Federal Accounting Standards Advisory Board

September 21, 2005

Memorandum

To: Members of the Board

From: Julia E. Ranagan, Assistant Director

Through: Wendy M. Comes, Executive Director

Subj: Research into the Application of the Liability Definition[1] – Tab E

At the August 17, 2005, meeting, staff summarized the project results to date and presented three options for continuing:

- Present educational sessions on IASB and FASB work on expected values and obligations;
- Begin developing an operational approach to different classes of liabilities; or,
- Divert staff resources to another project.

Staff noted that there are fundamental disagreements between the Board members, particularly on whether the liability is the future sacrifice itself or the stand-ready obligation to make that sacrifice, and that continuing to review individual programs one by one would probably not result in the timely settlement of many of these differences.

After a brief discussion, the Board members unanimously agreed that the project should continue but should focus on classes of liabilities from this point forward, rather than a review of individual programs. This tab presents three different approaches to utilizing classes of liabilities.

The staff objective for the October meeting is to obtain approval on the recommended classes of liabilities so that staff can begin researching the application of the liability definition to each of the proposed classes. Please contact me at 202-512-7377 or by e-mail at ranaganj@fasab.gov with questions or comments.

[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.

Research into the Application of the Liability Definition
Alternatives for Discussion
September 21, 2005

Table of Contents

Research into the Application of the Liability Definition
Alternatives for Discussion
September 21, 2005

Staff Objective for this Paper

The staff objective for this paper is to present a first draft of possible classes of liabilities for consideration by the Board.

Background

This project was formally introduced in April 2004. It has naturally evolved from the Social Insurance Liability Project due to the need to concurrently review other commitments undertaken by the Federal Government that may be more accurately portrayed with additional liability recognition, disclosure, and/or display requirements beyond due and payable.

At subsequent meetings, fact sheets prepared for Medicaid, Food Stamps, Temporary Assistance for Needy Families, and Supplemental Security Income were provided for the Board's information in conjunction with the Social Insurance Liability Project presentation. Staff also presented the Board with in-depth analyses of potential obligating events for the following four programs: Supplemental Security Income, Milk Income Loss Contract, Feed Grains Direct and Counter-Cyclical, and the Corporation for National and Community Service's Service Award Liability.

At the August 17, 2005, meeting, staff summarized the project results to date and presented three options for continuing:

- Present educational sessions on IASB and FASB work on expected values and obligations;
- Begin developing an operational approach to different classes of liabilities; or,
- Divert staff resources to another project.

Staff noted that there are fundamental disagreements between the Board members, particularly on whether the liability is the future sacrifice itself or the stand-ready obligation to make that sacrifice. As a result, staff feels that continuing to review individual programs one by one would probably not result in the timely settlement of many of these differences. Staff recommended diverting staff resources to another project.

After a brief discussion, the Board members unanimously agreed that the project should continue but should focus on classes of liabilities from this point forward, rather than a review of individual programs. This paper is a first step in that direction.

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Developing the Notion of Liability Classes

What is a class?

A class is “a group, set, or kind sharing common attributes” (characteristics).[1]

Why should we develop liability classes?

There is broad and general agreement among FASAB Board members that establishing liability classes will result in a more consistent application of the liability definition without the need for step-by-step rules on how to apply the definition to each government program as it comes into being.

Proposed Liability Class Alternatives

What role do the liability classes play in building on the conceptual framework?

The conceptual framework provides or will provide:

(1) reporting objectives,
(2) elements,
(3) recognition criteria,
(4) a framework for building financial statements from the elements,
(5) measurement attributes and related guidance, and
(6) other guiding principles.

The framework will be the primary means for ensuring a consistent approach is taken with respect to liabilities. In other words, for each class – and possibly subclass – the standards will seek to determine when the liability definition is met, whether or when the liability should be recognized and derecognized, and how it should be measured. Consistency is attained by assessing how well the standard adheres to the conceptual framework – not by reference between classes or subclasses.

The purpose of the classes and, possibly, subclasses is to facilitate implementation of the conceptual framework through understandable standards. To be effective, classes should group similar obligating events together. For example, obligations could be grouped at a very high level depending on whether they consist of unconditional or conditional promises. Another way to accomplish grouping by similar obligating events is to group by transaction or event type as was done in SFFAS 5. Alternatively, a more detailed break-down of transaction type or event could be developed. Staff believes the first question to be answered in each class is when the obligating event occurs.

Staff on the Elements project has established that there are two distinguishing characteristics that must be in place to create a liability: (1) a present obligation to provide assets or services to another entity and (2) an agreement or understanding as to when settlement of the obligation is to occur. The underlying notion that has carried through the last several drafts of the liability paper is that that every obligating event occurs when the agreement or understanding has been formed between two parties. The purpose of the classes, in this case, would be to help broadly identify when an agreement or understanding has been formed.

[1] Merriam-Webster Online at www.webster.com

Once the obligating event is identified, it is equally important to address recognition and measurement issues. To develop a complete standard, we will need to provide guidance that addresses how long the entity remains obligated, what is the best measurement attribute, changes in measurement during the period between obligation and settlement, and disclosure requirements. Ultimately, developing a standard for each class may lead to development of subclasses based on characteristics such as settlement type (e.g., contingent settlements or fixed amounts at fixed times).

Now that I know what you mean by "liability classes," the role classes play relative to the conceptual framework, and the advantages of using them, what do you propose to do next?

Staff is proposing three options below for your consideration, along with some advantages and disadvantages to selecting each of the options.

Option 1 – Apply New Liability Definition to the Current SFFAS 5 Liability Classes

The first option is to maintain the four broad classes that FASAB used to establish principle recognition points in SFFAS 5, *Accounting for Liabilities of the Federal Government*, as follows:

1. **Exchange Transactions** – an exchange transaction arises when each party to the transaction sacrifices value and receives value in return;
2. **Nonexchange Transactions** – a nonexchange transaction arises when one party to a transaction receives value without directly giving or promising value in return;
3. **Government-related Events** – government-related events are nontransaction-based events that involve interaction between the federal government and its environment; and,
4. **Government-acknowledged Events** – government-acknowledged events are nontransaction-based events that are of financial consequence to the federal government because it chooses to respond to the event.

Advantages to Accepting Option 1

- FASAB is currently using these classes and the federal financial community (auditors, preparers, users, and standard-setters) is familiar with these terms.
- Significant staff time would not need to be devoted to developing new terminology and groupings.

Disadvantages to Accepting Option 1

- Little would be gained; Board would still need to further classify nonexchange transactions in order to resolve current debates over recognition points earlier than due and payable.
- Very difficult to establish a consistent obligating event across such broad classes (although some would argue that due and payable is a broadly applicable obligating event).

Option 2 – Apply New Liability Definition to Liability Classes by Transaction Type

A second option is to classify liabilities by the type of transaction that has taken, is taking, or will take place. The following lists some of the major transaction types that could be considered:

1. **General Fund Benefit Payments** – Benefit payments that are financed by general revenues. Examples would be Temporary Assistance to Needy Families, Medicaid, Food Stamps, and Supplemental Security Income.
2. **Employee and Veteran Benefit Payments** – Examples would be federal employee pension and other retirement benefits, military pension and other retirement benefits, other post-employment benefits, FECA, and Veterans disability compensation.
3. **Insurance and Guarantees** – Examples would include Pension Benefit Guaranty Corporation, Federal Crop Insurance Corporation, Overseas Private Investment Corporation, Federal Deposit Insurance Corporation, Direct Loan Guarantees, and other stand-ready obligations.
4. **Capital Leases** – Leases that transfer substantially all the benefits and risks of ownership to the lessee.
5. **Federal Debt** – Includes Treasury debt to federal agencies, federal agency debt to the Treasury, and federal debt to the public.
6. **Grants** – Grants can be provided under different transactions. Some can be provided without any required exchange of service with the federal government, while others may require specific activities to occur before the funds are available.
7. **Social Insurance** – Includes Social Security, Medicare, and Railroad Retirement
8. **Environmental and Disposal** – Examples include Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA, or Superfund), and subsequent amendments; Safe Drinking Water Act; and Toxic Substances Control Act.
9. **Contingencies** – Includes pending or threatened litigation, possible claims and assessments, and collectibility of receivables.
10. **Goods and Services**
11. **Custodial**

Advantages to Accepting Option 2

- Federal financial community (auditors, preparers, users, and standard-setters) is very familiar with terminology; able to more quickly identify with classes by transaction type.
- Similar to the structure of the existing and proposed liability standards.
- Less coordination required for smaller groupings by transaction type than for major groupings by kind of relationship.
- Can move ahead with standards that cover more specific groupings more quickly than if a broader effort is required.
- Can more easily adapt existing standards to the new framework.
- “Easier” to identify a consistent obligating event within classes by transaction type than within broader classes.

Disadvantages to Accepting Option 2

- Application standards are required for each major transaction type, resulting in a greater number of standards over time.
- Without clear definitional guidelines, the number of different transaction types could be open-ended.
- There is some overlap between several of the classes that requires the same type of issues to be deliberated over and over again.
- In danger of repeating debates about recognition and measurement over and over again with each new transaction type.

Option 3 – Apply New Liability Definition to Liability Classes by Relationship Type

A third way to classify liabilities is by the process that establishes the binding relationship between the payable party and the receivable party.[2] The following lists some of the major relationship types that could be considered:

1. **Direct Exchange Transactions** – Liabilities under direct exchange transactions arise from an offer and acceptance process directly between the payable and receivable parties, each of whom is free to decide if and when a deal is satisfactory to them. The promised transfers are equal in value at the inception of the agreement. Examples would be arrangements for the receipt of goods and services, performance contracts, capital leases, and employee and veteran wages and benefits.
2. **Indirect Exchange Transactions** – Liabilities under indirect exchange transactions arise from an offer and acceptance process indirectly between the payable and receivable parties, each of whom is free to decide if and when a deal is satisfactory to them. The promised transfers are not directly between the payable and receivable parties and may not be exactly equal in value at the inception of the agreement. However, there must be a causal relationship between the action of the receivable party and the benefits provided by the payable party. In other words, since there is no causal relationship between paying general taxes and receiving general benefits, the payment of general taxes does not result in a liability. An example of an indirect exchange transaction would be the Corporation for National and Community Service's Service Award Liability, whereby the AmeriCorps member provides services for American citizens on behalf of a Corporation grantee and receives an education award from the Corporation in return.
3. **Subsidy Arrangements** – Liabilities under subsidy arrangements arise when the payable party promises to transfer assets or services to the receivable party and the receivable party promises to act in accordance with the terms of the agreement. These arrangements differ from imposed settlements below because each party is generally free to decide whether to accept and/or continue the arrangement. Furthermore, while the receivable party may be able negotiate some, the payable party dictates the terms to a large extent. Examples would be grants, contributions, gifts, bequests, farm subsidy programs, and general fund benefit programs.
4. **Imposed Settlements** – These liabilities are imposed by governmental authority. They arise from an act or circumstance of the payable party that invokes a legal directive to deliver assets or services to a specified receivable party or to expend assets or services for designated purposes under surveillance of an enforcing party. Examples would be tax and other assessments, judgments, arbitration awards, fines and forfeitures, and environmental cleanup responsibilities.

Advantages to Accepting Option 3

- More objectives-oriented overall than classes by transaction type.
- Application standards are only required for each major kind of relationship.

[2] All liabilities involve two or more parties. This paper uses the terms "payable party" and "receivable party" to refer to each of the two parties. With respect to liabilities, the term "payable party" can be interchanged with "the government entity for which financial statements are being prepared or for which liabilities are being considered."

Disadvantages to Accepting Option 3

- New terminology that the federal financial community (auditors, preparers, users, and standard-setters) is not familiar with.
- Significant staff time would need to be devoted to developing new terminology and groupings.
- Would require existing standards to be consolidated and reworked to fit new framework.
- May slow down the development of standards due to a broader coverage.
- May split transaction types (e.g., insurance agreement with premium versus insurance agreement without premium).
- Very difficult to establish a consistent obligating event across such broad classes.
- In danger of repeating debates about recognition and measurement over and over again with each new relationship type.

Liability Settlement Types

However we decide to classify liabilities, we must confront the fact that all types of liability require settlement. Broadly speaking, settlement terms will always be conditional or unconditional, and most if not all, liabilities contain both conditional and unconditional terms. The following lists some of the major settlement types that could be considered:

1. **Ordinary fixed time and amount settlements** – These liabilities have the amount and time of settlement specified precisely in the agreement or understanding.
2. **Ordinary variable time or amount settlements** – Typical liabilities of this type are for purchase of goods and services at the market price existing at the time of delivery, including variable rate loans payable.
3. **One-way option settlements** – Like variable time or amount settlements, these are variable time or amount settlements, but they differ from variable time or amount settlements in two respects: one, the amount and timing of settlement is contingent on events that cannot be controlled by the payable party, who is called the option writer, and two, if the events do not occur, the settlement amount is zero at the time the option expires. The most basic service provided by option writers is standing ready to absorb a loss (that is, to provide loss, or price, protection to the receivable party) should the contingent event occur. Thus, the receivable party, the option holder, receives full value for any premium paid even if the settlement amount is zero, as it often is.
4. **Two-way option settlements** – These are a pair of one-way options joined to one another and attached to opposite sides of the same underlying index, usually the price of something. The two options are joined together so that each party is both a payable party on one option and a receivable party on the other. Each payable party has a liability to the other receivable party. Normally the two options are of equal value at inception so there is no net value and no premium. Since the value of the two options moves in opposite directions in response to a change in the index, any change in the index produces gain for one payable party and loss for the other payable party (and vice versa from a receivable party perspective). Futures and swaps are common forms of two-way options.

We may want to establish a principle that a particular settlement type should be recognized and measured the same way regardless of the class of relationship from which it originated.

Staff Recommendation

These proposed options and classes are still in draft form. It is staff's intention to obtain the Board members' preference for approaching the liability classification from either a transaction or relationship point of view. Once the Board members' preference is obtained, additional work would need to be performed to present an acceptable list of classes. After considering the advantages and disadvantages to the above options, it is staff's recommendation that "Option 2 – Apply New Liability Definition to Liability Classes by Transaction Type" be selected as the preferred approach. Staff stresses that it is important to remember that the ability to consistently identify the obligating event within each of these classes (when the agreement or understanding is formed) is key to the selection of the classes.

FASB

APB 29, *Accounting for Nonmonetary Transactions*, par. 1 refers to the distinction between (a) an exchange with another entity (**reciprocal transfer**) that involves principally nonmonetary assets or liabilities or (b) a transfer of nonmonetary assets for which no assets are received or relinquished in exchange (**nonreciprocal transfer**). Par. 3 further defines these terms as:

c. Exchange (or exchange transaction) is a **reciprocal transfer** between an enterprise and another entity that results in the enterprise's acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations. A reciprocal transfer of a nonmonetary asset shall be deemed an exchange only if the transferor has no substantial continuing involvement in the transferred asset such that the usual risks and rewards of ownership of the asset are transferred.

d. **Nonreciprocal transfer** is a transfer of assets or services in one direction, either from an enterprise to its owners (whether or not in exchange for their ownership interests) or another entity or from owners or another entity to the enterprise. An entity's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

Distinguishing between reciprocal and nonreciprocal transfers has been used to a limited extent by FASB (e.g., FAS 116, *Accounting for Contributions Received and Contributions Made* and FAS 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*) but not to the same extent as GASB has used exchange versus nonexchange (see section below).

GASB

GASB Statement 33, *Accounting and Financial Reporting for Nonexchange Transactions,* states that state and local government engage in two kinds of transactions: (a) **exchange and exchange-like transactions**, in which each party receives and gives up essentially equal values, and (b) **nonexchange transactions**, in which a government gives (or receives) value without directly receiving (or giving) equal value in exchange. Statement 33 goes on to identify four classes of nonexchange transactions based on shared characteristics that affect the timing of recognition:

1. **Derived tax revenues**, which result from assessments imposed on exchange transactions (for example, income taxes, sales taxes, and other assessments on earnings or consumption)
2. **Imposed nonexchange revenues**, which result from assessments imposed on nongovernmental entities, including individuals, other than assessments on exchange transactions (for example, property taxes and fines)
3. **Government-mandated nonexchange transactions**, which occur when a government at one level provides resources to a government at another level and requires the recipient to use the resources for a specific purpose (for example, federal programs that state or local governments are mandated to perform)
4. **Voluntary nonexchange transactions**, which result from legislative or contractual agreements, other than exchanges, entered into willingly by the parties to the agreement (for example, certain grants and private donations).

FASAB

FASAB has issued several statements that establish standards related to liabilities. SFFAS 1 includes guidance for current liabilities including accounts payable, interest payable and other current liabilities.[3] SFFAS 2 provides guidance on liabilities resulting from direct loans and loan guarantees.[4] In SFFAS 5, FASAB provided a liability definition and established accounting standards to recognize and measure liabilities in general purpose federal financial reports, which are issued for both internal and external users. SFFAS 5 defines the recognition points for liabilities associated with different types of events and transactions,[5] as follows –

- A liability arising from "**reciprocal" or "exchange" transactions** (i.e., transactions in which each party to the transaction sacrifices value and receives value in return) should be recognized when one party receives goods or services in return for a promise to provide money or other resources in the future (e.g., a federal employee performs services in exchange for compensation).

- A liability arising from "**nonreciprocal" transfers or "nonexchange" transactions** (i.e., transactions in which one party to the transaction receives value without directly giving or promising value in return, such as grant and certain entitlement programs) should be recognized for any unpaid amounts due as of the reporting date. The liability includes amounts due from the federal entity to pay for benefits, goods, or services[6] provided under the terms of the program, as of the federal entity's reporting date, whether or not such amounts have been reported to the federal entity (e.g., estimated Medicaid payments due to health providers for service that has been rendered and that will be financed by the federal entity but have not yet been reported to the federal entity).

- **Government-related events** are nontransaction-based events that involve interaction between federal entities and their environment. The event may be beyond the control of the entity. A liability is recognized for a future outflow of resources that results from a government-related event when the event occurs if the future outflow of resources is probable and measurable (see paragraphs .114 and .115 below for the definitions of probable and measurable, respectively) or as soon thereafter as it becomes probable and measurable. Events, such as a federal entity accidentally causing damage to private property, would create a liability when the event occurred, to the extent that existing law and policy made it probable that the federal government would pay for the damage and to the extent that the amount of the payment could be estimated reliably. Government-related events also include hazardous waste spills on federal property caused by federal operations or accidents and catastrophes that affect government-owned property.

- **Government-acknowledged events** are events that are of financial consequence to the federal government because it chooses to respond to the event. A liability is recognized for a future outflow of resources that results from a government-acknowledged event when and to the extent that the federal government formally acknowledges financial responsibility for the event and a nonexchange or exchange transaction has occurred. The liability for a nonexchange transaction should be recognized for any unpaid amounts due as of the reporting date and the liability for an exchange transaction should be recognized when goods or services have been provided. The liability includes amounts due from the federal entity to pay for benefits, goods, or services provided under the terms of the program, as of the federal entity's reporting date, whether or not such amounts have been reported to the federal entity (Examples of government-acknowledged events include toxic waste damage caused by nonfederal entities and damage from natural disasters).

[3] See Subject Area Sections A10 Accounts Payable, I50 Interest Payable and O40 Other Current Liabilities.
[4] Subject Area Section L60 Loans and Loan Guarantees.
[5] See L40.4004 for an illustration of the recognition points.
[6] Goods or services may be provided under the terms of the program in the form of, for example, contractors providing a service for the government on the behalf of the disaster relief beneficiaries.

SFFAS 12 amended SFFAS 5's contingent liability criteria and applies to the evaluation, accounting recognition and disclosure of losses the existence of which must be confirmed by the future outcome of litigation.

Liabilities recognized according to SFFAS 5 include both liabilities covered by budgetary resources and liabilities not covered by budgetary resources. Liabilities covered by budgetary resources are liabilities incurred that will be covered by available budgetary resources encompassing not only new budget authority but also other resources available to cover liabilities for specified purposes in a given year. Liabilities not covered by budgetary resources include liabilities incurred for which revenues or other sources of funds necessary to pay the liabilities have not been made available through congressional appropriations or current earnings of the reporting entity. Notwithstanding an expectation that the appropriations will be made, whether they in fact will be made is completely at the discretion of the Congress. [footnote omitted]

SFFAS 5 established accounting standards for several specific classes of liabilities. They are covered by separate sections in Volume II as follows: L20 **Leases**; F10 **Federal Debt**; I40 **Insurance and Guarantee Programs**; and P20 **Pensions, Other Retirement Benefits, and Other Post-employment Benefits**. The Board is currently working on an accounting standard for **Social Insurance programs**.

IPSASB

The IPSASB (formerly PSC) January 2004 Invitation to Comment on "Accounting for Social Policies of Governments" breaks down the broad class of social benefits into the following four sub-classes:

- Collective and Individual Goods and Services;
- Cash Transfers to Individuals;
- Disaster Relief; and,
- Old Age Pension Benefits.