Federal Accounting Standards Advisory Board

June 13, 2018

Memorandum

MEMBER ACTIONS REQUESTED:

By June 20, 2018, please review the materials and answer the question on page 12.

To: Members of the Board

Robin M. Gilliam

From: Robin Gilliam, Assistant Director

Ross Simms

Ross Simms, Assistant Director

Wendy M. Payne

Through: Wendy M. Payne, Executive Director

Subj: Management's Discussion and Analysis–**TAB D**[1]

OBJECTIVE

The objective is to gain Board approval for proposed improvements to the management's discussion and analysis (MD&A) section of general purpose financial reports.

BRIEFING MATERIALS

The briefing material includes this memorandum.

[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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BACKGROUND

Upon completing the development of Statement of Federal Financial Accounting Concepts (SFFAC) 8, *Federal Financial Reporting*, the Board began discussing the need to improve the content of financial reports. Since May 2017, Board and roundtable discussions noted several areas for improvement, including management's discussion and analysis (MD&A), required supplementary stewardship information (RSSI), other information, the overall reporting model, and certain financial statements and note disclosures. The Board was particularly concerned about the voluminous content of financial reports and, to address the concerns, the Board decided to use a two-phased approach. During the first phase, the Board will focus on areas that can be addressed in the near term and, in the second phase, consider areas to address over the long term.

Key findings include:

1. MD&A is often broad and may overwhelm readers.
2. Information intended to be conveyed through RSSI can be obtained from other sources, such as *Analytical Perspectives, Budget of the United States Government*, ("the Budget") and performance information related to RSSI may also be presented in the entity's annual performance report (APR).
3. The APR is provided in February of each year and few CFO Act agencies provide a performance and accountability report (PAR). Instead, agencies present an agency financial report (AFR) and an APR at different times.
4. SFFAC 3, *Management's Discussion and Analysis*, provides guidance that preparers could consider. However, the concepts discuss topics that have evolved; making SFFAC 3 appear outdated.
5. The risk assumed project staff met with users and preparers in round table discussions to understand the information that would be useful to them and participants expressed similar concerns as the research to improve MD&A.

Due to the similarity of the issues raised in the reporting model and risk assumed projects, staff decided it would be more efficient and effective to combine efforts. Therefore, staff combined the concerns and proposed an alternative for improving the MD&A.

In April, staff proposed a new, integrated structure based on agencies' statement of net cost "major program" breakout. This would include information from the four current MD&A sections—mission and organizational structure; performance goals, objectives, and results; financial statements; and systems, controls, and legal compliance—as well as risk assumed information. The risk assumed information would be aligned with reporting entity enterprise risk management (ERM) terminology. This proposed format would tell an integrated story about each major program.

Additionally, to keep the focus on financial reporting, staff recommended a link to APRs instead of including that data in the MD&A. This would not only keep the focus on financial information, but also help reduce the size of the MD&A.

Members agreed with the Office of Management and Budget's (OMB) suggestion that changes to form and content as addressed in OMB Circular A-136, *Financial Reporting Requirements*, could address a number of issues, such as including the APR link. Also, staff should draft proposed changes that identify what would remain from SFFAC 3 and SFFAS 15 and what would be new. Also, prior to the June 2018 Board meeting, staff would meet and collaborate with OMB on updates to Circular A-136.

NEXT STEPS

The next step for the project will be determined during the meeting.

MEMBER FEEDBACK

If you have any questions or comments, please contact both Mr. Simms and Ms. Gilliam by email at simmsr@fasab.gov and gilliamr@fasab.gov with a cc to paynew@fasab.gov by **June 20, 2018**.

I. Proposed New Statement: Rescinding SFFAC 3 and SFFAS 15

Why the Board Undertook this Project?

The Board initiated this project to address concerns regarding the implementation of management's discussion and analysis (MD&A) guidance. MD&A is a section of the reporting entity's financial report based on conditions that exist at the reporting date and events that occurred in the preceding period. Statement of Federal Financial Accounting Standards (SFFAS) SFFAS 15, *Management's Discussion and Analysis*, provides principles-based guidance for preparing MD&A and Statement of Federal Financial Accounting Concepts (SFFAC) 3, *Management's Discussion and Analysis*, provides implementation guidance.[2]

The guidance requires management to present a section addressing the entity's "performance goals, objectives, and results." Typically, management includes non-financial performance information (NFPI) about the entity. However, since the issuance of SFFAS 15, reporting entities began reporting comprehensive NFPI in an Agency Performance Report issued after preparing the financial statements and MD&A. Reporting entities made the change to align NFPI with the preparation of reports needed for budget allocation decisions. Consequently, the actual NFPI would not be complete when reporting entities prepare MD&A.

Preparing the MD&A before NFPI for the same reporting period is complete means that management must prepare and present NFPI twice. This also means that the MD&A users receive information that may be less useful than the information presented in the APR.

In addition, SFFAS 15 and SFFAC 3 do not require MD&A to explain the entity's approach to disaggregating net cost of operations in financial reports. Currently, FASAB guidance requires preparers to disaggregate costs by responsibility segment in the basic financial statements[3] and disaggregate costs by stewardship investment in a separate section (RSSI)[4] of the general purpose federal financial report (GPFFR).

Also, the Board noted that the model for MD&A resulted in a combined presentation of different topics. SFFAS 15 requires reporting entities to address distinct topics and reporting entities would need to rely on sources other than FASAB standards to prepare some of them. While the standard requires reporting entities to address NFPI and systems, controls, and legal compliance (SCLC), reporting entities rely on Office of Management and Budget (OMB) guidance to present the information. Due to the evolution of NFPI reporting and SCLC since standards were developed, the resulting MD&A may not be integrated in a manner to help users understand the costs, accomplishments, and risks of the reporting entity's major programs.

[2] The Board intended that SFFAC 3 would provide implementation guidance for the MD&A standards.
[3] SFFAS 4, *Managerial Cost Accounting Concepts and Standards,* par. 77 – 88.
[4] SFFAS 8, *Supplementary Stewardship Reporting,* chapters 5 – 7.

Development of a Proposal

To develop a proposal for improving MD&A, staff considered the Board's conceptual framework. The conceptual framework guides the Board in developing standards and discusses:

- user's needs and the objectives of Federal financial reporting,
- the need for the Board to make judgments about the costs and benefits of requiring information,
- the qualitative characteristics of information in financial reports, and
- the Board's approach to developing standards.

While NFPI and SCLC may be needed to achieve the financial reporting objectives, staff noted challenges to the cost of implementing SFFAS 15, such as reporting entities using resources to prepare NFPI for MD&A separately from the APR. In addition, NFPI may not always be complete, posing concerns regarding the qualitative characteristics of the information. Also, the Board's approach to developing standards recognizes that sources other than general purpose federal financial reports (GPFFR) could provide NFPI and information on SCLC to address users' needs. Given this and the present state of financial performance information, staff suggests that MD&A place greater emphasis on financial performance information.

Users' Needs and the Objectives of Federal Financial Reporting

Staff believes that NFPI and SCLC would be useful to users of the financial statements and the information would help address the operating performance reporting objective. SFFAC 1, *The Objectives of Federal Financial Reporting*, discusses several of the concepts the Board reviewed, including users' needs which define the objectives of Federal financial reporting. SFFAC 1, paragraph 122 states

> Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities.

NFPI would provide users with information on the entity's operating performance, including information on accomplishments. However, NFPI would not inform users on program costs and the management of entity assets and liabilities.

Also, users seek information about the cost and accomplishments of programs. SFFAC 1 notes that users need information to determine:

- the costs of providing specific programs and activities and the composition of, and changes in, these costs, and

- the efforts and accomplishments associated with federal programs and the changes over time and in relation to costs.[5]

The Board has noted that reporting entities have broad missions and provide diverse programs. Reporting entities need to be segmented to associate the resources consumed by distinct lines of activity with the outputs of that activity. SFFAS 4, *Managerial Cost Accounting Standards and Concepts*, notes

> Most federal departments and agencies are engaged in more than one line of activity, or producing more than one type of service or product. Furthermore, the activities that an agency performs may differ from each other significantly in required resources and operations.[6]
>
> A responsibility segment is not, and should not be, an additional layer to the organization and the budget structure. It is an accounting mechanism to capture data generated in operations by various components of an organization in its existing structure. Organization and budget structures can be changed for better management but not for the sake of accounting. Accounting may influence but cannot dictate such changes.[7]
>
> The purpose of segmentation is to segregate entity-wide data by major lines of activities and their outputs. Information related to each segment should tell managers and other users of financial reports about the segment's specific outputs, the activities performed, and resources consumed to produce the outputs.[8]

In addition, users need information on the government's contribution to the nation's future well-being[9] and the reporting entity's stewardship investments in non-federal physical property, human capital, and research and development provide long-term benefits for the nation. These stewardship investments increase economic growth and provide benefits to the nation over an extended period. Discussing stewardship investments would help users understand the provisions that the government has made for the future. However, this discussion is likely to be included in MD&A as well as the APR when entities make significant investments.

Moreover, users need information regarding budgetary integrity and systems and control. In particular, users need information to assist them in determining how budgetary resources have been obtained and used and whether their acquisition and use were in accordance with the legal authorization.[10] Also, users need information to assist them in understanding whether financial management systems and internal accounting and administrative controls are adequate.[11]

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[5] SFFAC 1, pars. 126 and 128.
[6] SFFAS 4, par. 188
[7] SFFAS 4, par. 190.
[8] SFFAS 4, par. 191.
[9] SFFAC 1, par. 143.
[10] SFFAC 1, par. 116.
[11] SFFAC 1, par. 146.

Cost of Presenting Required Information versus Its Benefits

The Board recognizes that developing financial reporting standards is not a simple progression from determining users' needs to requiring the information. The Board also considers the cost of implementing standards versus the benefits of providing the information. SFFAC 1, paragraph 151 states

> Users' information needs define financial reporting. Even so, the process of articulating financial reporting objectives and then recommending accounting standards is not a simple progression from canvassing users of federal financial information to recommending standards. This is partly because such users, when asked about their information needs, may give answers that are limited by their past needs and experiences. More fundamentally, it is because articulating objectives and recommending accounting standards necessarily involve judgments about the costs and benefits of producing more information or of reporting it differently.

Because NFPI is currently aligned with budgetary reporting, reporting entities maintain a separate NFPI process to address MD&A requirements. Maintaining separate NFPI processes for budgetary and financial reporting imposes additional costs. These costs may be justified by benefits to the user; however, staff believes the users NFPI needs may be met in a less costly way by informing them about the APR and how to obtain it. Relying on a summary of NFPI in the MD&A imposes costs on the user who then needs to seek better information from another source.

In addition, reporting entities incur costs to present stewardship investment information in two separate sections of the GPFFR—basic financial statements and RSSI. If management determines that stewardship investments are an important part of the entity's mission, stewardship information is already included in the SNC and in NFPI. However, users of information on investments seek disaggregated budgetary-basis information presented in the Budget. Thus, the RSSI section is a separate exercise that consumes resources but does not provide intended benefits.

Qualitative Characteristics of Required Information

Staff noted challenges to the qualitative characteristics of NFPI in MD&A. The NFPI was not always complete, raising concerns about the reliability of the information. For instance, when presenting a table of performance trends, reporting entities indicted that some metrics for the financial statement reporting period were "not available." SFFAC 1, paragraph 160 states

> Financial reporting should be reliable; that is, the information presented should be verifiable and free from bias and should faithfully represent what it purports to represent. To be reliable, financial reporting needs to be comprehensive. Nothing material should be omitted from the information necessary to represent faithfully the

> underlying events and conditions, nor should anything be included that would likely cause the information to be misleading to the intended report user…

Consequently, the limited reliability of the NFPI presentations adversely impacted their relevance to users. SFFAC 1, paragraph 161 explains

> Relevance encompasses many of the other characteristics. For example, if the information provided in a financial report is not timely or reliable, it is not relevant…

The Board's Approach to Developing Standards

The Board acknowledged that sources other than financial reports may provide NFPI to achieve the reporting objectives. SFFAC 1, paragraphs 36 and 37 state

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

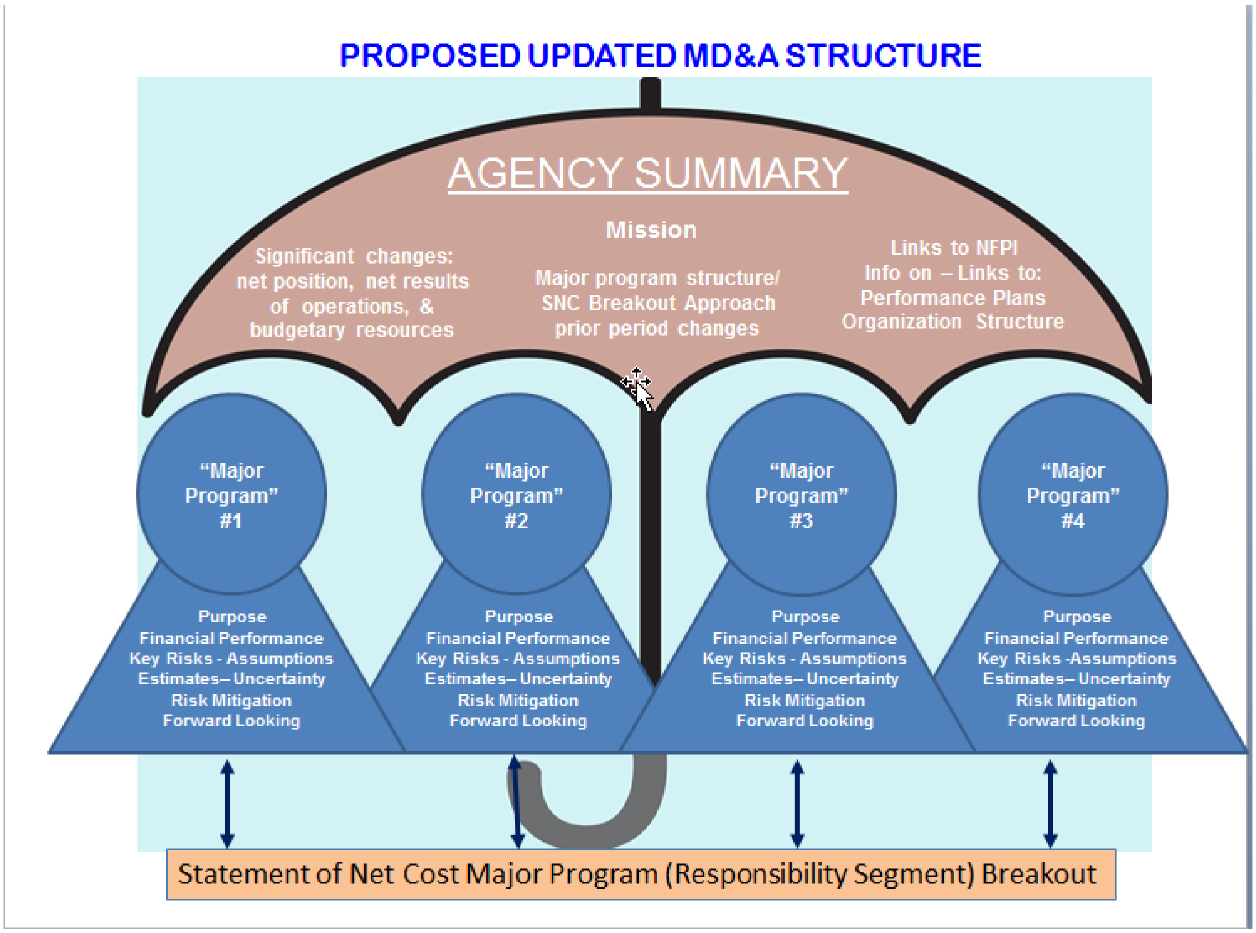
Currently, Office of Management and Budget (OMB) Circular A-11, *Preparation, Submission and Execution of the Budget*, provides detailed guidance for NFPI. NFPI is publicly available in the entity's annual performance report (APR) and Performance.gov, the website designed to inform the public on the Federal government's performance. The Board may wish to consider how these information sources might support meeting reporting objectives and enhance the qualitative characteristics of information.

Also, OMB and the Government Accountability Office (GAO) provide guidance on systems and controls and legal compliance. For instance, OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*, requires reporting entities to implement Enterprise Risk Management (ERM) capability. ERM would be coordinated with the strategic planning and strategic review process required by the Government Performance and Results Act Modernization Act (GPRAMA), the internal control processes required by the Federal Managers' Financial Integrity Act (FMFIA) and the GAO *Standards for Internal Control in the Federal Government* (Green Book). Risk management practices are intended to be forward-looking and designed to improve decision-making, alleviate threats and to identify previously unknown opportunities to improve the efficiency and effectiveness of government operations.[12]

[12] OMB Circular 1-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*.

In addition, staff considered users need for information about the reporting entity's operating performance and programs. For instance, potential users of risk assumed information sought a concise discussion of reporting entity programs in MD&A. They believed the concise presentation would address program performance, key risk factors, and forward-looking risk projections. The potential users would next seek granular data. Granular data allows them to analyze performance over time and the risk factors that may have impacted program performance. Also, potential users sought to understand the cause of significant changes in financial statement amounts, such as changes in the net results of operations.

What Changes in MD&A Preparation?



Overall, the changes are intended to clarify the information that should be provided to help users understand the operating performance of the reporting entity. Thus, MD&A should provide information regarding the reporting entity's:

1. mission;
2. performance plans and results or information on how a user can access information on the reporting entity's performance plans and results and when the information would be available;
3. organizational structure during the reporting period or how a user can access the organizational chart;
4. approach for determining responsibility segments presented in the statement of net cost, including an explanation of changes from the prior period's structure, such as why new major programs were added or removed; and
5. significant changes in net position, net results of operations, and budgetary resources, and the reasons thereof.

Also, to assist users in understanding the cost and accomplishments of the reporting entity's major programs, MD&A should:

1. discuss financial performance information for each segment presented in the statement of net cost, such as "major programs"[13] defined by management;
2. provide for each "major program"
    a. its purpose;
    b. a general discussion about financial performance and a concise explanation for significant changes in assets, liabilities, and costs, such as
        i. what caused a significant change in net cost?
        ii. was the change due to a change in assumptions, risk event, other?; and
    c. a forward-looking discussion about the potential significant financial impact of key risks on assets, liabilities, and costs for already existing events, including
        i. the significant assumptions used to estimate the potential financial impact of each key risk,

[13] OMB A-136 II.4.4. Statement of Net Cost (SNC); II.4.4.1. Introduction; Major Programs: The SNC should show the reporting entity's net cost of operations as a whole and by major programs. The term "major program" may describe an agency's mission, strategic goals, functions, activities, services, projects, or processes, or other meaningful grouping. Program structure definition is at the entity's discretion.

ii. the possibility of future changes in estimates due to the uncertainty of the assumptions used; and

iii. the mitigation strategies planned to reduce the potential financial impact of those key risks.

II. Collaboration with OMB on A-136 Updates

In addition to requesting proposed improvements that staff presented in Section I of this memo, the Board also asked staff to collaborate with OMB on updates to the MD&A form and content in OMB Circular A-136, *Financial Reporting Requirements*. The following is a summary of staff's collaboration efforts with OMB.

OMB staff we met with were very supportive of the overall future direction of the MD&A that staff recommended at the April 2018 Board meeting—the "umbrella" diagram [see page 9]. OMB staff generally agreed that the focus in the AFR should be on financial performance by major program and that information about strategic goals and performance may be obtained from other sources when those sources are identified in the MD&A.

The recommended changes to the 2018 A-136 that we (OMB & FASAB staff) agreed upon were limited to those consistent with SFFAS 15. For example, until the MD&A structure is officially changed in the accounting standards, OMB was unable to remove the four specific sections—*Mission and organizational structure; Performance goals, objectives, and results; Financial statements; and Systems, controls, and legal compliance*. Therefore, until FASAB updates the standards desirable revisions to the MD&A section of A-136 may not be consistent with GAAP.

However, we did make progress. Proposed changes will encourage discussions about financial performance and risk mitigation by "major programs" and start the process of integrating information.

SUMMARY:

In Section I of this memo, staff presented improvements to illustrate how updated standards will encourage clear and concise information to help users understand an overall summary of a reporting entity and the financial performance of major programs. These proposals also clarify how to discuss forward looking information about potential financial impacts by focusing on risk mitigation strategies, risks identified by major program, and related measurement uncertainty.

In Section II of this memo, staff reported on collaboration efforts with OMB to update the 2018 A-136. OMB staff was supportive of the general direction staff has presented in section I and is recommending as many updates to the 2018 A-136 as possible within the boundaries of SFFAS 15. Significant updates include replacing the strategic goals focus with a focus on financial performance by major programs, allowing entities to define major programs, and adding a discussion about risk mitigation.

To provide the full benefit for users to better understand how efficiently and effectively reporting entities and their major programs are financially performing, **Staff asks members to approve the proposed improvements as outlined in Section I.**

Question 1: Does the Board agree with the proposed improvements?