



Federal Accounting Standards Advisory Board

August 5, 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 Definition¹ – Tab G

At the June 22, 2005 meeting, staff presented an analysis of the Corporation for National and Community Service's (CNCS) Service Award Liability. Staff selected this program as an example of a government program that recognizes a liability before the due and payable point even though it is a nonexchange transaction and not all conditions have been met for the member to have a legal claim to the award. CNCS currently recognizes a liability for each member after he has completed 15 percent of his term of service.

Staff compared CNCS's program to the other programs presented by staff at prior meetings (Supplemental Security Income, Milk Income Loss Contract, and Feed Grains Direct and Counter-Cyclical Payment) and suggested that the point at which the member applies for the program could be considered the obligating event based on the same logic applied by staff to the other programs (the point at which a mutual understanding/"meeting of the minds" has been formed).

Board members did not make a formal decision on the obligating event at this meeting, but did agree that it seems appropriate for CNCS to recognize some amount earlier than due and payable for this program. However, under current FASAB SFFAS 5, a liability would not be recognized until due and payable if the transaction is characterized as nonexchange.

In addition, several Board members debated whether (1) the program was actually nonexchange and (2) the liability should, in fact, either be recognized in full after the member has completed service or on a prorated basis as he is performing service. The alternative recognition points proposed by members would still result in earlier recognition than due and payable, which for this program, is after a member has completed his full term of service and incurred eligible educational expenses.

In the last three meetings, staff has noted fundamental disagreements among board members on when the definition of a liability is met. Staff feels that continuing to review additional government programs one by one would probably not result in the timely resolution of these underlying differences.

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.

There are several conclusions that might be drawn from the results of this project so far:

- Due and payable is probably not the right answer for many nonexchange government programs;
- The obligation to stand ready to perform is a service and thus could be considered the liability in certain situations;
- There is a difference between programs that are conditional and programs that make “firm offers”; and,
- Members differ on when conditions are substantially met.

This tab presents a discussion of the inherent difficulties all standard-setters face and an operational analysis of the draft liability definition. In addition, this tab presents three options for proceeding on this project:

1. Staff could present educational sessions on IASB and FASB work on expected values and obligations;
2. Staff could begin developing an operational approach to three classes of liabilities:
 - Firm offers (e.g., Tsunami relief);
 - Conditional offers where the recipient has substantial control over meeting the conditions (e.g., CNCS, Social Security, SSI, Food Stamps, the \$1.5 billion offered to Metro); and,
 - Conditional offers where the environment or market influences the meeting of conditions (e.g., MILC, Feed Grains)
3. Staff resources could be diverted to another project until the liability definition is finalized.

The staff objective for the August meeting is to obtain comments, suggestions, and continued direction for the project. Please contact me at 202-512-7377 or by e-mail at ranaganj@fasab.gov with questions or comments.

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Staff Objective for this Paper

1. To discuss the inherent difficulties all standard-setters face;
2. To obtain the Board's general agreement that they will not be able to develop a completely objective set of liability characteristics in a timely manner through program-by-program analysis;
3. To confirm that members believe the program-by-program analysis has verified that the liability framework supports discussion of liability issues but does not and will not eliminate the need for judgment; and,
4. To present an operational liability recognition flowchart based on the current draft liability characteristics.

Inherent Difficulties All Standard-Setters Face

There are three "realities" that all standard-setters face:

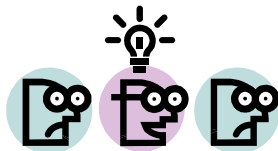
- There is not a single right answer to every question;
- Most concepts and standards will be open to interpretation; and,
- The majority of standards are reactive rather than proactive.

The following excerpts are taken from seasoned professionals who have experienced these realities firsthand:

. . . No Single Right Answer

"The difficulty in making financial comparisons between enterprises because of the use of different accounting methods has been accepted for many years as the principal reason for the development of accounting standards. Indeed the only other possible reason for wanting accounting standards would be a belief that there was one right method among the available alternatives, and few people, if any, hold such a belief." *How the FASB Approaches a Standard-Setting Issue*. Cheri L. Reither, Accounting Horizons, Dec. 1997, p. 92.

"FASB Board members are intelligent, independent, strong-willed individuals. They truly enjoy a vigorous debate and believe it is their responsibility to do so. It is a real strength of our system that each Board member considers the issues so carefully and argues for what he truly believes in. But it's also a weakness when the strength of conviction overrides the need to resolve issues on a reasonably timely basis. My experience leads me to conclude that the FASB's scales are weighted too much to seeking a perfect answer and not enough to resolving issues in a timely manner. With the increasing speed of change in our business world, I believe the Board *must* become more serious about its recently adopted strategic direction to set standards in a more efficient and timely way." *How to Succeed as a Standard Setter by Trying Really Hard*. Dennis R. Beresford, Accounting Horizons, Sep. 1997, p.85.



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. . . **Open to Interpretation**

“My experience as a member of the APB taught me many lessons. A major one was that most of us have a natural tendency and an incredible talent for processing new facts in such a way that our prior conclusions remain intact. [footnote omitted] Therefore, no matter what conceptual framework is developed, its success will be heavily affected by individual interpretations.” *Uses and limitations of a conceptual framework*. Charles T. Horngren, *Journal of Accountancy*, Apr. 1981, p. 92.

. . . **Reactive**

“The FASB is mostly reactive rather than proactive in its approach to identifying financial reporting issues that warrant agenda consideration. In general, the Board does not have a mechanism for identifying accounting problems “in need of fixing” unless those problems are brought to its attention through one or more of several sources that provide “candidates” for the Board’s agenda: (1) Financial Accounting Standards Advisory Committee, (2) Emerging Issues Task Force, (3) meetings of Board members and representatives of FASB constituents including the Securities and Exchange Commission and the AICPA Accounting Standards Executive Committee, (4) letters from other organizations and individuals, (5) technical inquiries, (6) the business press, and (7) international standard-setting activity. [footnote omitted]” *How the FASB Approaches a Standard-Setting Issue*. Cheri L. Reither, *Accounting Horizons*, Dec. 1997, p. 91.

In this project, as well as relevant FASB and GASB projects¹, we have seen where these realities come into play when discussing the following question:

Is the liability (1) the future sacrifice itself or (2) the obligation to make that sacrifice? “A New Conceptual Framework Project.” Halsey G. Bullen and Kimberley Crook, *Revisiting the Concepts*, May 2005, p. 14.

Is the liability (1) the payment to milk producers when the Boston Class I Milk Price falls below \$16.94 per hundredweight or (2) the guarantee to pay milk producers should the price of milk fall below \$16.94 per cwt? Based on prior deliberations by the Board, that question does not appear to have been answered in a way that is accepted by all members. However, certain decisions point to the answer that the liability is the obligation to make the sacrifice. For example:

1. Members agreed that it was feasible to have a zero dollar liability. This suggests there could be a liability without future sacrifices.
2. Members agreed that a requirement to provide a service could be a liability. In the context of FIN 45 and the IASB’s proposed amendments to contingent liability standards, an unconditional commitment to stand-ready to transfer resources if a certain condition is met is a service. Thus, an unconditional obligation to act in the event certain contingencies arise is a liability.

¹ FASB Interpretation No. 45 (FIN 45), *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, FASB FIN 47, *Accounting for Conditional Asset Retirement Obligations*, and GASB PV on *Accounting and Financial Reporting for Pollution Remediation Obligations*.

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Judgment of a Reasonable Person

FASB Concepts Statement Number 2, *Qualitative Characteristics of Accounting Information*, par. 132, provides a fundamental concept that I feel provides overriding guidance to preparers and auditors absent any specific authoritative guidance.

132. Individual judgments are required to assess materiality in the absence of authoritative criteria or to decide that minimum quantitative criteria are not appropriate in particular situations. The essence of the materiality concept is clear. The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

This notion is not specifically mentioned in any FASAB concepts but it is included in several FASAB standards. SFFAS 1, *Accounting for Selected Assets and Liabilities*, par. 13, states:

13. The determination of whether an item is material depends on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement.

I believe that the notion of “the judgment of a reasonable person relying on the information” is vastly important to what and how much information should be conveyed in a financial report. This notion is inherent in all concepts and standards promulgated by FASAB, but I believe that FASAB could place more emphasis in its deliberations and basis for conclusions on the ability of the preparers and auditors, working both independently and together, to determine what is materially important within the framework established by FASAB.

“One of the common criticisms of the FASB is that it writes rules that are too complex and cookbook-like rather than broader principles that can be applied with judgment. We are often pressed for more detailed and complex standards by the large public accounting firms, regulators such as the SEC, and others who prefer as much consistency as possible in the application of standards. But I think the FASB can and should do a better job of resisting those pressures for more and more complexity. The trick, of course, is to find the balance between standards that will lead to reasonable comparability in reporting similar economic activities and professional judgment that almost always must be used.” *How to Succeed as a Standard Setter by Trying Really Hard*. Dennis R. Beresford, *Accounting Horizons*, Sep. 1997, p.84.

“The new [PSAB liability] definition and [Liabilities, Section PS 3200] Handbook section moves the definition and recognition of liabilities away from contracts, agreements and legislation being in force at the accounting date to assessing when a government has little or no discretion to avoid the future sacrifice of economic benefits. The new definition may not be as easy to apply and may introduce a level of professional judgment, but it does get at the heart of what a liability is.” *Redefining liabilities*. Tim Beauchamp, *camagazine*, Dec. 2004. *Tim Beauchamp, CA, is a principal with the CICA’s public sector accounting department*

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1 Staff recommends that the members consider crafting a definition and standard that establishes
2 a framework that preparers and auditors can use in conjunction with the “judgment of a
3 reasonable person relying on the information.” Judgment will need to be applied, personal
4 biases will be involved, and some issues with inconsistent application will probably emerge.
5 These are the realities of standard-setting. One Board member seems to have adopted this
6 outlook at an earlier meeting:
7

8 I think what [the Board is] trying to do is get some definition so that we don’t have to look
9 at every milk and cheese and egg and who knows what other department there is. We
10 want a definition that says, “Here it is, you look at your program and you apply it.” The
11 Farm Service Agency might have come up with \$16.94 being the eligibility criteria and
12 we’d say “Fine, we’ve defined the eligibility criteria as that which is the important
13 measurement tool, so you can interpret that.” I don’t think we can interpret every
14 program in the federal government. – Mr. Farrell at the May 4, 2005 session on the Milk
15 Income Loss Contract Program
16

17 FASAB concepts and standards should provide the framework that the preparers and auditors
18 can apply to reach the “best” answer given their knowledge and experience of the program, the
19 user, and the specific circumstances currently underlying each situation (these circumstances
20 are usually subject to change on an ongoing basis due to change in law, change in
21 demographics, change in economy, etc). Specific standards on how the Board believes that
22 framework should be applied may be needed as situations come to its attention through any of a
23 variety of ways, including letters from individuals or organizations, technical inquires, meetings
24 of the AAPC, reviews of government audit reports, the press, and international standard-setting
25 activity.
26
27

28 **FASAB Objectives for Federal Financial Reporting**

29
30 Developing a new liability definition and recognition criteria requires the Board to consider what
31 the overall objective is for providing this information, and what the objective is for the balance
32 sheet and statement of net cost. The following objectives from SFFAC 1 seem especially
33 relevant:²
34

35 Objective #2 – Operating Performance – Federal financial reporting should assist report
36 users in evaluating the service efforts, costs, and accomplishments of the reporting entity;
37 the manner in which these efforts and accomplishments have been financed; and the
38 management of the entity’s assets and liabilities. Federal financial reporting should
39 provide information that helps the reader to determine:
40

41 2A. the costs of providing specific programs and activities and the composition of,
42 and changes in, these costs;

43 2B. the efforts and accomplishments associated with federal programs and the
44 changes over time and in relation to costs; and

45 2C. the efficiency and effectiveness of the government’s management of its assets
46 and liabilities.
47

48 Objective #3 – Stewardship – Federal financial reporting should assist report users in
49 assessing the impact on the country of the government’s operations and investments for
50 the period and how, as a result, the government’s and the nation’s financial condition has

² FASAB: Original Pronouncements, Version 4 (06/2004), p. 6

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1 changed and may change in the future. Federal financial reporting should provide
2 information that helps the reader to determine whether:

- 3
4 3A. the government's financial position improved or deteriorated over the period;
5 3B. future budgetary resources will likely be sufficient to sustain public services
6 and to meet obligations as they come due; and,
7 3C. government operations have contributed to the nation's current and future
8 well-being.
9

10
11 **Characteristics of a Liability**

12
13 At the June 2005 meeting, the Board continued deliberations begun at previous meetings under
14 the Elements project as to whether the essential characteristics of liabilities identified by FASB
15 in its Concepts Statements 6 for private-sector entities are also essential characteristics of
16 federal liabilities, and/or whether federal liabilities have other essential characteristics. The
17 characteristics of FASB are (par. 36):
18

- 19 (a) It embodies a present duty or responsibility to one or more other entities that
20 entails settlement by probable future transfer or use of assets at a specified or
21 determinable date, on occurrence of a specified event, or on demand;
22 (b) The duty or responsibility obligates a particular entity leaving it little or no
23 discretion to avoid the future sacrifice; and
24 (c) The transaction or other event obligating the entity has already happened.
25

26 Paragraphs 35 and 37 of Penny Wardlow's paper for the August meeting states "A liability is a
27 present obligation³ to provide assets or services to another entity at a determinable date, when
28 a specified event occurs, or on demand. A liability has two essential characteristics:
29

- 30 (a) it constitutes a present obligation to provide assets or services to another entity,
31 and;
32 (b) the entities have reached an agreement or understanding as to when settlement
33 of the obligation is to occur."
34

35 The Board will discuss the definition and the two proposed characteristics of a liability at the
36 August meeting.
37
38

³ 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.

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Proposed Revision to Liability Recognition Summary

Staff on this project has reviewed seven different government programs over the last 12 months and provided the Board with a program fact sheet for each one and a detailed analysis of obligating events for four of the programs. These analyses have attempted to demonstrate to the Board how the draft liability definition might be operationalized. The Board has generally found the analyses to be useful but has declined to make any decisions or vote on any issues while the liability definition is still being drafted. As a result, it has been difficult for staff to get a true sense of the Board on how to apply the liability definition. As such, staff felt it was a more valuable use of time and resources for this meeting to propose a revision to SFFAS 5, Figure 1, "Liability Recognition Summary," based on the draft liability definition rather than look at yet another government program. Staff feels that the Board will find this operational view of the application of the liability definition helpful as they review the draft concepts statement on Elements. The original Figure 1 in SFFAS 5, *Accounting for Liabilities of the Federal Government*, is included on the next page for your reference.

The proposed revision to SFFAS 5 Figure 1 is included on page 10. This revision is derived from paragraphs 35 through 44 and 5 of the draft concepts statement Penny Wardlow prepared for the August meeting:

Definition of a Liability

35. A liability is a present obligation⁴ to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

36. The definition of a liability addresses only whether a liability exists and not whether or when it should be recognized in a statement of financial position. Recognition criteria for all elements of financial statements are set forth and discussed in paragraphs 5 through 9. Issues of uncertainty concerning the existence of a liability (and other elements) and its amount are discussed in paragraphs X1 through X6.

Essential Characteristics of Liabilities

37. Similar to the definition of an asset, the definition of a liability is derived from the nature of liabilities—the characteristics that are fundamental or essential to all liabilities. A liability has two essential characteristics. First, it constitutes a present obligation to provide assets or services to another entity. Second, the entities have reached an agreement or understanding as to when settlement of the obligation is to occur. Paragraphs 38 through 44 discuss those characteristics.

Present Obligation

38. 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. [see block 1 on proposed Figure 1].** Thus, a present obligation should be distinguished from a mere expression of future intent, such as an entity's announcement that it intends to acquire equipment. A present obligation is not incurred until an entity takes a specific

⁴ 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.

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1 action that commits or binds itself and affects another entity—for example, contracting
2 with another entity for equipment.
3

4 **39. To meet the first essential characteristic of a liability, a present obligation**
5 **must entail the provision of assets (cash, cash equivalents, or goods) or services**
6 **to another entity in the future [see block 3 on proposed Figure 1].** For example, an
7 entity that has received but not yet paid for goods or services that it has agreed to
8 purchase from another entity has a liability to settle the purchase price in accordance with
9 the terms of the agreement. Further, when an entity agrees to provide financial
10 assistance to another entity or entities, the first entity incurs a liability when it extends an
11 unconditional promise to provide resources, even if the actual transfer of resources is not
12 required until a later date **[NOTE: This would be equivalent to the “offer” in an “offer”**
13 **and “acceptance” arrangement].**
14

15 **40. As indicated in paragraph 39, for a present obligation to qualify as a**
16 **liability, two separate entities must be involved, namely the federal entity that has**
17 **the obligation and another federal or nonfederal entity (or entities) that is external**
18 **to the obligated entity. Separate entities must be involved because the same entity**
19 **cannot be both the recipient of settlement of a liability and the entity with the duty**
20 **to settle [see block 2 on proposed Figure 1].** For example, a federal entity that
21 operates machinery may have an obligation to maintain it. However, the entity does not
22 have a liability for maintenance; the entity cannot have a liability to itself. In contrast, if
23 the entity contracts for maintenance from another entity, it may have a liability to that
24 other entity for the price of the maintenance services it has received.
25

26 **Settlement of the Obligation**
27

28 **41. The second essential characteristic of a liability is that the parties**
29 **involved have reached an agreement or understanding concerning settlement. The**
30 **timing of settlement often is expressed in contracts or other agreements as a**
31 **specific or determinable date, but in some cases the parties agree that settlement**
32 **will be triggered by a specific event or by the demand of the recipient of the assets**
33 **or services, the timing of which may be uncertain [see block 4 on proposed Figure**
34 **1 - NOTE: This would be equivalent to the “acceptance” in an “offer” and**
35 **“acceptance” arrangement].** If the entities have not reached an agreement and the
36 obligated entity is free to decide whether and when to settle the obligation, the entity's
37 obligation does not meet the definition of a liability.
38

39 **42. In addition to uncertainty as to the timing of settlement, many present**
40 **obligations involve uncertainty regarding the amount of settlement. For example, the**
41 **amount required to settle the obligation may be contingent on the occurrence or non-**
42 **occurrence of a future event, such as a decline in market prices. The entity nevertheless**
43 **is obligated to stand ready to fulfill its conditional obligation. Uncertainty regarding the**
44 **amount or timing of settlement is addressed through measurement of the liability [NOTE:**
45 **For this reason, amount and other terms and conditions that are not considered**
46 **essential to having a liability are not included in the diagram].**
47

48 **43. Frequently, an obligated entity will know which specific entities or individuals**
49 **will receive settlement before settlement is due. However, such advance identification of**
50 **specific recipients is not an essential characteristic of a liability. For example, an**
51 **employer may have a long-term disability agreement with its employees without knowing**
52 **the identity of each of the employees who ultimately will qualify for payment. The**
53 **obligation qualifies as a liability if both of the essential characteristics of a liability are**
54 **present.**
55

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1 44. Once incurred, a liability continues as a liability of the entity until the entity
2 settles it, or another event or circumstance discharges it or removes the entity's
3 responsibility to settle it.

4
5 **RECOGNITION CRITERIA**

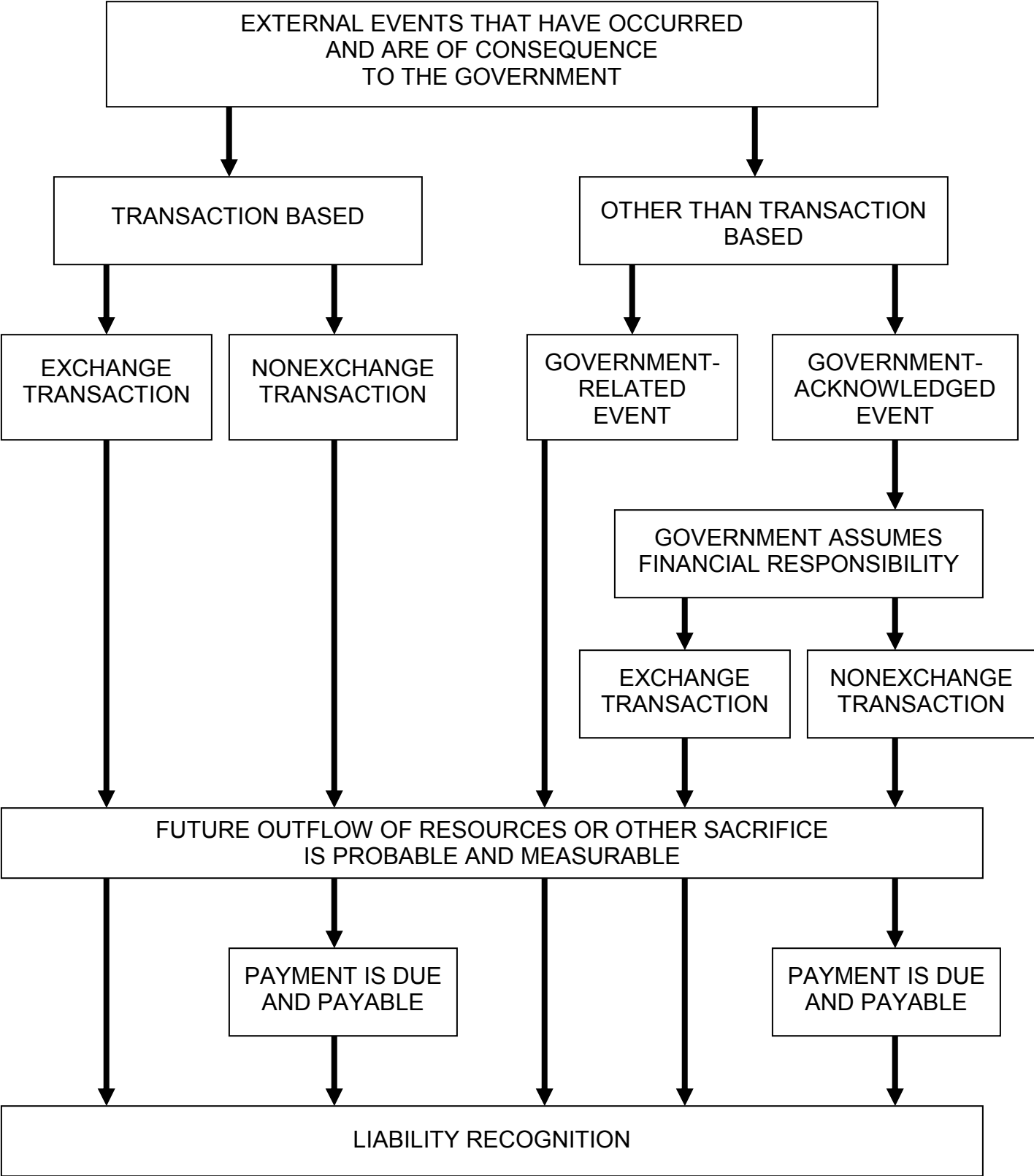
6
7 5. Recognition criteria are the conditions an item should meet in order to be
8 recognized in financial statements. **The recognition criteria established in this**
9 **Statement are (a) The item should meet the definition of an element of financial**
10 **statements and (b) The item should be measurable [see block 6 on proposed**
11 **Figure 1].**

12
13 In addition, the proposed revision to SFFAS 5 Figure 1 removes the reference to exchange
14 versus non-exchange transactions and government-related versus government-acknowledged
15 events. Staff is proposing that these distinctions are not necessary in light of the draft liability
16 definition and the notion of "judgment of a reasonable person relying on the information."
17

18 An analysis of how the proposed change to the SFFAS 5 Figure 1 might be operationalized is
19 provided beginning on page 11.

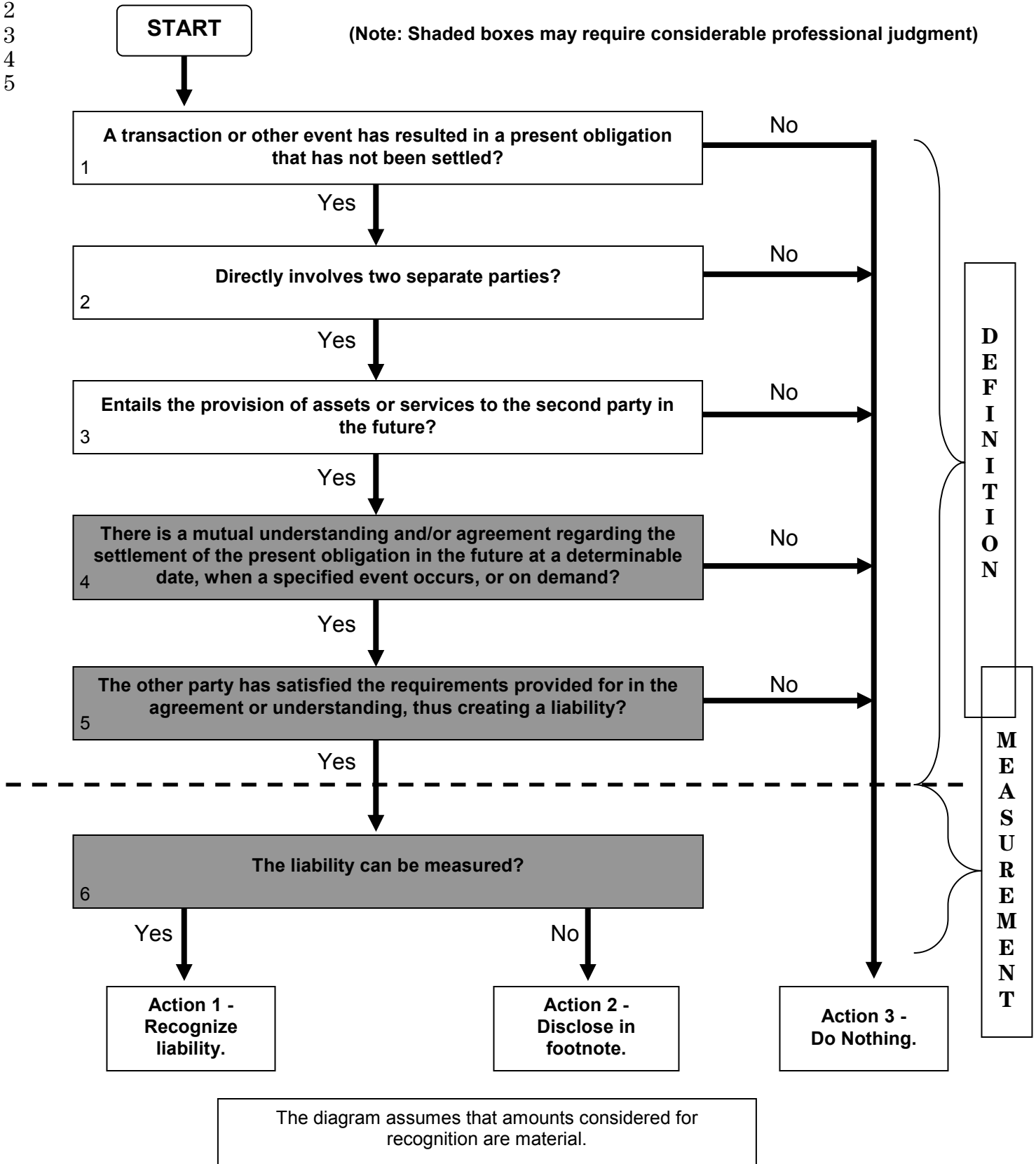
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1 SFFAS 5, Figure 1: Liability Recognition Summary



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1 Figure 1: Liability Definition and Recognition Summary (Proposed Revision)



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Operational Examples of New Liability Definition and Recognition Summary

The following examples demonstrate how accrued annual leave and accrued sick leave might be analyzed against the old SFFAS 5 Figure 1 – Liability Recognition Summary and staff’s proposed revision to Figure 1.

Scenario

John Doe works one full pay period for the U.S. Government. He accrues 4 hours of annual leave and 4 hours of sick leave. He has received these benefits in exchange for the service that he has provided to the government. He will receive payment for the annual leave at his current annual rate when the leave is used, either via approved vacation or separation from the government. The sick leave can only be used should John become sick or have another approved use for the sick leave (doctor or dentist appointment, to care for a sick family member, etc). John can carry over up to 240 hours of annual leave to the next leave year; leave in excess of 240 hours can be used in the current year or donated to another government employee in need. While he can donate excess annual leave, he can never transfer his unused sick leave to another government employee. Upon separation or death, all unused sick leave will be forfeited.

In the case of both annual leave and sick leave, there is one additional condition that must be met before the employee can receive payment for the leave – the employee must use the leave in an approved manner. The primary difference between the two types of leave is in the case of death or separation from the government. If the employee should separate from the government or die before he uses his annual leave, he or his heirs would receive a lump sum payment of the accrued annual leave. Unused sick leave is forfeited upon death or separation of the government (note: if the employee later re-enters government service, he can receive a reinstatement of his forfeited sick leave).

I chose to analyze accrued annual leave and accrued sick leave because FASAB SFFAS 5 does not address compensated absences. First, I will use the old SFFAS 5, Figure 1 to determine how to account for accrued annual leave and then I will use the proposed revision to SFFAS 5, Figure 1. Then I will apply the same comparison to accrued sick leave.

Accrued Annual Leave

Old: SFFAS 5, Figure 1: Liability Recognition Summary

1. “External events that have occurred and are of consequence to the government” – The accrual of annual leave is of consequence (importance) to the government because it will result in the future provision of assets (in the form of a cash payment) to the employee when he uses the annual leave in an approved manner or upon death or separation from the government. The term “external” is very ambiguous, having several meanings, not the least of which is “not intrinsic or essential.” SFFAS 5, par. 20, states “An event may be an internal event that occurs within an entity, such as transforming raw materials into a product. An event may also be an external event that involves interaction between an entity and its environment, such as a transaction with another entity, an act of nature, a theft, vandalism, an injury caused by negligence, or an accident.” Since the employee is an employee within the federal government working on a federal mission, it is difficult to call this an external event.

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- 1 2. “Transaction based”/“Other than transaction based” – A transaction is defined in the
2 consolidated glossary⁵ as “A particular kind of external event involving the transfer of
3 something of value concerning two or more entities. The transfer may be a two way or one
4 way flow of resources or of promises to provide resources. (Adapted from Financial
5 Accounting Standards Board, *Statement of Financial Accounting Concepts No. 6*, Elements
6 of Financial Statements).” I find this definition to be circular: if a transaction is an external
7 event and an event is a transaction, what is the true definition of transaction? Insert the
8 ambiguous word “external” into the definition and I again question how the accrual of annual
9 leave based on services performed working on a federal mission can be external.

10
11 Merriam-Webster defines transaction as “to carry to completion” and event as “something
12 that happens.”⁶ One could argue that a transaction is something that willfully occurs while
13 an event is something that happens on its own. If John got food poisoning from eating out
14 at a restaurant, the eating out would be a transaction while the food poisoning would be an
15 event. In order to continue my analysis of the old Figure 1 for accrued annual leave, I will
16 agree that accrued annual leave would probably fit into the category of “transaction based”
17 (eating out) more closely than “other than transaction based” (food poisoning).

- 18
19 3. “Exchange Transaction”/“Nonexchange Transaction” – Once the preparer chooses whether
20 an external event is a transaction (external event) or an event (see the dilemma here?), and
21 decides on transaction (external event), he must then decide whether that transaction is an
22 exchange transaction or a nonexchange transaction.

23
24 Determining whether a transaction is exchange or nonexchange is much more difficult than
25 it might seem at first. Paragraphs 22 and 24 of SFFAS 5 as well as the glossary definitions
26 are inconsistent in stating whether a transaction needs to be direct in order to be an
27 exchange.

28
29 **SFFAS 5, par. 22**

30
31 An **exchange transaction** arises when each party to the transaction sacrifices
32 value and receives value in return. There is a two-way flow of resources or of
33 promises to provide resources. In an exchange transaction, a liability is
34 recognized when one party receives goods or services in return for a promise to
35 provide money or other resources in the future.⁷

36
37 **SFFAS 5, par. 24**

38
39 A **nonexchange transaction** arises when one party to a transaction receives
40 value without directly giving or promising value in return. There is a one-way flow
41 of resources or promises. For federal nonexchange transactions, a liability should
42 be recognized for any unpaid amounts due as of the reporting date. . . [underline
43 added for emphasis]

44
45

⁵ Volume I, Original Pronouncements, Version 4 (06/2004), Appendix E, Consolidated Glossary, p. 1340

⁶ Merriam-Webster Online Dictionary at www.webster.com

⁷ Executory contracts where goods and services have not been received are not generally recognized as liabilities in financial accounting, although they are generally recognized as obligations in governmental budgetary accounting.

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Glossary (SFFAS 5 and Codification)

Exchange Transaction - A transaction that arises when each party to the transaction sacrifices value and receives value in return.

Nonexchange Transaction - A transaction that arises when one party to a transaction receives value without giving or promising value in return or one party to a transaction gives or promises value without receiving value in return.

As evidenced by the excerpts from SFFAS 5 above, the only place that the word “directly” appears in any of the definitions is in par. 24 with respect to a nonexchange transaction. This word can have significant meaning in considering whether a transaction is exchange or nonexchange. If the exchange need not be direct, a wide variety of programs could be considered to be exchange programs (e.g., CNCS where the member is performing service for the grantee in exchange for an education award from the government).

In addition, SFFAS 5 does not address whether an exchange of assets, services, or other benefits needs to be of approximately the same value. International Public Sector Accounting Standard Number 9, *Revenue for Exchange Transactions*, par. 5 states “An exchange transaction is one in which the entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of goods, services or use of assets) to the other party in exchange.”

If an exchange is defined as returning something of the same value, would not some employees be providing services of like value in return for the benefits while others are returning more or less in value based on their personal aptitude and work ethic? If the benefits will be provided in the same way regardless of how much effort is expended by the employee, does it matter what is being exchanged? Is it not the promise to provide the benefits and not the services provided that is the real key?

In order to continue my analysis of the old Figure 1 for accrued annual leave, I will agree that accrued annual leave is more of an “exchange transaction” than a “nonexchange transaction.”

4. “Future outflow of resources or other sacrifice is probable and measurable” – This is probably the only block on the old figure that is not extremely controversial other than the insertion of the word “probable.” The board has agreed to move the notion of probability from the definition and recognition phase to the measurement phase. Other than that, in the case of annual leave, the payment will be made with near certainty because even if John dies, his heirs or estate can collect a lump sum payment for all accrued but unused annual leave. Therefore, in this case, probability is 100 percent or close to it. It is measurable as John’s current hourly rate (including benefits) times the number of hours accrued.
5. As a result of accrued annual leave being deemed an external event/transaction-based (external event)/exchange transaction/probable/measurable, it is recognized on the balance sheet as John’s currently hourly rate (including benefits) times the number of hours accrued. The expense is calculated as the difference between the prior and current accruals.

Result: Annual leave is recorded as an expense as it is earned under the old SFFAS 5, Figure 1.

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1 New: SFFAS 5, Figure 1: Liability Definition and Recognition Summary

- 2
- 3 1. "A transaction or other event has resulted in a present obligation that has not been settled?"-
- 4 With the proposed revision, there is no need to differentiate between whether something is
- 5 an event or a transaction (external event). One only needs to determine that something has
- 6 happened that needs to be evaluated. John has started working for the U.S. Government;
- 7 his employment is the transaction or event that has occurred and the accrual of annual
- 8 leave is one aspect of that employment that needs to be evaluated.

9

10 Wardlow's August Liability Paper, par. 38, states "To have a present obligation means that

11 the obligation arose as a result of a past transaction or other event and has not yet been

12 settled."

- 13
- 14 2. "Directly involves two separate parties?" – The involvement of a second party is critical
- 15 because the government cannot have a liability to itself. The accrued annual leave involves
- 16 the government and an employee.

17

18 Wardlow's August Liability Paper, par. 40, states "for a present obligation to qualify as a

19 liability, two separate entities must be involved, namely the federal entity that has the

20 obligation and another federal or nonfederal entity (or entities) that is external to the

21 obligated entity. Separate entities must be involved because the same entity cannot be both

22 the recipient of settlement of a liability and the entity with the duty to settle."

- 23
- 24 3. "Entails the provision of assets or services to the second party in the future?" – Each
- 25 agency's employee benefits package specifies the benefits that will accrue as the employee
- 26 performs his service.

27

28 Wardlow's August Liability Paper, par. 39, states "To meet the first essential characteristic of

29 a liability, a present obligation must entail the provision of assets (cash, cash equivalents, or

30 goods) or services to another entity in the future.

- 31
- 32 4. "There is a mutual understanding and/or agreement regarding the settlement of the present
- 33 obligation in the future at a determinable date, when a specified event occurs, or on
- 34 demand?" – This agreement or understanding may be much harder to pinpoint or prove in
- 35 other programs and require a much higher level of judgment than in the case of employee
- 36 benefits. Employee benefits are explained widely in government human resources literature
- 37 and are well-publicized. John understands that if he performs 80 hours of service, he will
- 38 accrue 4 hours of annual leave (in addition to other benefits) in return. John also
- 39 understands that he will receive payment for the annual leave when he uses it in an
- 40 approved manner, dies, or separates from the government (when a specified event occurs).

41

42 Wardlow's August Liability Paper, par. 41, states "The second essential characteristic of a

43 liability is that the parties involved have reached an agreement or understanding concerning

44 settlement. The timing of settlement often is expressed in contracts or other agreements as

45 a specific or determinable date, but in some cases the parties agree that settlement will be

46 triggered by a specific event or by the demand of the recipient of the assets or services, the

47 timing of which may be uncertain."

- 48
- 49 5. "The other party has satisfied the requirements provided for in the agreement or
- 50 understanding, thus creating a liability?" – This block is subjective and does not have a
- 51 particular counterpart in Penny's draft liability characteristics. Some members feel that

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1 certain [eligibility] requirements must be met to create a liability while other members feel
2 that the mutual understanding and/or agreement can create a liability without the second
3 party actually doing anything.
4

5 While John may have an understanding that if he works 80 hours, the government will then
6 accrue 4 hours of annual leave for him, some members may believe that the present
7 obligation is not created until John actually follows through and works the 80 hours. They
8 might argue that each pay period, John must continue to show up for work and provide 80
9 hours of service in order to receive 4 hours of annual leave. Recording the value of the 4
10 hours of annual leave is recording the obligation to stand ready to perform when annual
11 leave is requested. However, this question is open to substantial professional judgment and
12 interpretation. Other members may argue that the obligation to stand ready to perform is
13 the point the agreement is made, regardless of whether any hours have been worked. The
14 completion of requirements would be a measurement issue.
15

- 16 6. "The liability can be measured?" -- On a pay period by pay period basis, it is relatively
17 simple to multiply the accrued annual leave balance by John's current hourly rate to arrive at
18 the government's liability for accrued annual leave. However, developing an estimate of
19 expected hours to be accrued over a longer period of time would require substantially more
20 judgment and estimate. The inability to accurately measure accrued annual leave over a
21 longer period of time may lead management to choose to accrue leave over a shorter period
22 of time (as it is earned rather than as the mutual understanding and/or agreement is
23 reached).
24

25 Wardlow's August Liability Paper, par. 5, states "Recognition criteria are the conditions an
26 item should meet in order to be recognized in financial statements. The recognition criteria
27 established in this Statement are:

- 28 (a) The item should meet the definition of an element of financial statements.
29 (b) The item should be measurable."
30

31
32 *Result:* Depending on which view you hold, with the proposed revision to SFFAS 5, Figure 1,
33 annual leave would be recorded as an expense either:

- 34 a. When the mutual understanding and/or agreement is formed between the federal
35 government and the employee; or,
36 b. As the annual leave is earned each pay period.

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Accrued Sick Leave

FASB's standard on "Accounting for Compensated Absences" (FAS43) concluded that accrued sick leave should be recorded as a liability but declined to require it as a result of "respondents' comments that the amounts involved generally would not be large enough to justify the cost of computing the probable payments for nonvesting accumulating sick pay benefits" (par. 15).

FAS43, Accounting for Compensated Absences

14. Board members' views differ regarding whether employees' rights to receive compensation for unused sick days that accumulate for possible future use but do not vest qualify as a liability in terms of the definition in the elements Exposure Draft. Some Board members believe that the relevant "past transaction or event" that creates an obligation to transfer assets to (that is, compensate) employees is the illness and that only a potential liability (that is, a loss contingency) exists before the illness occurs. However, the Board concluded that the relevant event is the past event of working; permitting accumulated sick days to be carried forward for use in future periods represents part of the employees' compensation for past work performed. The accumulated amount at year-end is an obligation that leaves the employer with little or no discretion to avoid future payment. Therefore, a liability exists to the extent that some or all of the accumulated sick days are likely to be used. That view parallels the reasoning of FASB Statement No. 5, Accounting for Contingencies, which requires a loss contingency to be accrued if (a) it is probable that a liability has been incurred and that future events will confirm the fact of loss and (b) the amount of loss can be reasonably estimated.

15. Notwithstanding the Board's conclusion that accrual of a liability for the probable payment of accumulated unused sick days is appropriate under the liability definition in the elements Exposure Draft, the Board was influenced by respondents' comments that the amounts involved generally would not be large enough to justify the cost of computing the probable payments for nonvesting accumulating sick pay benefits. The Board concluded that accrual should not be required for an obligation related to employees' accumulating rights to receive compensation for future absences that are contingent on the absences being caused by an employee's future illness because, in the Board's judgment, the lower degree of reliability of estimates of future sick pay and the cost of making and evaluating those estimates do not justify a requirement for such accrual. Furthermore, the Board believes that the probable payments for accumulating sick pay benefits rarely would be material unless they vest or are otherwise normally paid without an illness-related absence (as discussed in the following paragraph), in which cases the benefits would not be dependent on an employee's future illness and the criteria of paragraph 6 would apply. On the other hand, this Statement does not prohibit an employer from accruing a liability for such nonvesting accumulating sick pay benefits, providing the criteria of paragraph 6 are met.

16. The Board believes that the employer's actual administration of sick pay benefits should determine the appropriate accounting. For example, if employees are customarily paid "sick pay" benefits even though their absences from work are not actually the result of illness or if employees are routinely allowed to take compensated "terminal leave" for nonvesting accumulated unused sick pay benefits prior to retirement, the Board believes such accumulated benefits should not be considered as sick pay benefits for purposes of the exclusion described in paragraph 7 but rather should be accounted for in accordance with paragraph 6.

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FAS43, Accounting for Compensated Absences, contd.

17. Some respondents said that requiring employers to estimate and accrue a liability for compensated absences could be an undue burden for employers, particularly smaller enterprises with limited staff and resources. The Board believes that the accrual accounting specified in paragraph 6 ordinarily will not cause an additional significant record-keeping burden because it centers on employee rights that accumulate or vest. Records maintained by employers for the administration of employee benefits ordinarily will be adequate to provide information for such an accrual. By excluding nonvesting sick pay benefits from required accruals, the Board sought to minimize the estimating burden.

Old: SFFAS 5, Figure 1: Liability Recognition Summary

1. "External events that have occurred and are of consequence to the government" – One could argue that the accrual of sick leave is of consequence (importance) to the government because it will result in the future provision of assets (in the form of a cash payment) to the employee when he uses the sick leave in an approved manner (doctor or dentist appointment, to care for a sick family member, etc). Others could discount this view from a cost/benefit perspective, stating that sick leave is not of consequence to the government because it merely displaces regular compensation. In any case, the term "external" is very ambiguous, having several meanings, not the least of which is "not intrinsic or essential." SFFAS 5, par. 20, states "An event may be an internal event that occurs within an entity, such as transforming raw materials into a product. An event may also be an external event that involves interaction between an entity and its environment, such as a transaction with another entity, an act of nature, a theft, vandalism, an injury caused by negligence, or an accident." Since the employee is an employee within the federal government working on a federal mission, it is difficult to call this an external event.

"Transaction based"/"Other than transaction based" – See discussion under accrued annual leave. In order to continue my analysis of the old Figure 1 for accrued sick leave, I will agree that accrued sick leave would probably fit into the category of "transaction based" more closely than "other than transaction based."

2. "Exchange Transaction"/"Nonexchange Transaction" – Once the preparer chooses whether an external event is a transaction (external event) or an event (see the dilemma here?), and decides on transaction (external event), he must then decide whether that transaction is an exchange transaction or a nonexchange transaction.

Determining whether a transaction is exchange or nonexchange is much more difficult than it might seem at first. See discussion under accrued annual leave. In order to continue my analysis of the old Figure 1 for accrued sick leave, I will agree that accrued sick leave is more of an "exchange transaction" than a "nonexchange transaction."

3. "Future outflow of resources or other sacrifice is probable and measurable" – This is probably the only block on the old figure that is not extremely controversial other than the insertion of the word "probable." The board has agreed to move the notion of probability from the definition and recognition phase to the measurement phase. Other than that, in the case of sick leave, the payment will be made only if the sick leave is used in an approved manner. This requires an estimate that involves more uncertainty than annual leave. For

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1 example, it is may be much less likely that an individual who is near retirement and has
2 accrued 1,500 hours of sick leave over their career will use their accrued sick leave than an
3 individual, such as myself, who is a diabetic with a small child. However, if the individual
4 nearing retirement needs to take off to care for an ailing parent or spouse, he may very well
5 use the accrued sick leave. It could be measurable as John's current hourly rate (including
6 benefits) times the number of hours accrued times the probability that the sick leave will be
7 used in an approved manner.
8

- 9 4. As a result of accrued sick leave being deemed an external event/transaction-based
10 (external event)/exchange transaction/probable/measurable, it is recognized on the balance
11 sheet as John's currently hourly rate (including benefits) times the number of hours accrued
12 times the probability that the sick leave will be used in an approved manner. The expense is
13 calculated as the difference between the prior and current accruals.
14
15

16 *Result:* Setting the cost/benefit considerations aside for a moment, sick leave would be
17 recorded as an expense as it is earned under the old SFFAS 5, Figure 1.
18
19

20 New: SFFAS 5, Figure 1: Liability Definition and Recognition Summary
21

- 22 1. "A transaction or other event has resulted in a present obligation that has not been settled?"-
23 With the proposed revision, there is no need to differentiate between whether something is
24 an event or a transaction (external event). One only needs to determine that something has
25 happened that needs to be evaluated. John has started working for the U.S. Government;
26 his employment is the transaction or event that has occurred and the accrual of sick leave is
27 one aspect of that employment that needs to be evaluated.
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30 the obligation arose as a result of a past transaction or other event and has not yet been
31 settled."
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- 33 2. "Directly involves two separate parties?" – The involvement of a second party is critical
34 because the government cannot have a liability to itself. The accrued sick leave involves
35 the government and an employee.
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37 Wardlow's August Liability Paper, par. 40, states "for a present obligation to qualify as a
38 liability, two separate entities must be involved, namely the federal entity that has the
39 obligation and another federal or nonfederal entity (or entities) that is external to the
40 obligated entity. Separate entities must be involved because the same entity cannot be both
41 the recipient of settlement of a liability and the entity with the duty to settle."
42

- 43 3. "Entails the provision of assets or services to the second party in the future?" – Each
44 agency's employee benefits package specifies the benefits that will accrue as the employee
45 performs his service.
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48 a liability, a present obligation must entail the provision of assets (cash, cash equivalents, or
49 goods) or services to another entity in the future.
50

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- 1 4. “There is a mutual understanding and/or agreement regarding the settlement of the present
2 obligation in the future at a determinable date, when a specified event occurs, or on
3 demand?” – This agreement or understanding may be much harder to pinpoint or prove in
4 other programs and require a much higher level of judgment than in the case of employee
5 benefits. Employee benefits are explained widely in government human resources literature
6 and are well-publicized. John understands that if he performs 80 hours of service, he will
7 accrue 4 hours of sick leave (in addition to other benefits) in return. John also understands
8 that he will receive payment for the sick leave when he uses it in an approved manner
9 (doctor or dentist appointment, to care for a sick family member, etc).

10
11 Wardlow’s August Liability Paper, par. 41, states “The second essential characteristic of a
12 liability is that the parties involved have reached an agreement or understanding concerning
13 settlement. The timing of settlement often is expressed in contracts or other agreements as
14 a specific or determinable date, but in some cases the parties agree that settlement will be
15 triggered by a specific event or by the demand of the recipient of the assets or services, the
16 timing of which may be uncertain.”

- 17
18 5. “The other party has satisfied the requirements provided for in the agreement or
19 understanding, thus creating a liability? – This block is subjective and does not have a
20 particular counterpart in Penny’s draft liability characteristics. Some members feel that
21 certain [eligibility] requirements must be met to create a liability while other members feel
22 that the mutual understanding and/or agreement can create a liability without the second
23 party actually doing anything.

24
25 While John may have an understanding that if he works 80 hours, the government will then
26 accrue 4 hours of sick leave for him, some members may believe that the present obligation
27 is not created until John actually follows through and works the 80 hours. They might argue
28 that each pay period, John must continue to show up for work and provide 80 hours of
29 service in order to receive 4 hours of sick leave. Recording the value of the 4 hours of sick
30 leave is recording the obligation to stand ready to perform when sick leave is requested.
31 However, this question is open to substantial professional judgment and interpretation.
32 Other members may argue that the obligation to stand ready to perform is the point the
33 agreement is made, regardless of whether any hours have been worked. The completion of
34 requirements would be a measurement issue.

- 35
36 6. “The liability can be measured?” – On a pay period by pay period basis, the accrual for sick
37 leave would be somewhat more complex than that for annual leave. To arrive at the
38 government’s liability for accrued sick leave, one would need to multiply the accrued sick
39 leave balance by John’s current hourly rate and then by the probability that the sick leave
40 would be used in an approved manner. However, developing an estimate of expected hours
41 to be accrued over a longer period of time would require substantially more judgment and
42 estimate. The inability to accurately measure accrued sick leave over a longer period of
43 time may lead management to choose to accrue leave over a shorter period of time (as it is
44 earned rather than as the mutual understanding and/or agreement is reached).

45
46 Wardlow’s August Liability Paper, par. 5, states “Recognition criteria are the conditions an
47 item should meet in order to be recognized in financial statements. The recognition criteria
48 established in this Statement are:

- 49 (a) The item should meet the definition of an element of financial statements.
50 (b) The item should be measurable.”

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1 *Result:* Depending on which view you hold and setting the cost/benefit considerations aside,
2 with the proposed revision to SFFAS 5, Figure 1, sick leave would be recorded as an expense
3 either:

- 4 a. When the mutual understanding and/or agreement is formed between the federal
5 government and the employee; or,
- 6 b. As the sick leave is earned each pay period.

7
8 *Note:* The cost/benefit argument will probably continue to win out, however, since a lump sum
9 payment is not made for accrued sick leave upon death or separation from the government.
10 While lump sum annual payments can dramatically increase compensation expense from one
11 period to the next, payment of sick leave in place of regular pay merely serves to displace
12 compensation from one category to another. As a result, there would be no large swings in
13 compensation expense from period to period from the payment of sick leave.
14

15 **Staff Recommendation**

16
17 At this time, staff feels that there are three options for proceeding on this project:

- 18 1. Staff could present educational sessions on IASB and FASB work on expected
19 values and obligations;
- 20 2. Staff could begin developing an operational approach to three classes of liabilities:
21
 - 22 • Firm offers (e.g., Tsunami relief);
 - 23 • Conditional offers where the recipient has substantial control over meeting the
24 conditions (e.g., CNCS, Social Security, SSI, Food Stamps, the \$1.5 billion
25 offered to Metro); and,
 - 26 • Conditional offers where the environment or market influences the meeting of
27 conditions (e.g., MILC, Feed Grains)
- 28 3. Staff resources could be diverted to another project until the liability definition is
29 finalized.

30
31 These options are not necessarily mutually exclusive. If the majority of Board members feel that
32 they have enough background on government programs to finalize the liability definition, staff
33 resources could be diverted to another project and/or to presenting educational sessions on
34 IASB and FASB work on expected values and obligations (options 1 and 3 above). If the
35 majority of Board members feel that a framework for making liability decisions for various types
36 of programs is helpful but would like more information on IASB and FASB work on expected
37 values and obligations, staff could address the three classes of liabilities and include analyses
38 from a broader view along with educational sessions on IASB and FASB work on expected
39 values and obligations (options 1 and 2 above).