Federal Accounting Standards Advisory Board

February 4, 2011

Memorandum

To: Members of the Board

From: Eileen W. Parlow, Assistant Director

Through: Wendy M. Payne, Executive Director

Subj: Earmarked Funds – **Tab I**[1]

MEETING OBJECTIVES

- To select among Options 1, 2, and 3 for proposed amendments to SFFAS 27*, Identifying and Reporting Earmarked Funds,* to resolve remaining concerns regarding the classification of funds as earmarked.

  Option 1. Revise the earmarked funds definition so that such funds must be intended to benefit members of the general public (rather than military or civilian employees)

  Option 2. Revise the earmarked funds definition so that such funds must be primarily financed by non-exchange revenue

  Option 3. Exclude post-employment benefit funds from earmarked funds

- To approve language providing guidance on funds with mixed sources of revenue

- If decisions are made on the above alternatives, members will be asked to select a new term for "earmarked funds."

Board decisions on the above options will facilitate the drafting of a preballot draft exposure draft (ED) following the February 2011 meeting.

[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.

BRIEFING MATERIAL

This memorandum provides the pros and cons for various options, based upon staff research, including feedback from the Earmarked Funds Task Force. Questions for members begin on page 7.

Attachment 1 is a summary of the largest earmarked funds reported in FY 2009, and includes a staff analysis of which funds would still be classified as earmarked funds under Options 1 and 2 above.

Note: The spreadsheet at Attachment 1 displays activity for the federal government's largest earmarked funds. The last four columns show (a) the total net position of those funds, (b) the total net position of those funds under Option 1, and (c) the total net position of those funds under Option 2,and (d) the total net position of those funds under Option 3.

BACKGROUND

At the December 2010 Board meeting, the members approved changes to SFFAS 27 and the related Basis for Conclusions to explicitly require non-federal funding sources for classification as an earmarked fund and to change existing requirements for information on the face of component entity statements and related disclosures. The members also requested staff research on the possibility of using a definitional change rather than an exclusion to remove certain types of funds from the earmarked category and to solicit input on draft language.

Staff provided draft language to the Earmarked Funds Task Force and held a Task Force meeting on January 25, 2011. Feedback from the Task Force is incorporated into the analysis of options beginning on page 2 of this memorandum.

1. Option 1: Revision to the existing earmarked funds definition so that such funds must be intended to benefit members of the general public (rather than military or civilian employees)

Amendments previously agreed by the board are shown in *<u>underscored and italicized</u>* text. Revisions shown in **<u>bold underscored text</u>** are new proposals to be discussed.

Option 1

> [11] Earmarked funds are financed by specifically identified revenues, *<u>provided to the government by non-federal sources</u>*, often supplemented by other financing sources, which remain available over time. These specifically identified revenues and other financing sources are required by statute to be used for designated activities, benefits or purposes, and must be accounted for separately from the Government's general revenues. The three required criteria for an earmarked fund are:

1. A statute committing the Federal Government to use specifically identified revenues ~~and~~ or other financing sources *that are originally provided to the federal government by a non-federal source*[3a] only for designated activities, benefits or purposes **that are intended to benefit the general public;**[3b]

2. Explicit authority for the ~~*earmarked*~~ fund to retain revenues and other financing sources not used in the current period for future use to finance the designated activities, benefits, or purposes; and

3. A requirement to account for and report[4] on the receipt, use, and retention of the revenues and other financing sources that distinguishes the ~~*earmarked*~~ fund from the Government's general revenues.

Footnote 3a: In some cases, specifically identified revenues or other financing sources are collected from a non-federal source by one agency and transferred or appropriated to another. For example, Social Security taxes are collected from non-federal entities (employees and employers) by the Internal Revenue Service. Those amounts are subsequently appropriated and transferred to the Social Security Administration. This internal process does not change the nature of the revenue or other financing source (i.e., specifically identified revenues or other financing sources originally collected from a non-federal source).

Footnote 3b: "Benefit the general public" means that it is possible for most or all members of the general public to have access to the benefits derived from the designated activities, benefits or purposes of the fund. For example, funding for transportation provides infrastructure that benefits the public, by facilitating commerce. In contrast, military and civilian federal pensions are not available to most members of the general public and the related funds do not meet this criterion.

Staff analysis

As shown in Attachment 1, Option 1 would exclude many funds with large negative balances, so that the total net position of the funds shown would increase from $660.3 billion to $2.845 trillion.

Note that any of the three options would support the objective of SFFAS 27 to show the extent to which the cumulative financing provided by earmarked funds to the general fund that will need to be repaid in order to use the earmarked funds for the designated activities, purposes or benefits.

Pros and Cons – Option 1

Pro	**Con**
This option avoids adding an additional exclusion to the list of exclusions in paragraph 18 of SFFAS 27. Together with other revisions to paragraph 11 (re non-	This option may not be the most cost-beneficial to the federal government. The definition is the core of SFFAS 27. A revision to the definition will require

federal funding), this option may even eliminate the need for some or all of the exclusions currently listed in paragraph 18 of SFFAS 27.	agencies to re-examine all 500 funds currently reported as earmarked to see if they still qualify as earmarked funds. Agencies will also need to examine their funds that are not currently classified as earmarked.
Review of this option by the Earmarked Funds Task Force and public comments from an exposure draft (ED) should help to avoid unintended consequences of amendments to the definition.	This option may result in reclassifications of funds (to or from the classification of earmarked) that are contrary to what the Board expects or intends. Some unexpected consequences (such as the classification of post-employment benefit funds) occurred with SFFAS 27 in spite of the ED exposure. Significant unintended consequences would require future remedial action by the Board. Some task force members expressed concern that this option would result in including some funds not previously included.
	Two Task Force members indicated that the concept of "benefit to the general public" may be difficult to apply in some cases. For example, Federal Crop Insurance has indirect benefits to the general public but primarily benefits farmers. A similar concern was reported by representatives from the Dept. of Energy regarding whether four major DOE funds (including the Nuclear Waste Fund and the Decontamination and Decommissioning (D&D) Fund) could be considered as benefiting the general public.

2. Option 2: Revisions to the existing earmarked funds definition so that such funds must be primarily financed by non-exchange revenue

The word "non-exchange" would be inserted into the first sentence of paragraph 11, as follows. Note: This revision is an alternative to option 1 and would <u>not</u> be combined with option 1.

[11] Earmarked funds are financed by specifically identified <u>**non-exchange**</u>[3b] revenues, <u>*provided to the government by non-federal sources*</u>, often supplemented by other financing sources, which remain available over time.

<u>**3b The classification "non-exchange" is governed by SFFAS 7, *Accounting for Revenue and Other Financing Sources*.**</u>

Staff analysis

As shown in Attachment 1, Option 2 would exclude many funds with large negative balances, so that the total net position of the funds shown would increase from $660.3 billion to $2.830 trillion.

Note that any of the three options would support the objective of SFFAS 27 to show the extent to which the cumulative financing provided by earmarked funds to the general fund that will need to be repaid in order to use the earmarked funds for the designated activities, purposes or benefits.

Pros and Cons – Option 2

Pro	**Con**
This option avoids adding an additional exclusion to the list of exclusions in paragraph 18 of SFFAS 27. Together with other revisions to paragraph 11 (re non-federal funding), this option may even eliminate the need for some or all of the exclusions currently listed in paragraph 18 of SFFAS 27.	This option may not be the most cost-beneficial to the federal government. The definition is the core of SFFAS 27. A revision to the definition will require agencies to re-examine all 500 funds currently reported as earmarked to see if they still qualify as earmarked funds. Agencies will also need to examine their funds that are not currently classified as earmarked.
Review of this option by the Earmarked Funds Task Force and public comments from an exposure draft (ED) should help to avoid unintended consequences of amendments to the definition. Several Task Force members indicated that Option 2 would be considerably easier to implement than Option 1, because revenues are already required by SFFAS 7 to be classified as exchange or nonexchange. They also believe that Option 2 is a better (more clearly principle-based) option than Option 1.	This option would likely result in the reclassification of numerous funds that the Board intended to be reported as earmarked – for example, this option would potentially cause Medicare Parts B and D to be excluded from earmarked funds reporting because the premiums are exchange. Other funds currently reported as earmarked funds, such as the Exchange Stabilization Fund ($44 B net position), the Land and Water Conservation Fund ($17 B) and Ginnie Mae ($14 B), may also be excluded by this option. Significant unintended consequences would require future remedial action by the Board.

3. Option 3: An addition to the list of exclusions to exclude post-employment benefit funds

The following would be added to the list of exclusions in paragraph 18 of SFFAS 27:

<u>Funds established to account for pensions, other retirement benefits, and other post-employment benefits provided to federal employees (civilian and military) should be not reported as earmarked funds because such funds account for employee-employer transactions and requirements tailored to those transactions are provided by SFFAS 5, *Accounting for Liabilities of the Federal Government*.</u>

If the Board prefers not to add exclusions, this change could also be accomplished through the definition and related criteria in paragraph 11. For example, a footnote could be added to clarify that "Revenues received from federal employees in exchange for pension and other retirement or post-employment benefits, whether civilian or military, are cost-sharing arrangements and do not constitute non-federal sources of revenue for purposes of identifying earmarked funds." Staff prefers to identify this as an exclusion. The alternative approach may lead to confusion about the principles underlying accounting for revenues collected from employees.

[Note: paragraph 18 of SFFAS 27 currently lists the following exclusions:

> Intragovernmental funds are excluded because they are revolving funds that conduct business primarily within and between Government agencies. Credit financing accounts are also excluded. Credit financing accounts are nonbudgetary funds that do not accumulate results of operations; they primarily serve as clearing accounts for cash activity relating to Federal credit programs. Fiduciary funds, which are not Government-owned, are also excluded.

With the amendments requiring a non-federal source of funds for a fund to be considered earmarked, the par. 18 list would be revised to only exclude credit financing accounts and fiduciary funds.]

<u>*Staff analysis*</u>

As shown in Attachment 1, Option 3 would exclude federal pension funds, which have the largest negative balances, so that the total net position of the funds shown would increase from $660.3 billion to $2.91 trillion.

Note that any of the three options would support the objective of SFFAS 27 to show the extent to which the cumulative financing provided by earmarked funds to the general fund that will need to be repaid in order to use the earmarked funds for the designated activities, purposes or benefits.

If the Board selects Option 3, the Task Force member representing Treasury has asked if the Board might wish to add District of Columbia (DC) pension funds to this exclusion. DC pension funds are primarily funded by employee contributions, are administered by Treasury, and currently have a negative fund balance. However, DC employees are not employees of the federal government, and staff believes that these funds are not material enough to warrant a separate exclusion. Accordingly, staff does not recommend adding the Treasury Department's DC Pension Funds to the recommended exclusion.

Pros and Cons – Option 3

Pro	**Con**
This option is likely to be the most cost-beneficial to the federal government because it does not require amending the definition, which is the core of SFFAS 27. A revision to the definition would require agencies to re-examine all 500 funds currently reported as earmarked to see if they still qualify as earmarked funds. Agencies would also need to examine their funds that are not currently classified as earmarked. In contrast, this option only requires action by agencies with post-employment benefit funds.	This option would require adding an exclusion to the existing list of exclusions in paragraph 18 rather than a more principle-based revision to the definition.
Paragraph 18 provides a logical rationale for each of the exclusions. This option includes such a rationale for post-employment benefit funds, which is very similar to the "principle" involved in Option 1 (need to benefit the general public) and so can be viewed as "principle-based" even though the format is a list of exclusions.	This option does not appear to be principle-based because it consists of adding a category of funds to a list of exclusions.

Staff recommendation regarding Options 1, 2 and 3

Staff recommends option 3 because:

- it is the most likely to avoid unintended reclassifications and
- it is likely to be the most cost-beneficial to the federal government.

Question 1 for the Board
Does the Board agree with staff recommendation to include Option 3 (add an additional category of funds to the list of exclusions in paragraph 18 of SFFAS 27)?

4. Approve language to provide guidance on funds with mixed sources of revenue

The following revisions would be made to paragraph 13 of SFFAS 27:

[13] Fund in this statement's definition of earmarked funds refers to a "fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations."[5] **Classification as earmarked or non-earmarked is made at the level of an individual fund. A fund should be classified as earmarked if it meets the criteria in paragraphs 11.2 and 11.3 and either:**

1. its predominant sources of funding are non-federal sources meeting the paragraph 11.1 criterion, or

2. it has non-federal sources of funding material to the reporting entity that meet the paragraph 11.1 criterion

For example, as currently funded, Medicare Parts B and D do not have as their predominant sources of funding non-federal sources as described in item 1 above. However, they do have a non-federal source of funding that is material to the reporting entity and should be subject to the earmarked fund reporting requirements. Therefore, they should be classified as earmarked funds.

Footnote 5: National Council on Governmental Accounting Statement 1, par. 16.

[13a][2] In situations where there is a mixed source of funding (so that not all of the funding sources meet the criteria in paragraph 11) and the proportion and/or amounts of funding sources vary from year to year so that it is difficult to determine a "predominant source of funds" and/or assess materiality, acceptable options for classification include but are not limited to:

1. **long-term expectations rather than periodic results that may fluctuate**
2. **36-month averages**

[13b] Preparers should use judgment in deciding whether such funds should be analyzed annually or on a less frequent basis. Changes in classification of funds from year to year should be disclosed.

Staff analysis

The above revisions to paragraph 13 are intended to clarify how to apply SFFAS 27 to funds with mixed sources of funding and implement decisions at the October and December Board meetings. New paragraphs 13a and 13b address a situation that was mentioned by Task Force members as a problem area that needs clarification.

[2] Note: When a new paragraph is added to an existing standard, it is numbered in such a way (a, b, c, or a decimal) to avoid re-numbering all the subsequent paragraphs of the existing standard. Hence paragraphs 13a and 13b.

Question 2 for the Board
Does the Board approve the above clarifying language for funds with mixed sources of funding?

5. Select a new proposed term for "Earmarked Funds"

At the December 2010 Board meeting, members indicated that a new term for Earmarked Funds should be proposed, but that the new term should not be selected until the Board reaches a consensus on proposed revisions to the definition of Earmarked Funds. A list of potential new terms with pros and cons is presented below.

Potential New Terms for "Earmarked Funds"

	Pro	Con
Funds from Dedicated Collections	• "Funds from Dedicated Collections" is a unique and descriptive term that will not be confused with other commonly used terms. • This term explicitly states the reason for separate reporting (dedicated collections).	• The term "dedicated collections" is not currently used in accounting literature. However, the term "dedicated collections was used in the past (prior to 2006) and included funds later categorized as earmarked funds and fiduciary activities.
Dedicated Funds	• "Dedicated funds" is a unique and descriptive term that will not be confused with other usages.	• This term might imply that appropriated funds financed by the general fund are not dedicated to specific purposes and/or may be used with greater management discretion than really exists.
Specific Restricted Funds	• Is unique, highlights the limitations on the use of the funds, and does not give more emphasis to restricted versus unrestricted funds	• This term may imply that "other funds" or "unrestricted funds" may be used with greater management discretion than really exists.
Funds from Restricted Collections	• "Funds from Restricted Collections" is a descriptive term that will not be confused with other commonly used terms. It explicitly states the reason for separate reporting (dedicated collections)	• This term may imply that "other funds" or "unrestricted funds" may be used with greater management discretion than really exists.

Staff recommendation

Based on the analysis in the table above, staff recommends “Funds from Dedicated Collections.”

Question 3 for the Board **Does the Board agree with staff recommendation, “Funds from Dedicated Collections”?**

Attachment:
Largest Earmarked Funds
FY 2009 Data (in millions)

These columns show ending net position under Options 1, 2 and 3

Line No and Description	Component Entity	Net position, beginning of period	Taxes and other non-exchange revenue	Intragovernmental transfers out	Exchange revenue	Gross costs	Net position, end of period	Option 1- Net position- Benefit General Public**'	Option 2- Net position- Nonexch Revenue	Option 3- Net position- Exclude federal retirement funds
Federal Crop Insurance Corporation Fund	USDA	(2,210)	6,815	0	2,878	10,060	(2,577)	0	(2,577)	(2,577)
Agricultural Disaster Relief Trust Fund	USDA	833	703	0	0	5	1,531	0	1,531	1,531
Funds for Strengthening Markets, Income, and Supply	USDA	680	1,013	0	1	1,017	677	677	677	677
Cooperative Work	USDA	263	131	0	91	126	359	359	359	359
Agricultural Quarantine Inspection User Fee Account	USDA	220	(347)	0	486	230	129	129	0	129
NTIA Digital Television Transition and Public Safety Fund	Commerce	1,069	(0)	7,378	16,689	764	9,617	9,617	0	9,617
Broadband Technology Opportunities Program - Recovery Act	Commerce	0	4,670	0	0	12	4,658	0	0	4,658
USPTO Earmarked Funds	Commerce	433	0	2	1,927	1,982	376	376	0	376
Digital-to-Analog Converter Box Program - Recovery Act	Commerce	0	650	71	0	351	228	0	0	228
Damage Assessment and Restoration Revolving Fund	Commerce	38	5	0	0	7	37	37	37	37
Military Retirement	DoD	(901,021)	0	0	75,268	73,004	(898,757)	0	0	0
DOD Medicare-Eligible Retiree Health Care Fund	DoD	(366,710)	0	0	22,469	17,336	(361,577)	0	0	0
D&D Fund	Energy	(10,555)	477	0	184	(431)	(9,463)	(9,463)	0	(9,463)
Federal Hospital Ins. (Medicare Part A)	HHS	302,907	224,705	0	0	235,238	292,374	292,374	292,374	292,374
Federal Supp Medical Ins. (Medicare Parts B and D)	HHS	52,000	186,755	0	57,332	252,119	43,968	43,968	43,968	43,968
National Flood Insurance Program	DHS	(23,648)	136	0	0	(3,124)	(20,388)	(20,388)	(20,388)	(20,388)
Customs User Fees	DHS	847	1,619	0	(1,256)	399	811	811	811	811
Sport Fish restoration and Boating Trust Fund	DHS	768	658	721	0	0	705	705	705	705
Immigration Examination Fees	DHS	17	64	4	2,707	2,378	406	0	0	406
Ginnie Mae	HUD	13,526	0	10	657	138	14,035	14,035	0	14,035
Unemployment	Labor	72,109	57,404	5,295	1,004	114,684	10,539	10,539	10,539	10,539
Black Lung Disability	Labor	(10,439)	7,144	57	0	2,968	(6,320)	0	(6,320)	(6,320)

Largest Earmarked Funds
FY 2009 Data (in millions)

These columns show ending net position under Options 1, 2 and 3

Line No and Description	Component Entity	Net position, beginning of period	Taxes and other non-exchange revenue	Intragovernmental transfers out	Exchange revenue	Gross costs	Net position, end of period	Option 1- Net position-Benefit General Public**'	Option 2- Net position-Nonexch Revenue	Option 3- Net position-Exclude federal retirement funds
Foreign Service Ret. and Disability Fund	State	(142)	0	0	1,292	2,663	(1,513)	0	0	(1,513)
Land and Water Conservation Fund	Interior	16,024	1	284	901	0	16,641	16,641	0	16,641
Exchange Stabilization Fund	Treasury	39,818	0	0	4,951	923	43,846	43,846	0	43,846
Highway Trust Fund	DOT	12,435	41,964	0	93	44,758	9,734	9,734	9,734	9,734
Airport and Airway	DOT	4,823	10,860	0	0	11,783	3,899	3,899	3,899	3,899
Medical	VA	1,635	(2,703)	0	2,863	462	1,333	0	0	1,333
Insurance	VA	(348)	41	0	1,072	1,168	(403)	0	0	(403)
Benefits	VA	66	0	0	1	2	65	0	0	65
Burial	VA	3	0	0	0	0	3	0	0	3
Leaking Underground Storage Tanks	EPA	3,244	291	0	0	99	3,436	3,436	3,436	3,436
Hazardous Substance Superfund	EPA	2,703	1,770	0	616	1,672	3,417	3,417	3,417	3,417
Environmental Services	EPA	211	21	0	0	0	232	232	232	232
Universal Service Fund	FCC	5,927	8,241	0	0	8,117	6,051	6,051	6,051	6,051
Gift & TFB funds	LOC	147	14	0	1	17	145	145	145	145
Offsetting Collection funds	LOC	26	2	0	31	35	24	24	0	24
Public Revolving funds	LOC	3	1	0	9	10	3	3	0	3
Gift Trust Fund	Nat'l Endow. for the Arts	4	1	0	0	1	3	3	3	3
H1-B Fund	NSF	365	89	0	0	97	356	356	356	356
Civil Service Retirement and Disability	OPM	(653,535)	0	0	92,695	135,149	(695,989)	0	0	0
Civil Service Health Benefits	OPM	(285,480)	0	0	40,327	45,599	(290,752)	0	0	0
Employees' Life Insurance	OPM	(2,107)	0	0	4,382	4,668	(2,393)	0	0	0
Railroad Retirement	RRB	25,611	2,022	0	0	4,234	23,400	0	23,400	23,400
Social Security Equivalent Benefit Account	RRB	457	6,523	0	0	6,402	578	0	578	578
Railroad Unemployment Ins. Trust Fund	RRB	110	81	0	23	177	37	0	37	37
Federal Old-Age and Survivors Insurance	SSA	2,128,633	691,019	0	1	549,472	2,270,181	2,270,181	2,270,181	2,270,181
Federal Disability Insurance	SSA	196,648	106,352	0	26	116,391	186,635	186,635	186,635	186,635
Totals		628,407	1,321,423	13,822	329,722	1,605,395	**660,335**	**2,888,378**	**2,829,817**	**2,909,803**

***Notes on ending net position under options 1 and 2:**
Classification represents FASAB staff judgment. Agency judgment may differ.
** "Benefit the general public" is FASAB staff opinion; agency analysis may differ.
Note:
The following were excluded because they have no non-federal revenue – but otherwise may have been included under either option:
Broadband Technology Opportunities Program - Recovery Act
Digital-to-Analog Converter Box Program - Recovery Act
DoD D&D Fund
The following were excluded because they have no non-federal revenue - but would also would likely be <u>excluded</u> under either option:
Military Retirement
DOD Medicare-Eligible Retiree Health Care Fund