies, and government corporations, as well as their agencies, bureaus, offices, administrations, corporations, and other organizational units. An item that meets the definition of an element of the federal government is also an element of a component entity. It is recognized in the component entity's accrual-basis financial statements provided it meets the basic recognition criteria and the additional considerations for recognition decisions.

12. Sometimes a question may arise as to which component entity should report a particular item. Typically, a review of the authorizing legislation establishing a government program or activity, the appropriations act funding it, and related federal laws, regulations or other executive issuances clearly identifies one component entity as having a comprehensive relationship to the program or activity. That is, the component entity is responsible and accountable for receiving, controlling, managing, and utilizing government assets or incurring liabilities on behalf of the government in performing operations related to the program or activity. When a component entity has such a comprehensive relationship, the assets and other elements involved should be reported by that component entity.

13. When no component entity has a comprehensive relationship to a government program or activity, the assets and other elements involved should be reported by the component entity most responsible for managing them. For example, assume that two component entities support a single program to which neither has a comprehensive relationship. If one of the component entities has acquired and has some control over a government asset but the other component entity presently manages and utilizes the asset as part of its routine operations, the second component entity should report the asset. In other circumstances, a component entity's management responsibilities may be limited to, for example, collecting monies owed to the federal government and depositing them in the U.S. Treasury. Although the component entity has no authority or responsibility to retain or use the monies collected, it should report the assets and other elements involved in the collection activity.

Appendix 1--Consideration of Existing Concepts and Standards (previously included in August 2011 Materials)

SFFAC 1, *Objectives of Federal Financial Reporting* and SFFAC 2, *Entity and Display* recognize that different users of financial reports may require data at different levels of aggregation. The Board contemplated if there should be a separate set of objectives of federal financial reporting for the component entity reports during deliberations of SFFAC 1. The Board determined that it might emphasize different sets of objectives depending upon the report and audience, but there wasn't a need for different objectives. As the Basis for Conclusions of SFFAC 1, states the following:

Objectives For Governmentwide And Component Entity Reports

248. Some respondents suggested there should be separate sets of objectives for governmentwide and component entity reports. Similarly, it might also be possible to distinguish objectives for reporting by organizational unit components from those for functional or program components. Alternatively, one might imagine separate sets of objectives for reports to different audiences. The Board concluded that different reports are likely to emphasize different objectives but that there is no need to prepare separate statements of objectives. The Board will give due consideration to variations in emphasis among the objectives for different types of reports in subsequent statements and projects.

SFFAC 2, par. 56 discussed the different types of reporting entities, while pars. 75 – 76 built upon this notion and discussed the importance of component reporting entities:

56. In the Federal Government, there are several types of reporting entities (organizations, suborganizations, programs, and the government as a whole) and several financial reporting objectives (budgetary integrity, operating performance, stewardship, and systems and control). Each of the reporting objectives can be met to a certain degree by the statements prepared by or for one type of reporting entity and to a greater or lesser degree by the statements prepared by or for the other types of reporting entities. For example, the objective of budgetary integrity can be best met with the program and financing schedules prepared for individual budget accounts. The objective of operating performance can be best met with financial statements from organizations/suborganizations and programs (although financial statements at this level can also help readers evaluate the reporting entity's budgetary integrity). The objective of stewardship can be best met with a financial statement for the entire government. Meeting the financial reporting objectives in their totality requires financial statements from all of the types of reporting entities.

75. With some organizations, and even suborganizations, the activities of one or more programs or other components are as important to the readers of the financial statements as are the activities of the entity as a whole. This would be particularly true for a Department composed of many bureaus, administrations, agencies, services, etc., and particularly if their programs are dissimilar. In those instances, consideration should be given to the preferability of reporting the assets, liabilities, revenues, expenses, etc. of both the significant components individually and of the entity in its entirety. Hence, larger organizations, and particularly those composed of many bureaus, administrations,

agencies, etc., would prepare not only consolidated financial statements for the organizational entity, but also provide information pertaining to their individual significant components.

The information for the individual components could be provided with separate columns in consolidating financial statements (with the information for the less significant components, and possibly the entity's management component, aggregated into a single separate column), in separate financial statements for each significant component, or in the accompanying footnotes. The significant components can be suborganizations or programs. If they are suborganizations, information regarding programs should be provided in some manner.

76. Furthermore, there are frequently instances when one or more of the suborganizations conduct a very visible or critical activity and there is a high level of public interest, e.g., tax collection activity; maintains large and complex fund flow activity; has earmarked tax activity; or its financial viability is of special concern to the Executive Branch or the Congress, e.g., deposit insurance funds. In those situations, it may be desirable for the sub-organization to prepare and issue a separate financial statement that is consistent with the concepts presented in this concepts statement. In doing so, it would need to identify the parent entity and describe the sub-organization's relationship to the parent.

Staff notes the Board also deliberated the Entity Concept and the notion of component entities in SFFAC 5, *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements*. Specifically, par. 10 - 16 (see Appendix 1 for excerpt containing par. 10-16 of SFFAC 5) describes that:

- An item that meets the definition of an element of the federal government is also an element of a component entity
- When determining which component entity should report an item, it should be the component entity responsible and accountable for receiving, controlling, managing, and utilizing government assets or incurring liabilities on behalf of the government because the component entity has such a comprehensive relationship, the assets and other elements involved should be reported by that component entity.
- When no component entity has a comprehensive relationship to a government program or activity, the assets and other elements involved should be reported by the component entity most responsible for managing them.
- Some items recognized in the financial statements of component entities are not recognized in the consolidated financial statements of the federal government because they do not meet definitions of elements from the perspective of the federal government.
- For a component entity, the terms "another entity" and "other entities" include other component entities of the government as well as entities external to the government.

Staff also notes a key notion was conveyed in the release of Technical Bulletin 2002-1: *Assigning to Component Entities Costs and Liabilities that Result from Legal Claims Against the Federal Government*. The Board explained the notion that all costs and liabilities included in the government-wide must first be attributed to a component entity. Specifically par. 9 stated:

9. All liabilities and costs must be attributed to the component entities responsible for the programs or activities that contributed to the claims or to their successor component entities. This attribution follows the general principle that all transactions or events reported on the consolidated statements should be attributed to some Federal component entity.

The Basis for Conclusions provided further explanation that the Board's position was that all costs and liabilities must be attributed to component entities; that is, entities other than the federal government as a whole-- all costs and liabilities must be reported at the component level before flowing into the consolidated statements. In general, the Board believed that the consolidated government-wide financial statement was a summation of component entity financial statements.

SFFAC 5, Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements

10. All elements defined in this Statement are defined in relation to the U.S. Government ("federal government" or "government"). That is, an item that meets the relevant definition is an asset, liability, net position, revenue, or expense of the federal government. An item that meets the basic recognition criteria established in paragraph 5 and the additional considerations for recognition decisions referred to in paragraph 7 is recognized in the consolidated financial statements of the federal government, except when it is eliminated in the consolidation process, as discussed in paragraphs 14 and 15.

11. The federal government is composed of component entities that control, manage, or are otherwise accountable for the government's assets and may be authorized to incur liabilities. Component entities include departments, independent agencies, and government corporations, as well as their agencies, bureaus, offices, administrations, corporations, and other organizational units. An item that meets the definition of an element of the federal government is also an element of a component entity. It is recognized in the component entity's accrual-basis financial statements provided it meets the basic recognition criteria and the additional considerations for recognition decisions.

12. Sometimes a question may arise as to which component entity should report a particular item. Typically, a review of the authorizing legislation establishing a government program or activity, the appropriations act funding it, and related federal laws, regulations or other executive issuances clearly identifies one component entity as having a comprehensive relationship to the program or activity. That is, the component entity is responsible and accountable for receiving, controlling, managing, and utilizing government assets or incurring liabilities on behalf of the government in performing operations related to the program or activity. When a component entity has such a comprehensive relationship, the assets and other elements involved should be reported by that component entity.

13. When no component entity has a comprehensive relationship to a government program or activity, the assets and other elements involved should be reported by the component entity most responsible for managing them. For example, assume that two component entities support a single program to which neither has a comprehensive relationship. If one of the component entities has acquired and has some control over a government asset but the other component entity presently manages and utilizes the asset as part of its routine operations, the second component entity should report the asset. In other circumstances, a component entity's management responsibilities may be limited to, for example, collecting monies owed to the federal government and depositing them in the U.S. Treasury. Although the component entity has no authority or responsibility to retain or use the monies collected, it should report the assets and other elements involved in the collection activity.

14. While items that meet the definition of an element from the perspective of the federal government are assigned to component entities, some items recognized in the accrual-basis financial statements of component entities are not recognized in the consolidated financial statements of the federal government because they do not meet definitions of elements from the perspective of the federal government. Instead, they are items that would meet element definitions from the component entity perspective and are treated as such by the component entity. For example, component entities may exchange services for a fee and recognize the resulting intra-governmental assets, liabilities, and related elements in their financial statements. However, intra-governmental items offset each other when the government is viewed as a whole and are eliminated in preparing the government's consolidated financial statements.

15. Appropriations are another example of items reported in the accrual-basis financial statements of component entities but not in the consolidated financial statements of the federal government. For the component entities, appropriations are inflows of resources against which the component entity may incur obligations in support of authorized activities. Assuming an appropriation complies with the basic recognition criteria and additional considerations for recognition decisions, a component entity would recognize the appropriation as an increase in assets and revenues and would recognize the use of the appropriation as an increase in expenses and a decrease in fund balance with Treasury. However, from the perspective of the government as a whole, an appropriation is not a resource flow to the federal government or from the government to a component entity. Rather, it is a budgetary amount that constitutes legal authority for a component entity to incur obligations for specified purposes during specified time periods, and for the U.S. Treasury to liquidate the resulting obligations of the component entity. The actual liquidation will be from cash and other assets of the U.S. Treasury resulting from the inflow of resources from taxes and other financing sources. Therefore, appropriations recognized by component entities are eliminated in the process of consolidation and are not reported in the consolidated financial statements of the federal government.

16. The definitions of elements may refer to another entity or other entities. For the federal government, these terms describe entities external to the government, such as foreign, state, and local governments, business enterprises, not-for-profit organizations, and individuals. For a component entity, the terms another entity and other entities include other component entities of the government as well as entities external to the government.