



Federal Accounting Standards Advisory Board

March 16, 2006

Memorandum

To: Members of the Board

From: Julia E. Ranagan, Assistant Director

Through: Wendy M. Comes, Executive Director

Subject: Application of the Liability Definition¹ – Tab C

At the January 12, 2006, board meeting, staff presented the Board with a revised project plan that included the four classes of liabilities from SFFAS 5 (exchange transactions, nonexchange transactions, government-related events, and government-acknowledged events), mapped transaction types to each of the four classes, and proposed the engagement of a task force. The Board was in overall agreement with the revised project plan and directed staff to conduct a task force on liability classification, as proposed.

To keep you informed of progress on the project, staff has attached a copy of the invitation letter that has been sent to various members from the federal preparer and auditor community, including the Federal Financial Management Council and the Financial Statement Audit Network. Staff is seeking 20 – 25 individuals that are representative of the federal community to participate on the task force. As indicated in the attached invitation letter, the first two meetings of the task force are expected to result in a free exchange of information and ideas from across the federal government, including specific examples of what has worked well over the last ten years in the area of liability recognition and measurement, as well as areas where additional guidance or changes may be needed. After these initial two meetings, participants may be contacted again to provide more specific information, comment on draft papers, or attend additional meetings of the task force.

Staff is allotted 15 minutes after lunch on Wednesday, March 29, 2006, should you have any comments or questions on the attached invitation. Please contact me at 202-512-7377 or by e-mail at ranaganj@fasab.gov with any 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.



Federal Accounting Standards Advisory Board

March XX, 2006

Anita Standard
1600 Liability Lane NW
Washington DC 20548

Dear Ms. Standard:

Since August 2003, the Federal Accounting Standards Advisory Board (FASAB) has undertaken several projects to evaluate current concepts and standards regarding what constitutes a liability of the federal government. These projects – Social Insurance Liability, Elements, and Application of the Liability Definition – are focused on ensuring that federal financial reporting properly reports liabilities and may result in greater accruals for nonexchange transactions and government-acknowledged events. The concepts and standards being developed as a result of this effort will affect virtually all federal agencies. In an effort to involve the federal financial community in this process, we are inviting you to join a limited-duration task force to assist us in more efficiently and effectively developing new liability standards. We believe that your participation on this task force will provide valuable insights. The first and second meetings of the task force will be held on **Wednesday, April 12, 2006**, and **Thursday, May 11, 2006**.

Since its inception, FASAB has issued several Statements of Federal Financial Accounting Standards (SFFAS) related to accounting for federal liabilities.

- SFFAS 1, *Accounting for Selected Assets and Liabilities*, which was issued in March 1993, established accounting standards for liabilities of the federal government arising from accounts payable, interest payable, and other current liabilities.
- SFFAS 2, *Accounting for Direct Loans and Loan Guarantees*, which was issued in August 1993, established accounting standards for liabilities arising from loan guarantees.
- SFFAS 5, *Accounting for Liabilities of the Federal Government*, which was issued in September 1995, defines the recognition points for liabilities associated with different classes of events and transactions – exchange transactions, nonexchange transactions, government-related events, and government-acknowledged events. In addition to discussing the general liability recognition principle, SFFAS 5 includes specific liability accounting standards for contingencies; capital leases; federal debt; pensions, other retirement benefits, and other postemployment benefits; and, insurance and guarantee programs.
- SFFAS 6, *Accounting for Property, Plant, and Equipment*, which was issued in November 1995, provides additional guidance on the recognition of cleanup costs over the life of the related property, plant, and equipment and supplements the accounting requirements for liabilities in SFFAS 5.

- SFFAS 12, *Recognition of Contingent Liabilities from Litigation*, which was issued in December 1998, amended the contingent liability criteria in SFFAS 5 and applies to the evaluation, accounting recognition, and disclosure of the future outcome of litigation.

As part of the Board's project to update the Concepts, a different approach to liability recognition is being considered that could require major changes to or abandonment of the existing four classes of events and transactions (exchange transactions, nonexchange transactions, government-related events and government-acknowledged events). Relevant insights from representatives of the federal financial management community are important to the development of standards that cover the broad range of government programs.

The objective of this limited-duration task force is to offer insights from the perspective of preparers and auditors in the following four areas:

1. Provide feedback on whether the four classes of liabilities established in SFFAS 5 (exchange transactions, nonexchange transactions, government-related events, and government-acknowledged events) have proven useful to federal preparers and auditors in determining how to appropriately apply liability definition, recognition, and measurement criteria across a broad spectrum of federal events and transactions. Discuss specific challenges and successes encountered while following the liability standards in SFFASs 1, 2, 5, 6, and 12.
2. Describe common relationships and key events among different federal events and transactions that serve to either support the current liability classification structure (exchange transactions, nonexchange transactions, government-related events, and government-acknowledged events) or suggest that a different classification structure may be more appropriate.
3. If the four classes of liabilities established in SFFAS 5 are deemed appropriate, provide feedback on whether the enhancements to the definitions of the four classes proposed by staff serve to clarify some of the application difficulties that may have arisen over the years since SFFAS 5 was implemented. If not, suggest alternative solutions.
4. If the four classes of liabilities established in SFFAS 5 are deemed appropriate, provide feedback on the completeness and usefulness of the proposed classes, sub-classes, and relationships against knowledge of current practice, including whether each sub-class is operationally distinct. If not, suggest alternative solutions.

The feedback received from task force members will be utilized by FASAB staff to develop new federal liability standards. At the initial meetings on April 12, 2006, and May 11, 2006, we hope to receive a free exchange of information and ideas from across the federal government, including specific examples of what has worked well over the last ten years in the area of liability recognition and measurement, as well as areas where additional guidance or changes may be needed. After these initial two meetings, you may be contacted again to provide more specific information, comment on draft papers, or attend additional meetings of the task force.

To help you prepare for the task force, we are providing you with some background information. Enclosed are an agenda with some administrative information; copies of SFFAS 1, 2, 5, 6, and 12; a summary of the project and objectives; and a list of questions to consider. Also, you may review a history of the liability projects on our website at <http://www.fasab.gov/activeprojects.html>.

We appreciate your interest in continuing to improve federal financial reporting and we look forward to your participation in this important endeavor. We will be contacting you by telephone to confirm your availability. If you need any additional information or assistance, please contact Ms. Julia Ranagan at 202.512.7377 or ranaganj@fasab.gov.

Sincerely,

Wendy M. Comes
Executive Director

Enclosures

**Federal Accounting Standards Advisory Board
Task Force on Liability Classification
441 G St NW – Room 7C13**

Agenda

Wednesday, April 12, 2006

- | | |
|------------------|---|
| 8:15 – 8:30 | Continental Breakfast |
| 8:30 – 8:45 | Introductions and Overview of Project |
| 8:45 – 10:30 | Group Discussion |
| | Task I – Provide Feedback on the Liability Classification Structure Established by SFFAS 5 and Overall Satisfaction with the Level of Liability Guidance Provided by SFFASs 1, 2, 5, 6, and 12 |
| 10:10:30 – 10:45 | Break |
| 10:45 – 12:15 | Group Discussion |
| | Task II – Describe the Common Relationships and Key Events among Federal Events and Transactions |
| 12:15 – 12:30 | Wrap-Up |

**Federal Accounting Standards Advisory Board
Task Force on Liability Classification
441 G St NW – Room 5N30**

Agenda

Thursday, May 11, 2006

- | | |
|---------------|---|
| 8:15 – 8:30 | Continental Breakfast |
| 8:30 – 8:45 | Introductions and Summary of Comments from March 12th Meeting |
| 8:45 – 9:30 | Group Discussion |
| | Task III – Provide Feedback on Staff’s Proposed Enhancements to the Definitions of the Four Classes |
| 9:30 – 10:30 | Group Discussion |
| | Task IV – Provide Feedback on the Completeness of the Liability Sub-Classes within Each of the Liability Classes |
| 10:30 – 10:45 | Break |
| 10:45 – 12:15 | Group Discussion contd. |
| | Task IV – Provide Feedback on the Completeness of the Liability Sub-Classes within Each of the Liability Classes |
| 12:15 – 12:30 | Wrap-Up |

**Federal Accounting Standards Advisory Board
Task Force on Liability Classification**

April/May 2006

Administrative Information

Task Force Location

Government Accountability Office (GAO)
441 G St NW
Washington DC 20548

Wednesday, April 12, 2006 – Room 7C13 (7th Floor)
Thursday, May 11, 2006 – Room 5N30 (5th Floor)

General Information

The sessions will begin at 8:30 a.m. and conclude at 12:30 p.m. Participants are asked to arrive prior to 8:30 a.m. to process through GAO security. Continental breakfast will be available at 8:15 a.m. for your convenience. The GAO building is located near the Judiciary Square or Gallery Place metro stops.

Federal Accounting Standards Advisory Board Task Force on Liability Classification

Introduction

The Federal Accounting Standards Advisory Board (FASAB) is the source of generally accepted accounting principles for financial reporting in the federal government. The Board issues its guidance through a range of vehicles such as Statements of Federal Financial Accounting Concepts and Standards (SFFAC and SFFAS), Interpretations, Technical Bulletins, Technical Releases of the Accounting and Auditing Policy Committee, and Implementation Guides published by FASAB staff. Since its inception, FASAB has issued several standards related to accounting for federal liabilities (see text box at left).

SFFAS 1, Accounting for Selected Assets and Liabilities (1993)

- Accounts Payable
- Interest Payable
- Other Current Liabilities

SFFAS 2, Accounting for Direct Loans and Loan Guarantees (1993)

- Loan Guarantees

SFFAS 5, Accounting for Liabilities of the Federal Government (1995)

- General Principles (exchange transactions, nonexchange transactions, government-related events, and government-acknowledged events)
- General Fund Benefit Programs
- Employee Benefits
- Insurance and Guarantees
- Capital Leases
- Federal Debt
- Contingencies

SFFAS 6, Accounting for Property, Plant, and Equipment (1995)

- Cleanup Costs

SFFAS 12, Recognition of Contingent Liabilities from Litigation (1998)

- Litigation

SFFAS 1, *Accounting for Selected Assets and Liabilities*, which was issued in March 1993, established accounting standards for liabilities of the federal government arising from accounts payable, interest payable, and other current liabilities. SFFAS 2, *Accounting for Direct Loans and Loan Guarantees*, which was issued in August 1993, established accounting standards for liabilities arising from loan guarantees. SFFAS 5, *Accounting for Liabilities of the Federal Government*, which was issued in September 1995, established accounting standards for liabilities of the federal government not covered by SFFAS 1 and SFFAS 2. SFFAS 5 defines the recognition points for liabilities associated with different classes of events and transactions – exchange transactions, nonexchange transactions, government-related events, and government-acknowledged events. In addition to discussing the general liability recognition principle, SFFAS 5 includes specific liability accounting standards for contingencies; capital leases; federal debt; pensions, other retirement

benefits, and other postemployment benefits; and, insurance and guarantee programs. SFFAS 6, *Accounting for Property, Plant, and Equipment*, which was issued in November 1995, provides additional guidance on the recognition of cleanup costs over the life of the related property, plant, and equipment and supplements the accounting requirements for liabilities in SFFAS 5. SFFAS 12, *Recognition of Contingent Liabilities from Litigation*, which was issued in December 1998, amended the contingent liability criteria in SFFAS 5 and applies to the evaluation, accounting recognition, and disclosure of the future outcome of litigation.

Generally speaking, SFFAS 5 requires that the liability for a nonexchange transaction be recognized for any unpaid amounts due as of the reporting date (due and payable) and the

liability for an exchange transaction be recognized when goods or services have been provided. SFFAS 5 further requires that the liability for government-related events be recognized when the event occurs if the future outflow of resources is probable and measurable and the liability for government-acknowledged events be recognized when and to the extent that the federal government formally acknowledges financial responsibility for the event and an exchange or nonexchange transaction has occurred.

In August 2003, FASAB began an extensive review of the "elements of financial reporting," including liabilities. As part of that Elements project, FASAB has tentatively agreed¹ upon a revised definition and essential characteristics of a liability of the federal government (see text box at right). More information on the history and status of the Elements project is currently located on the FASAB website at <http://www.fasab.gov/projectselements.html>.

Also in August 2003, FASAB renewed deliberations on accounting for social insurance (e.g., Social Security and Medicare). As part of the ongoing Social Insurance Liabilities Project, FASAB has tentatively agreed to begin recognizing a liability for individuals who have accumulated 40 quarters of work in covered employment, thereby abandoning "due and payable" as the default recognition point for nonexchange transactions. More information on the history and status of the Social Insurance project is currently located on the FASAB website at <http://www.fasab.gov/projectssocialinsurance.html>.

"A liability is a present obligation⁶ of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand...A liability of the federal government has two essential characteristics. First, it constitutes a present obligation to provide assets or services to another entity. Second, the federal government and the other entity have an agreement or understanding as to when settlement of the obligation is to occur."

Staff Draft of a Proposed Concepts Statement on Elements and Recognition Criteria, December 14, 2005

⁶ The term obligation is used 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.

In March 2004, FASAB initiated a project titled, "Research into the Application of the Liability Definition," as a companion project to the Elements and Social Insurance projects. The purpose of this project is to reconsider the recognition, measurement and display of liability and expense, potential new elements/statements, and all related disclosures for obligations of the federal government that could potentially result in a net outflow of resources (other than social insurance). Some such obligations may not currently be recognized as liabilities on the balance sheet while others may be recognized based on "due and payable" concepts. The focus of this project is on both (1) how to recognize, measure, and display obligations that meet the revised definition of a liability and (2) how (and whether) to disclose information about obligations that do not meet the revised definition of a liability. More information on the history and status of the "Application of the Liability Definition" project is currently located on the FASAB website at <http://www.fasab.gov/projectsresearch.html>.

Tentative results from current FASAB deliberations on the definition of a liability and accounting for social insurance indicate that it will be necessary to revisit the current liability standards in SFFASs 1, 2, 5, 6, and 12 to ensure that they align with FASAB's vision for more transparency in federal financial reporting. With regard to the liability classification structure, FASAB has

¹ Official positions of the FASAB, whether proposed or final concepts or standards, are presented in FASAB publications issued in accordance with our "Rules of Procedure" and "Memorandum of Understanding." "Tentatively agreed" refers to working majority views conveyed to staff at public meetings. These agreements sometimes change before an official position is taken.

preliminarily decided to maintain the four classes of events and transactions from SFFAS 5 – exchange transactions, nonexchange transactions, government-related events, and government-acknowledged events. A majority of the FASAB members believe that it is important to maintain the four classes, rather than develop new ones, because the federal financial community is already familiar with these classes that have been in use for over a decade.

Task Force Objectives

Task forces play an important role in the accounting standard-setting process. Task force members provide expert views and recommend solutions to accounting issues or problems. Task force members can also be instrumental in proactively raising potential issues before a standard gets too far in the standard-setting process. As part of the Board's project to update the Concepts, a different approach to liability recognition is being considered that could require major changes to or abandonment of the existing four classes of events and transactions (exchange transactions, nonexchange transactions, government-related events and government-acknowledged events). Relevant insights from representatives of the federal financial management community are important to the development of standards that cover the broad range of government programs.

The objective of this particular task force is to provide feedback from the perspective of preparers and auditors in the following four areas:

1. Provide feedback on whether the four classes of liabilities established in SFFAS 5 (exchange transactions, nonexchange transactions, government-related events, and government-acknowledged events) have proven useful to federal preparers and auditors in determining how to appropriately apply liability definition, recognition, and measurement criteria across a broad spectrum of federal events and transactions. Discuss specific challenges and successes encountered while following the standards in SFFASs 1, 2, 5, 6, and 12.
2. Describe common relationships and key events among different federal events and transactions that serve to either support the current liability classification structure (exchange transactions, nonexchange transactions, government-related events, and government-acknowledged events) or suggest that a different classification structure may be more appropriate.
3. If the four classes of liabilities established in SFFAS 5 are deemed appropriate, provide feedback on whether the enhancements to the definitions of the four classes proposed by staff serve to clarify some of the application difficulties that may have arisen over the years since SFFAS 5 was implemented. If not, suggest alternative solutions.
4. If the four classes of liabilities established in SFFAS 5 are deemed appropriate, provide feedback on the completeness and usefulness of the proposed classes, sub-classes, and relationships against knowledge of current practice, including whether each sub-class is operationally distinct. If not, suggest alternative solutions.

The feedback received from task force members will be utilized by FASAB staff to develop new federal liability standards.

Specific Tasks to be Accomplished

I. Provide Feedback on the Liability Classification Structure Established by SFFAS 5 and Overall Satisfaction with the Level of Liability Guidance Provided by SFFASs 1, 2, 5, 6, and 12

Discuss your overall experience with classification, recognition, and measurement of federal liabilities based on the guidance in SFFASs 1, 2, 5, 6, and 12. Specifically discuss your overall experience implementing the liability classes⁴ in SFFAS 5 for purposes of establishing when an obligating event has occurred and applying recognition and measurement criteria in a consistent manner (see excerpt in text box at right and in Attachment 1).

A liability for federal accounting purposes is a probable future outflow or other sacrifice of resources as a result of past transactions or events. General purpose federal financial reports should recognize² probable and measurable future outflows or other sacrifices of resources arising from (1) past exchange transactions, (2) government-related events, (3) government-acknowledged events, or (4) nonexchange transactions that, according to current law and applicable policy, are unpaid amounts due as of the reporting date.³

SFFAS 5, par. 19

- What has worked particularly well?
- What could be improved?
- Have any transactions, events, or circumstances arisen that should cause the Board to reconsider the current liability classification structure?
- How would you characterize the level of guidance that is provided by SFFASs 1, 2, 5, 6, and 12 in regard to overall classification, recognition, and measurement of federal liabilities (too much guidance, too little guidance, or just right)?

II. Describe the Common Relationships and Key Events Among Federal Events and Transactions

There is broad and general agreement among FASAB Board members that establishing liability classes would 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. The classification structure established in SFFAS 5 is but one way to group federal transactions and events to promote a common application of liability recognition and measurement criteria (see text box below). Discuss the common relationships and key events among all federal events and transactions.

- Do the common relationships and key events among federal events and transactions, or lack thereof, support the current liability classification structure or suggest that a different classification structure may be more appropriate?
- Do you believe that there are other relationships or key events that might do a better job of distinguishing between different types of federal events and transactions? If so, provide alternative suggestions.

² SFFAS 5, footnote 16: Recognition means reporting a dollar amount on the face of the basic financial statements.

³ SFFAS 5, footnote 17: This document uses the term "nonexchange transaction" in a way similar to FASB's "nonreciprocal transfer." That is, it implies a one-way flow of resources, services, or promises between two parties. "Transaction" in the phrase "nonexchange transaction" does not include reclassification, closing, and similar "internal" entries to the accounting records, though some accountants use the term in that broader sense. "Probable" means more likely than not. "Measurable" means reasonably estimable.

⁴ A class is a "group, set, or kind sharing common attributes" (characteristics) as defined by Merriam-Webster Online at www.webster.com.

Exchange transactions – arises when each party to the transaction sacrifices value and receives value in return.

- Involves two parties;
- There is a two-way flow of resources or of promises to provide resources of equal value; and,
- A liability is recognized when one party receives goods or services in return for a promise to provide money or other resources in the future.
- An example of an exchange transaction occurs when a federal employee performs services in exchange for compensation. The compensation includes current salary and future retirement benefits. An exchange transaction occurs because both parties (the employee and the employer) receive and sacrifice value. The expense is recognized in the period that the exchange occurs (in the period the employee works). The compensation liability includes unpaid salary amounts earned and the cost of future retirement benefits related to current period services.
- A second example of an exchange transaction occurs when the federal government orders goods or services from a vendor. An exchange transaction occurs because both parties (the federal government and the vendor) receive and sacrifice value. The expense is recognized in the period that the exchange occurs (in the period that the federal government accepts the delivery of goods or services). The liability includes the amount due to the vendor for the cost of goods or services received and accepted in the current period.

Nonexchange transactions – arises when one party to a transaction receives value without directly giving or promising value in return.

- Involves two parties;
- There is a one-way flow of resources or promises to provide resources;
- One party to a transaction receives value without directly giving or promising value in return; and,
- A liability is recognized for any unpaid amounts due as of the reporting date.
- Many grant and certain entitlement programs are nonexchange transactions. When the federal government creates an entitlement program or gives a grant to state or local governments, the provision of the payments is determined by federal law rather than through an exchange transaction.

Government-related events – nontransaction-based events that involve interaction between the federal government and its environment.

- Involves two parties (the federal government and some aspect of its environment);
- The event is of financial consequence to the federal government because it is directly involved during the course of federal operations;
- May or may not be beyond the control of the federal government;
- A liability is recognized on the same basis as those that arise in exchange transaction; and,
- Government-related events resulting in a liability should be recognized in the period the event occurs if the future outflow or other sacrifice of resources is probable and the liability can be measured, or as soon thereafter as it becomes probable and measurable.
- Government-related events include cleanup from federal operations resulting in hazardous waste that the federal government is required by statutes and/or regulations to clean up, accidental damage to nonfederal property caused by federal operations, and other damage to federal property caused by such factors as federal operations or natural forces.
- 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 make it probable that the federal government would pay for the damages and to the extent that the amount of the payment could be estimated reliably.

Government-acknowledged events – nontransaction-based events that are of financial consequence to the federal government because it chooses to respond to the event.

- Involves two parties;
- The event is not directly related to federal operations;
- The event is of financial consequence to the federal government only because it chooses to respond to the event; and,
- A liability is recognized when (1) The federal government has formally acknowledged financial responsibility for the cost of the event through an appropriation or authorization from Congress, and (2) an exchange occurs.
- Events, such as tornado damage to a U.S. town, would create a liability when (1) Congress appropriates funds, and (2) transactions resulting from the appropriations, including disaster loans, outright grants to individuals, and work performed by contractors paid by the federal entities, are recognized as exchange or nonexchange transactions.

(definitions from SFFAS 5, pars.22, 24, 27, and 30; common relationships and key events are mainly from SFFAS 5, pars. 20 – 32)

III. Provide Feedback on Staff’s Proposed Enhancements to the Definitions of the Four Classes

Staff drafted proposed revisions to the four liability class definitions from SFFAS 5 to apply the word “direct” more consistently and to more appropriately clarify the distinction between a government-related event and a government-acknowledged event (denoted by underlined additions in each of the four text boxes below). Provide feedback on whether the proposed enhancements to the definitions of the four classes would serve to clarify some of the application difficulties that may have arisen over the years since SFFAS 5 was implemented.

- Are the proposed revisions helpful?
- What could be improved?

Exchange Transactions – an exchange transaction arises when each party to the transaction directly sacrifices value and directly receives similar value in return. There is a reciprocal or two-way flow of resources or of promises to provide resources of similar value. In an exchange transaction, a liability is recognized when one party receives goods or services in return for a promise to provide money or other resources of similar value in the future (e.g., the federal government purchase of goods or services at market value¹ from a vendor).

SFFAS 5, par. 22 (underlined items indicate proposed clarifications by staff)

Nonexchange transactions – a nonexchange transaction arises when one party to a transaction receives value without directly giving or promising similar value in return or one party to a transaction gives or promises value without directly receiving similar value in return. In a nonexchange transaction, there is either no reciprocal or two-way flow of resources or of promises to provide resources or the transaction is not direct and of similar value (e.g., grants to state and local governments, subsidies, and other transfer programs for individuals).

SFFAS 5, par. 24 (underlined items indicate proposed clarifications by staff)

Government-related Events – government-related events are nontransaction-based events that are of financial consequence to the federal government because they involve direct interaction between the federal government and its environment, either through the conduct of federal operations or because the events take place on federal property (e.g., accidental damage to nonfederal property caused by federal operations).

SFFAS 5, par. 27 (underlined items indicate proposed clarifications by staff)

Government-acknowledged Events – government-acknowledged events are nontransaction-based events that are not the result of federal operations and do not directly involve the federal government but are of financial consequence to the federal government because it chooses to respond to the event (e.g., damage to nonfederal property caused by a natural disaster).

SFFAS 5, par. 30 (underlined items indicate proposed clarifications by staff)

IV. Provide Feedback on the Completeness of the Liability Sub-Classes within Each of the Liability Classes

The sub-classes currently included in SFFASs 1, 2, 5, 6, and 12 do not specifically address all federal events and transactions (see text box at top right and Attachment 1). Would you consider a more comprehensive list of sub-classes that addresses all federal events and transactions with specific standards for each one (such as the list in the text box at bottom right) to be more useful for purposes of establishing when an obligating event has occurred and applying recognition and measurement criteria across a broad spectrum of government events and transactions in a consistent manner?

- What has worked particularly well?
- What could be improved?
- Are the sub-classes in the proposed list (see text box at bottom right) operationally distinct?
- Are there additional transactions or events that you believe are not included in the proposed sub-classes (see text box at bottom right)?
- Do you believe there is a more appropriate grouping of liabilities by relationship or key events?

CURRENT

SFFAS 1

- Accounts Payable
- Interest Payable
- Other Current Liabilities

SFFAS 2

- Loan Guarantees

SFFAS 5

- Contingencies
- Capital Leases
- Federal Debt
- Pension/Other Retirement Benefits/Other Postemployment Benefits
- Insurance and Guarantees

SFFAS 6

- Cleanup Costs

SFFAS 12

- Litigation

STAFF DRAFT

Exchange Transactions

- Employee and Veteran Benefit Payments
- Capital Leases
- Federal Debt
- Accounts Payable for Goods and Services
- Interest Payable
- Other (TBD)

Nonexchange Transactions

- General Fund Benefit Payments
- Insurance and Guarantees
- Grant and Award Payments
- Social Insurance
- Environmental and Disposal
- Other (TBD)

Government-Related Events

- Environmental and Disposal
- Damage to nonfederal property caused by federal operations
- Damage to federal property resulting from federal operations or natural disasters
- Other (TBD)

Government-acknowledged Events

- Environmental and Disposal
- Damage to nonfederal property caused by natural disasters
- Other (TBD)

Definition and General Principle for Recognition of a Federal Liability

The following comparison table is provided to illustrate the differences between current and proposed liability concepts and standards. The left-hand column contains excerpts from Statement of Federal Financial Accounting Standards 5, *Accounting for Liabilities of the Federal Government*, issued in September 1995 and currently in effect today. The right-hand column contains excerpts from a “Staff Draft of a Proposed Concepts Statement on Elements and Recognition Criteria,” dated December 14, 2005, and presented to the board members at the January 11, 2006, board meeting. The proposed concepts statement in the right-hand column is still under deliberation by the board. Official positions of the FASAB are determined only after extensive due process and deliberations.

The definition of a federal liability currently in use was presented in SFFAS 5, which is a standard and not a concepts statement. The board has undertaken a project to define the major financial statement elements in a concepts statement; hence, the working draft below in the right-hand column (note that the Board has not made a formal proposal at this time). Since the purpose of a concepts statement is to describe the concepts and relationships that will underlie future federal financial accounting standards and practices, and not to establish application standards, there will be fundamental differences in what is addressed in SFFAS 5 in the left-hand column versus what is addressed in the draft concepts statement in the right-hand column. The table below attempts to align the two in a comparable manner and highlight similarities and differences between the two.

<i>Current Definition and General Principle for Recognition of a Liability</i>	<i>Working Definition and General Principle for Recognition of a Liability</i>
SFFAS 5, <i>Accounting for Liabilities of the Federal Government</i>:	Staff Draft of a Proposed Concepts Statement on Elements and Recognition Criteria, December 14, 2005, pp. 14 – 18:
<p><u>Definition of a Liability</u></p> <p>19. A liability for federal accounting purposes is a probable future outflow or other sacrifice of resources as a result of past transactions or events. General purpose federal financial reports should recognize⁵ probable and measurable future outflows or other sacrifices of resources arising from (1) past exchange transactions, (2) government-related events, (3) government-acknowledged events, or (4) nonexchange transactions that, according to current law and applicable policy, are unpaid amounts due as of the reporting date.⁶</p>	<p><u>Definition of a Liability</u></p> <p>37. A liability is a present obligation⁷ of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.</p> <p>38. The definition of a liability addresses only whether a liability exists and not how it should be measured or whether or when it should be recognized in the federal government’s or a component entity’s balance sheet. Recognition criteria for all elements of financial statements are set forth and discussed in paragraphs 5 through 9. Those paragraphs also acknowledge the possibility of uncertainty about whether an item meets the definition of a liability and the need for judgment based on the available evidence.⁸</p>

⁵ SFFAS 5, footnote 16: Recognition means reporting a dollar amount on the face of the basic financial statements.

⁶ SFFAS 5, footnote 17: This document uses the term “nonexchange transaction” in a way similar to FASB’s “nonreciprocal transfer.” That is, it implies a one-way flow of resources, services, or promises between two parties. “Transaction” in the phrase “nonexchange transaction” does not include reclassification, closing, and similar “internal” entries to the accounting records, though some accountants use the term in that broader sense. “Probable” means more likely than not. “Measurable” means reasonably estimable.

⁷ FASAB December 14, 2005, Staff Draft, Footnote 6: The term obligation is used in this Statement with its general meaning of a duty or responsibility to act in a certain way. It does not mean that an obligation of budgetary resources is required for a liability to exist in accounting or financial reporting or that a liability in accounting or financial reporting is required to exist for budgetary resources to be obligated.

Definition and General Principle for Recognition of a Federal Liability

[SFFAS 5 does not discuss the essential characteristics of liabilities. The proposed concepts statement is attempting to provide overarching principles that can be used to determine when an item meets the definition of a liability.]

Essential Characteristics of Liabilities

39. 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 of the federal government has two essential characteristics. First, it constitutes a present obligation to provide assets or services to another entity. Second, the federal government and the other entity have an agreement or understanding as to when settlement of the obligation is to occur. Paragraphs [40 through 47] discuss those characteristics.

Present Obligation

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

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

⁸ *Ibid*, footnote 7: See footnote 2 [of FASAB December 14, 2005, Staff Draft, which states “Uncertainty and its effects on financial reporting are discussed further in paragraphs 56 through 60.”]

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42. As indicated in the previous paragraph, for a present obligation to qualify as a liability of the federal government, two separate entities must be involved, namely the government and an entity that is external to the government. Separate entities must be involved because the same entity cannot be both the recipient of settlement of a liability and the entity with the duty to settle. For example, when the government operates machinery, the government may have an obligation to maintain it. However, the obligation does not qualify as a liability for maintenance because the government cannot have a liability to itself. In contrast, if the government contracts for maintenance from another entity, it may have a liability to that other entity for the price of the maintenance services it has received.
43. To meet the definition of a liability, the federal government's contract or other agreement to provide assets or services to another entity must be based on existing conditions, including current law, because an essential characteristic of a liability is that the government has a present obligation, even if conditions may change before settlement is due. For example, the Congress may change a law under which the federal government has incurred a present obligation and erase the obligation or otherwise enable the government to avoid settlement. Alternatively, the government may be able in the future to renegotiate the obligation with the payee or recipient of the promised services. However, liabilities and all other elements of financial statements are based on transactions or events that already have occurred. Thus, the possibility of a future change in the conditions that gave rise to a present obligation does not mean that the government currently has no obligation and therefore no liability.

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Settlement of the Obligation

44. The second essential characteristic of a liability is that the government and the other entity involved have an agreement or understanding concerning settlement. The timing of settlement often is expressed in contracts and other agreements as a specific or determinable date. However, in some cases the parties agree that settlement will be triggered by a specific event or by the demand of the recipient of the assets or services, the timing of which may be uncertain. If the government and the other entity do not have an agreement or understanding concerning settlement and the government is free to decide whether and when to settle the obligation, the government's obligation does not meet the definition of a liability.
45. In addition to uncertainty as to the timing of settlement, many present obligations involve uncertainty regarding the amount of settlement. For example, the amount required to settle the obligation may be contingent on the occurrence or non-occurrence of a future event, such as a decline in market prices. The government nevertheless is obligated to stand ready to fulfill its obligation upon resolution of any contingencies affecting the timing and amount of settlement. Uncertainty regarding the amount or timing of settlement is addressed through measurement of the liability.
46. Frequently, the federal government knows which specific entities or individuals will receive settlement before settlement is due. However, such advance identification of specific recipients is not an essential characteristic of a liability. For example, the government may have a long-term disability agreement with federal employees without knowing the identity of each of the employees who ultimately will qualify for payment. The obligation qualifies as a liability if both of the essential characteristics of a liability are present.
47. Once incurred, a liability of the federal government continues as a liability until the government settles it or another event or circumstance discharges it or removes the government's responsibility to settle it.

Definition and General Principle for Recognition of a Federal Liability

Events and Transactions

20. The existence of a past event (which includes transactions) is essential for liability recognition. An event is a happening of financial consequence to an entity.⁹ 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.
21. As the term is used in this Statement, a transaction involves the transfer of something of value. Transactions may be either exchange transactions or nonexchange transactions. The distinction between exchange and nonexchange transactions is important in determining the point of liability recognition in federal accounting.
22. An exchange transaction arises when each party to the transaction sacrifices value and receives value in return. There is a two-way flow of resources or of promises to provide resources. In an exchange transaction, a liability is recognized when one party receives goods or services in return for a promise to provide money or other resources in the future.¹⁰
23. An example of an exchange transaction occurs when a federal employee performs services in exchange for compensation. The compensation includes current salary and future retirement benefits. An exchange transaction occurs because both parties (the employee and the employer) receive and sacrifice value. The expense is recognized in the period that the exchange occurs. The compensation liability includes unpaid salary amounts earned and the cost of future retirement benefits related to current period services.

[The staff draft concepts statement does not discuss the various kinds of events and transactions. The Board has tentatively agreed¹¹ to maintain one definition of a liability without respect to whether the transaction is an exchange transaction, nonexchange transaction, government-related event or government-acknowledged event in the concepts statement. It may be helpful to group like transactions and events for discussion in the standards of when an obligating event has occurred, but one overarching liability definition may be all that is needed in the concepts statement. Staff anticipates that the discussion of transactions and events will remain at the standards level.]

⁹ SFFAS 5, footnote 18: "Consequence" is defined as something of importance or significance.

¹⁰ SFFAS 5, footnote 19: 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.

¹¹ Official positions of the FASAB, whether proposed or final concepts or standards, are presented in FASAB publications issued in accordance with our "Rules of Procedure" and "Memorandum of Understanding." "Tentatively agreed" refers to working majority views conveyed to staff at public meetings. These agreements sometimes change before an official position is taken.

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24. A nonexchange transaction arises when one party to a transaction receives value without directly giving or promising value in return. There is a one-way flow of resources or promises. For federal nonexchange transactions, a liability should be recognized for any unpaid amounts due as of the reporting date. This includes amounts due from the federal entity to pay for benefits, goods, or services¹² 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 (for example, 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).
25. Many grant and certain entitlement programs are nonexchange transactions. When the federal government creates an entitlement program or gives a grant to state or local governments, the provision of the payments is determined by federal law rather than through an exchange transaction.
26. An event is defined as a happening of financial consequence to an entity. For federal financial reporting, some events may be other than transaction based and these events may be classified in one of two categories: (1) government-related events or (2) government-acknowledged events.
27. Government-related events are nontransaction-based events that involve interaction between the federal government and its environment. The event may be beyond the control of the federal entity. In general, a liability is recognized in connection with government-related events on the same basis as those that arise in exchange transactions. 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 damages and to the extent that the amount of the payment could be estimated reliably.¹³

¹² SFFAS 5, footnote 20: 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.

¹³ SFFAS 5, footnote 21: The vast majority of claims against the United States Government stemming from tortious government conduct are adjudicated under the Federal Tort Claims Act (FTCA), which provides for both administrative and judicial resolution. Administrative awards under the established threshold are paid from agency appropriations. Administrative awards in excess of the established threshold are paid from the judgment appropriation. Court judgments and compromise settlements by the Department of Justice are paid from the judgment appropriation regardless of amount. This Act means that, for certain types of events it is not necessary for the government to acknowledge financial responsibility separately for each individual event as is the case for events described in paragraph 30.

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28. Government-related events include: (1) cleanup from federal operations resulting in hazardous waste that the federal government is required by statutes and/or regulations, that are in effect as of the Balance Sheet date, to clean up (i.e., remove, contain, or dispose of);¹⁴ (2) accidental damage to nonfederal property caused by federal operations; and (3) other damage to federal property caused by such factors as federal operations or natural forces.¹⁵
29. Government-related events resulting in a liability should be recognized in the period the event occurs if the future outflow or other sacrifice of resources is probable and the liability can be measured, or as soon thereafter as it becomes probable and measurable.
30. Government-acknowledged events are those nontransaction-based events that are of financial consequence to the federal government because it chooses to respond to the event. The federal government has broad responsibility to provide for the public's general welfare. The federal government has established programs to fulfill many of the general needs of the public and often assumes responsibilities for which it has no prior legal obligation.
31. Consequently, costs from many events, such as toxic waste damage caused by nonfederal entities and natural disasters, may ultimately become the responsibility of the federal government. But these costs do not meet the definition of a "liability" until, and to the extent that, the government formally acknowledges financial responsibility for the cost from the event and an exchange or nonexchange transaction has occurred. In other words, the federal entity should recognize the liability and expense when both of the following two criteria have been met (1) the Congress has appropriated or authorized (i.e., through authorization legislation) resources and (2) an exchange occurs (e.g., when a contractor performs repairs) or nonexchange amounts are unpaid as of the reporting date (e.g., direct payments to disaster victims), whichever applies.

¹⁴ SFFAS 5, Footnote 22: See SFFAS No. 6, Accounting for Property, Plant, and Equipment, for a detailed discussion of cleanup cost.

¹⁵ SFFAS 5, Footnote 23: The subjects of valuing assets and of measuring asset impairments--thus measuring the loss to be recognized--are beyond the scope of this Statement. See SFFAS No. 6, Accounting for Property, Plant, and Equipment, for a discussion on the impairment or loss of federal property.

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<p>32. The following example illustrates the liability recognition of government-acknowledged events. A tornado damages a U.S. town and the Congress appropriates funds in response to the disaster. This event is of financial consequence to the federal government because the federal government chooses to provide disaster relief to the town. Transactions resulting from this appropriation, including disaster loans, outright grants to individuals, and work performed by contractors paid by the federal entities, are recognized as exchange or nonexchange transactions. In the case of exchange transactions, amounts payable for goods and services provided to federal entities are recognized when the goods are delivered or the work is done. In the case of nonexchange transactions, a liability 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 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.</p>	
<p><u>Probable Future Outflow or Other Sacrifice of Resources</u></p> <p>33. "Probable" refers to that which can reasonably be expected or is believed to be more likely than not on the basis of available evidence or logic. [See SFFAS 12 for addition text and footnote.] The probability of a future outflow or other sacrifice of resources is assessed on the basis of current facts and circumstances. These current facts and circumstances include the law that provides general authority for federal entity operations and specific budget authority to fund programs. If budget authority has not yet been provided, a future outflow or other sacrifice of resources might still meet the probability test if (1) it directly relates to ongoing entity operations and (2) it is the type for which budget authority is routinely provided. Therefore, the definition applies both to liabilities covered by budgetary resources and to liabilities not covered by budgetary resources.¹⁶</p>	<p><u><i>[The staff draft concepts statement does not currently require the future outflow or other sacrifice of resources to be probable in order for an item to meet the definition of a liability. While probability would still naturally be factored in during the measurement phase, this is a change from the current definition of a liability, which requires the future outflow or other sacrifice of resources to be probable.]</i></u></p>

¹⁶ SFFAS 5, Footnote 24: See Statement of Federal Financial Accounting Standards Number 1, Accounting for Selected Assets and Liabilities, (March 30, 1993), app. A, par. 95.

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Measurability

34. "Measurability" means that an item has a relevant attribute that can be quantified in monetary units with sufficient reliability to be reasonably estimable. Liabilities reported in the financial report are measured by different attributes specified by various accounting standards. Several different measurement attributes are used for different items in present practice (e.g., fair market value, current cost, present value, expected value, settlement value, and historical cost).

Recognition Criteria

5. Recognition criteria are the conditions an item should meet in order to be recognized in financial statements. The recognition criteria established in this Statement are (a) The item meets the definition of an element of financial statements and (b) The item is measurable. As used in this Statement, the term measurable means quantifiable in monetary units. However, whether an item should be measured at its historical cost, current cost, fair value, expected value, or some other value is beyond the scope of this Statement.¹⁷
6. As indicated by the recognition criteria, satisfying the definition of an element is a necessary but not sufficient condition for an item to be recognized in financial statements. Accordingly, there is no need to consider whether an item is measurable and should be recognized if it does not meet the definition of an element.
7. The existence or amount (or both) of many assets, liabilities, and other elements may not be certain, but the definitions and recognition criteria in this Statement do not require certainty. Conclusions about the existence of an element require judgment as to whether, based on the available evidence, the item possesses the essential characteristics of that element. However, a formal probability assessment is not required. The measurement of an element being considered for recognition in the financial statements often will require estimates and approximations. Measurement also may require a more formal probability assessment of future inflows or outflows of resources to enhance the reliability of amounts recognized in the financial statements.¹⁸
8. Recognition decisions also are influenced by assessments of the materiality and benefit versus cost of recognizing the results of the measurement of elements and by the extent to which the information meets the qualitative characteristics of understandability, reliability, relevance, timeliness, consistency, and comparability.¹⁹ Thus, it is possible that items meeting the definition and capable of being measured would not be recognized.

¹⁷ FASAB December 14, 2005, Staff Draft, Footnote 1: That issue may be addressed in a future concepts statement or in individual statements of standards.

¹⁸ FASAB December 14, 2005, Staff Draft, Footnote 2: Uncertainty and its effects on financial reporting are discussed further in paragraphs 56 through 60.

¹⁹ FASAB December 14, 2005, Staff Draft, Footnote 3: The qualitative characteristics of information in financial reports are discussed in SFFAC 1, Objectives of Federal Financial Reporting, Chapter 6.

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	<p>9. An item that meets the appropriate definition of an element is an asset, liability, revenue, or expense, even if it is not recognized in the financial statements because, for example, it is not measurable in monetary units, its amount is not material, or the qualitative characteristics are not met. Unrecognized elements are candidates for disclosure in the notes to financial statements or as supplementary information.</p>
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Liability Classification Structure

Current			Staff Draft		
Standard	Class	Sub-Class	Standard	Class	Sub-Class
SFFAS 1		Accounts Payable Interest Payable Other Current Liabilities	SFFAS XX	Exchange Transactions	- Employee and Veteran Benefit Payments - Capital Leases - Federal Debt - Accounts Payable for Goods and Services - Interest Payable - Other (TBD)
SFFAS 2		Loan Guarantees			Nonexchange Transactions - General Fund Benefit Payments - Insurance and Guarantees - Grant and Award Payments - Social Insurance - Environmental and Disposal - Other (TBD)
SFFAS 5	- Exchange Transactions - Nonexchange Transactions - Government-Related Events - Government-Acknowledged Events	- Contingencies - Capital Leases - Federal Debt - Pension/Other Retirement Benefits/Other Postemployment Benefits - Insurance and Guarantee Programs			
SFFAS 6		Cleanup Costs		Government-related Events - Environmental and Disposal - Damage to nonfederal property caused by federal operations - Damage to federal property resulting from federal operations or natural disasters - Treaties - Other (TBD)	
SFFAS 12		Litigation		Government-acknowledged Events - Environmental and Disposal - Damage to nonfederal property caused by natural disasters. - Other (TBD)	