Federal Accounting Standards Advisory Board

April 8, 2019

Memorandum

MEMBER ACTION REQUESTED
Please provide answers to the 10 questions by April 17, 2019

To: Members of the Board

Robin M. Gilliam

From: Robin M. Gilliam, Assistant Director

Wendy M. Payne *Monica R. Valentine*

Through: Wendy M. Payne, Outgoing Executive Director / Monica Valentine, Incoming Executive Director

Subject: **Risk Reporting[1] – Tab B**

MEETING OBJECTIVES

The meeting objective is to review interview responses and staff recommendations for amending management's discussion and analysis concepts and standards.

BRIEFING MATERIAL

The briefing material includes this memorandum and the following:

Attachment 1: Interview Preparation Document

Attachment 2: Pilot Interview Meeting Notes

Appendix A: Risk Reporting: Project History and Milestones

Appendix B: SFFAC 3, *Management's Discussion and Analysis* [Concepts]

Appendix C: SFFAS 15, *Management's Discussion and Analysis* [Standards]

[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 FASAB or its staff. Official positions of FASAB are determined only after extensive due process and deliberations.

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BACKGROUND

At the December 2018 meeting, members discussed the current status of risk reporting under SFFAS 15, paragraph 3 on forward-looking information. During the meeting, the Board discussed the intent of SFFAS 15 in relation to the forward-looking information provided by agencies in their 2017 management's discussion and analysis (MD&A).

Members agreed that the original intent for forward-looking information was to focus on the financial effects of risks on amounts in the financial statements even though the word "financial" was not specifically included in SFFAS 15, paragraph 3. However, this is not the information that agencies are providing.

Members also agreed that forward-looking information should include a discussion of the short-term financial effects, as well as the possible long-term financial effects of financial statement balances. Short-term effects may relate to the next two or three periods covered in the budget planning cycle, while long-term effects may be defined by an agency's life cycle to complete program missions.

Members agreed that staff should prepare an Interpretation to clarify how to discuss risk in MD&A and explain what is meant by financial effect and time horizon. Additional guidance may be included in the Interpretation, such as sensitivity tests and/or best practices.

To develop the Interpretation, the Board suggested staff interview agency staff to understand what guidance preparers need to discuss short- and long-term financial effects of risks.

Members agreed that the Interpretation addressing forward-looking information discussed in SFFAS 15, paragraph 3 will be separate from the Interpretation that will address MD&A structure. This is to avoid losing the risk reporting clarification within the formatting clarification.

I. INTRODUCTION

After the December 2018 meeting, staff distributed an *Interview Preparation Document* to assist agency staff in preparing for interviews. [Please see attachment 1]. Staff conducted interviews with the original intention of presenting recommendations for an Interpretation of SFFAS 15, paragraph 3.

However, after careful consideration of the responses and analysis of SFFAC 3 and SFFAS 15, **staff is recommending amendments**[2] to the MD&A concepts and

[2] NOTE: "Interpretation" is still referenced in the documented interview responses.

standards to provide concise guidance for MD&A risk reporting and forward-looking information.

II. PILOT INTERVIEW

Staff met with Courtney Timberlake, Senior Vice President and Director of Federal Financial Advisory Services at the Craddock Group, LLC, **to pilot the *Interview Preparation Document.*** Ms. Timberlake has nearly 25 years of federal budget, credit, and financial management expertise.

The following are Ms. Timberlake's major points. Please see attachment 2 for the full meeting minutes:

1. The diagram on page two [attachment 1] is a good representation of FASAB's role in relation to an agency's enterprise risk management (ERM) process at agencies.

2. The seven questions (reviewed below) are appropriate for agency interviews.

3. The Interpretation should not dictate what agencies should say. Instead, the guidance should be dynamic enough to allow the discussion to evolve over time as agencies develop and mature ERM processes.

4. It would be helpful to include guidance on how to discuss metrics to better understand how past performance could impact future financial effects.

5. It would be helpful to include guidance on how to discuss the risk to the agency of not participating in cost avoidance.

6. It would be helpful to include guidance on how to discuss how a potential change in appropriations could affect program financing and, as a result, program performance.

III. INTERVIEW PARTICIPANTS

After the pilot interview with Ms. Timberlake, staff interviewed the following people:

Doug Glenn, Assistant Deputy Chief Financial Officer, Department of Defense – Due to his extensive government knowledge in preparing financial statements, staff interviewed Mr. Glenn from a holistic view of the government and not from a specific agency view.

Department of Energy (Energy) – Staff conducted an interview with Energy staff because they had presented forward-looking information in relation to accomplishing their missions in the *Management Priorities* section of the MD&A. The following individuals were present at the interview:

- Karin Dasuki, Deputy Director for Office of Finance and Accounting (OFA)
- Lynn Harshman, Division Director Internal Controls - OFA
- Mindy Bledsoe, Team Lead Internal Controls, Analysis and Reporting - OFA
- Pamela Green, Budget Analyst, Office of Budget
- Christine DuLac, Program Analyst, Office of Budget

Department of Labor (Labor) - Staff conducted an interview with Labor staff because they had presented a *Looking Forward* discussion for each major program in their *Program Performance Overview* section of the MD&A. The following individuals were present at the interview:

- Dylan Sacchetti, Director, Division of Financial Policy and Compliance, Office of the Chief Financial Officer (OCFO)
- Cynthia D. Simpson, Accountant, Division of Financial Reporting, OCFO
- Tesfaye Wyes, Lead Accountant, Division of Financial Reporting, OCFO
- Arkesha Moses, Program Manager, Office of the Assistant Secretary for Administration and Management, Performance Management Center

Department of Veterans Affairs (VA) - Staff conducted an interview with VA staff because they had made significant changes to the forward-looking information in the agency financial report (AFR) MD&A from 2017 to 2018. The following individuals were present at the interview:

- Ronald Hallameyer, Acting Associate Deputy Assistant Secretary (ADAS) for Financial Policy
- Michael Ploen, Senior Policy Advisor
- Antonio DeNicolis, Lead Systems Accountant
- Noah Hertach, Staff Accountant
- Eric Schneider, Supervisory Accountant
- Tamara Faraca, Accountant
- Joanna Bramer, KPMG Consultant

Staff thanks the individuals and agencies that took their time to participate in this interview process. Your answers were very helpful in directing staff on the following recommendations to the Board.

IV. STAFF ANALYSIS AND RECOMMENDATIONS

The following sections are divided by interview question (IQ). Respondents' answers, staff notes, and recommendations follow each IQ and agency response.

A. FINANCIAL EFFECTS OF RISK

1. **IQ #1:** What do you think MD&A should convey regarding risks and the financial effects of risk?

2. **RESPONDENT ANSWERS**

Doug Glenn: It would be helpful to have a forward-looking discussion about the nature of the risk(s), the likelihood of the risk(s) occurring, and the potential impact to related financial statement line items. It would be helpful if the discussion included what actions were being taken to mitigate risks.

Energy: There are a number of risks. There is risk in investing in a technology that proves less effective than an alternative technology, leading to discontinuation of investment prior to full implementation. There is risk in lacking available funding to continue a project. There is risk in changing clean-up method, which could result in cost and schedule consequences. There is risk in shifting project/mission scope due to changes in Departmental and Administration priorities.

Energy would like specific guidance on how to discuss risk-reporting information. Quantifying the financial effects of risk is very difficult due to the unknown and to continual changes in cost estimates for activities, such as environmental cleanup and pension liabilities.

Energy is concerned about the Office of the Inspector General (OIG) and auditors discerning more guidance in the Interpretation than FASAB intends, which could result in auditors requiring more information in principal statements and notes.

Labor: Even though MD&A is not audited, auditors still want support that ties to related balances.

There are already a number of forward-looking risk and condition discussions in MD&A's *Program Performance Overview*, such as the compensation and benefits program discussion. This includes the Black Lung Benefits Act (Black Lung) Program and Energy Employees Occupational Illness Compensation Program Act (Energy Program). However, they are focused on performance information and not financial effects.

Some accounting standards require disclosures of risks and the financial effects of risk. The *Financial Performance Overview* section in MD&A includes information about the risks and conditions for social insurance, the Black Lung Disability Benefit Program. The social insurance accounting standards require forward-looking information in required supplementary information (RSI) for a projection period (25 years in the case of Black Lung), including analyses under different assumptions. The MD&A, *Financial Performance Overview* section, includes information about the condition/liability of the

Energy Employees Occupational Illness Compensation Benefits Program. This information can be tied to the financial statements.

Labor is also concerned with what leadership will buy into and allow in such a public document.

Other federal agencies rely on Labor for intragovernmental workers' compensation information, which has a separate audit and special audit report. Information provided by Labor may have to be reported by other federal agencies.

VA: The financial effects of risk should be captured on the face of the balance sheet as a contingent liability and the notes to the financial statements, depending upon the likelihood of its occurrence. MD&A should focus on the risks and challenges presented to an agency in a broader sense, discussing events to be addressed which may not yet have a calculated or approximate related cost.

Financial effects of risks should be captured in the risk mitigation strategy and be aligned with the risks internal controls monitor. This information should not be duplicated in the MD&A of the AFR as it would add to the length and complexity of the document, which is counter to the Association of Government Accountants' effort to create a more citizen-centric AFR.

3. STAFF NOTES

One respondent would like to see forward-looking information include a discussion about the nature and likelihood of risk(s) occurring, and the effect on related financial statement line items, as well as what actions are being taken to mitigate risks.

Due to unknown and uncertain cost estimates related to risk, another respondent would like specific guidance on how to discuss risk-reporting information.

Two respondents were concerned with adding additional burden by duplicating risk information that is already in other areas of the financial statements and MD&A, such as contingent liabilities and performance and financial MD&A sections, and information in internal risk management documents.

Two respondents want to avoid required forward-looking information that may cause additional audit work related to financial statement line items and note disclosures.

All respondents agreed that risk should be presented broadly in MD&A with a focus on qualitative rather than quantitative forward-looking information.

4. STAFF RECOMMENDATIONS

To set the stage for discussing risk in MD&A's forward-looking information, **staff recommends** reporting entities include a summary such as the following presented by Tennessee Valley Authority (TVA) and Apple. Both Securities and Exchange Commission (SEC) 10-K 1A summaries caution that risks are uncertain and that future results could vary materially from historic results for each risk alone or in concert with other risks. Due to uncertainty these risks could possibly adversely affect the organization's financial condition, operating results, and/or stock price.

While federal agencies are not concerned with making a profit or with stock prices, users are concerned with how tax dollars are being invested and any adverse financial effect on operating results and financial statement elements, such as specific assets and/or liabilities.

The following summaries helped staff to undertstand how risk factors and uncertainty may impact the financial condition of TVA and Apple.

Apple

Share

Multinational Technology Company

Apple Inc. is an American multinational technology company headquartered in Cupertino, California, that designs, develops, and sells consumer electronics, computer software, and online services. The company's hardware products include the iPhon... +

FORM 10-K

Annual report pursuant to section 13 and 15(d)

Filing Date: **2017-11-03** | Period of Report: **2017-09-30**

SEC Accession No. 0000320193-17-000070

(HTML Version on secdatabase.com)

Item 1A. Risk Factors [Apple]

The following discussion of risk factors contains forward-looking statements. These risk factors may be important to understanding other statements in this Form 10-K. The following information should be read in conjunction with Part II, Item 7, “Management’s Discussion and

Analysis of Financial Condition and Results of Operations” and the consolidated financial statements and related notes in Part II, Item 8, “Financial Statements and Supplementary Data” of this Form 10-K. The business, financial condition and operating results of the Company can be affected by a number of factors, whether currently known or unknown, including but not limited to those described below, any one or more of which could, directly or indirectly, cause the Company’s actual financial condition and operating results to vary materially from past, or from anticipated future, financial condition and operating results. Any of these factors, in whole or in part, could materially and adversely affect the Company’s business, financial condition, operating results and stock price. Because of the following factors, as well as other factors affecting the Company’s financial condition and operating results, past financial performance should not be considered to be a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

(MARK ONE)

☒ ANNUAL REPORT PURSUANT TO

SECTION 13, 15(d), OR 37 OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended September 30, 2018

OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

TVA

Commission file number 000-52313

TENNESSEE VALLEY AUTHORITY
(Exact name of registrant as specified in its charter)

A corporate agency of the United States created by an act of Congress	62-0474417
(State or other jurisdiction of incorporation or organization)	*(IRS Employer Identification No.)*

ITEM 1A. RISK FACTORS [TVA]

> The risk factors described below, as well as the other information included in this Annual Report, should be carefully considered. Risks and uncertainties described in these risk factors could cause future results to differ materially from historical results as well as from the results anticipated in forward-looking statements. Although the risk factors described below are the ones that TVA considers significant, additional risk factors that are not presently known to TVA or that TVA presently does not consider significant may also impact TVA's business operations. See Forward Looking Information above for a description of some matters that could affect the below risks or generate new risks. Although the TVA Board has the authority to set TVA's own rates and may mitigate some risks by increasing rates, there may be instances in which TVA would be unable to partially or completely eliminate one or more of these risks through rate increases over a reasonable period of time or at all. Accordingly, the occurrence of any of the following could have a material adverse effect on TVA's cash flows, results of operations, and financial condition. For ease of reference, the risk factors are presented in four categories: (1) regulatory, legislative, and legal risks, (2) operational risks, (3) financial, economic, and market risks, and (4) general business risks.

While some of the language may be boilerplate, it does educate users about the uncertainty of risk and possible material adverse effects to financial statement elements and financial condition that may be discussed throughout the MD&A.

QUESTION 1: Does the Board agree to include a forward-looking summary to help users understand how risk and uncertainty may have a material financial effect on operating results and financial statement balances different from historical results?

B. DEFINITION OF FINANCIAL EFFECTS

1. IQ #2: Would a definition of “effects” be helpful to understand how risk events can cause financial effects? If yes, why?

2. RESPONDENT ANSWERS

Doug Glenn: A short one- or two-sentence definition would be helpful.

Energy: Yes, a specific definition would help to prevent interpretation issues for what to report internally and externally. The Interpretation should tell agencies what FASAB means by “financial effect.”

Energy sometimes experiences challenges obtaining the Office of Management and Budget's (OMB) Resource Management Office (RMO) clearance of language in the AFR. A clear definition could help the OMB clearance process.

Labor: Risk statements for agencies using an "if-then" model have been useful.

The accounting standards for social insurance programs (Black Lung and unemployment insurance) already require disclosures in RSI about the financial effects under different assumptions. Information in the MD&A should not duplicate information that is already required in other sections.

VA: Yes, a definition of effects would be helpful to understand the intent of FASAB's 'to be' interpretation [see page 3 of attachment 1] and to what extent FASAB expects agencies to detail the financial effects. As the proposed change currently reads, it may be confusing to preparers in determining how this disclosure differs from the required contingent liability disclosures. Additionally, requesting the future financial effects associated with risks identified could be construed as FASAB requesting that agencies document the expected future budget needs associated with a given risk, which is in contradiction to the following excerpt from SFFAS 15 par. 21: "This information can be highly useful, but management should avoid turning this part of MD&A into mere "lobbying" for more budgetary authority."

3. STAFF NOTES

Three respondents agreed that a definition would be helpful to understand how risk events can cause financial effects and what the Board expects in a discussion of financial effects. While one respondent did not specifically state that a definition would be helpful, the respondent did note that an "if-then" model might be helpful.

A definition would help to address the respondents' concerns to 1) avoid duplicating information that is already required in other sections and 2) prevent information that may be "lobbying for more budget authority."

To provide a definition that would help preparers, SFFAC 3 [See appendix B] and SFFAS 15 [See appendix C] should be **amended to** clearly require "financial effects" of risk factors.

Currently, SFFAC 3, paragraph 31 only alludes to financial effects with the statement "affect the amounts."

> *MD&A should describe important existing, currently-known demands, risks, uncertainties, events, conditions and trends--both favorable and unfavorable--…**that affect the amounts** reported in the financial statements and supplementary information…* [**emphasis** added]

Another example of a vague reference to financial effects is the word “future” in SFFAC 3, paragraph 32, and SFFAS 15, paragraph 3.

> (*This discussion of possible* ***future*** *effect of existing, currently-known factors is required pursuant to the standards in Standards for Management’s Discussion and Analysis*). [**emphasis** added]

SFFAS 15, paragraph 3 states:

> *MD&A should include forward-looking information regarding the possible* ***future*** *effects of the most important <u>existing,</u> currently-known demands, risks, uncertainties, events, conditions and trends. MD&A may also include forward-looking information about the possible effects of <u>anticipated</u>* ***future*** *demands, events, conditions, and trends.…*

the phrase “future effects,” in the concepts and standards does not provide solid guidance for how to discuss what type of effect the Board intends. This could explain why agencies are more focused on non-financial performance effects instead of the impact to financial statement balances.

4. STAFF RECOMMENDATIONS

To clarify what the Board intended, **staff recommends**:

1) An amendment to SFFAS 15, paragraph 3 to add the word “financial” to “effects” to read “financial effects” as follows:

> *MD&A should include forward-looking information regarding the possible future* ***financial*** *effects of the most important <u>existing,</u> currently-known demands, risks, uncertainties, events, conditions and trends. MD&A may also include forward-looking information about the possible* ***financial*** *effects of <u>anticipated</u> future demands, events, conditions, and trends…*

2) A definition of financial effects

QUESTION 2: Does the Board want to amend SFFAS 15 to add the word “financial” to “effects” to clearly state “financial effects?”

QUESTION 3: Does the Board want to include a definition of financial effects?

C. **EXAMPLES**

1. **IQ #3:** Would <u>examples</u> help to illustrate how risk events can impact financial statement balances? If yes, why?

2. **RESPONDENT ANSWERS**

Doug Glenn: Specific examples should be included in the Interpretation to help clarify the intent and reader understanding.

Examples would be preferred over requirements for how to disclose/quantify primary financial risks, such as continuing resolutions, shutdowns, budget changes, fiscal unsustainability, and/or other legislative and Administration changes. These could be highly political internal and external to an agency.

Staff explained that only risks included in an agency's risk profile should be discussed in forward-looking information; FASAB is not going to dictate or mandate what risks an agency should discuss as diagrammed on page two of the preparation document. Mr. Glenn found this diagram helpful in understanding FASAB's role in what risks were to be included.

Energy: Energy would like at least three to four examples of different types of risk events and associated sample MD&A language regarding the financial effect of these risks. Examples will provide guidance on how Energy should prepare the MD&A and serve as information for OMB and auditors to understand what FASAB expects.

Labor: Examples would be very helpful to guide agencies and to keep risk reporting consistent across the agencies.

VA: In general, VA's Office of Enterprise Integration uses examples of risk impact and likelihood to convey what is needed to its Administrations and staff offices; providing examples of how risk events can impact financial statements could serve the same purpose. However, VA does not believe the information used to support its evaluation of risk and the financial effects in ERM belongs in the AFR. The MD&A is management's opportunity to discuss risks and challenges the agency faces. These may not yet have enough information or meet the requirements to be disclosed in the financial statement balances. The point is to provide citizens with information regarding the future of the agency, not to confuse them with technical information.

3. **STAFF NOTES**

All four respondents agreed that examples would be helpful. Providing examples will help to distinguish reporting risk in forward-looking information from how risk may be discussed in internal ERM documentation.

One respondent emphasized that MD&A provides an opportunity to discuss an agency's risks and challenges that may not yet have enough information or meet the requirements to be disclosed in the financial statement balances. Therefore, the respondent noted that it would be helpful to have examples as to how to provide citizens with information regarding the future of the agency, rather than technical information maintained in internal documents.

TVA’s 2018 10-K Section 1A, Risk Factors, provides a good “if-then” model for presenting a qualitative discussion rather than quantitative information that preparers should be able to provide with no additional burden.

> **Weather conditions may influence TVA's ability to supply power and its customers' demands for power.**
>
> Extreme temperatures may increase the demand for power and require TVA to purchase power at high prices to meet the demand from customers, while unusually mild weather may result in decreased demand for power and lead to reduced electricity sales. Also, in periods of below normal rainfall or drought, TVA's low-cost hydroelectric generation may be reduced, requiring TVA to purchase power or use more costly means of producing power. Additionally, periods of either high or low levels of rainfall may impede river traffic, impacting barge deliveries of critical items such as coal and equipment for power facilities. Furthermore, high river water temperatures in the summer may limit TVA's ability to use water from the Tennessee or Cumberland River systems for cooling at certain of TVA's generating facilities, thereby limiting its ability to operate these generating facilities. This situation would be aggravated during periods of reduced rainfall or drought. If changes in the climate make such shifts in weather more common or extreme, TVA may be required to, among other things, change its generation mix or change how it conducts its operations, which could have a material adverse effect on TVA's cash flows, results of operations, and financial condition.

In the above example, extreme temperatures was the risk factor. TVA explained how this risk could affect operations, provided a brief discussion of limitations and/or changes that might need to be made to mitigate this risk, and included a statement that these changes “*could have a material adverse effect on TVA’s cash flows, results of operations, and financial condition.”*

> **Catastrophic events may negatively affect TVA's cash flows, results of operations, and financial condition.**
>
> TVA's cash flows, results of operations, and financial condition may be adversely affected, either directly or indirectly, by catastrophic events such as fires, earthquakes, explosions, solar events, electromagnetic pulses ("EMP"), droughts, floods, tornadoes, wars or other casualty events or national emergencies, terrorist activities, pandemics, or other similar destructive or disruptive events. These events, the frequency and severity of which are unpredictable, may, among other things, lead to legislative or regulatory changes that affect the construction, operation, and decommissioning of nuclear units and the storage of spent fuel; limit or disrupt TVA's ability to generate and

transmit power; limit or disrupt TVA's ability to provide flood control and river management; reduce the demand for power; disrupt fuel or other supplies; require TVA to produce additional tritium; lead to an economic downturn; require TVA to make substantial capital investments for repairs, improvements, or modifications; and create instability in the financial markets. If public opposition to nuclear power makes operating nuclear plants less feasible as a result of any of these events, TVA may be forced to shut down its nuclear plants. This would make it substantially more difficult for TVA to obtain greater amounts of its power supply from low or zero carbon emitting resources and to replace its generation capacity when faced with retiring or idling certain coal-fired units. Additionally, some studies have predicted that climate change may cause catastrophic events, such as droughts and floods, to occur more frequently in the Tennessee Valley region, which could adversely impact TVA.

In this example, catastrophic events was the risk factor. TVA provided a different structure by starting the discussion with "*TVA's cash flows, results or operations, and financial condition may be adversely affected…"* Then TVA included specific examples of what could occur operationally if a catastrophic risk event happens.

4. STAFF RECOMMENDATIONS

Staff recommends the Board model the 10-K, Item 1A. Risk Factor section to provide qualitative forward-looking examples because this would 1) meet the respondents' request for a qualitative discussion of financial effects; and 2) meet the principles set forth in paragraphs 31 and 32 of SFFAC 3.

> 31. <u>Current Demands, Risks, Uncertainties, Events, Conditions, and Trends</u>—MD&A should describe important existing, currently-known demands, risks, uncertainties, events, conditions and trends--both favorable and unfavorable--that affect the amounts reported in the financial statements and supplementary information. The information called for by this paragraph and paragraph 32 is closely related. Preparers should combine the presentation of this information in whatever fashion is appropriate under the circumstances that apply to the reporting entity.
>
> 32. <u>Future Effects of Current Demands, Risks, Uncertainties, Events, Conditions and Trends</u>—The discussion of these current factors should go beyond a mere description of existing conditions, such as demographic characteristics, claims, deferred maintenance, commitments [FN omitted] undertaken, and major unfunded liabilities, to include a discussion of the possible future effect of those factors. (This discussion of possible future <u>effect</u> of existing, currently-known factors is required pursuant to the standards in *Standards for Management's Discussion and Analysis*.)

Both TVA paragraphs provide a qualitative reference to financial effects, noting that these risk factors could materially affect financial position and operating results.

In addition, TVA’s forward-looking discussion on extreme temperatures is a good example of the principle to “go beyond the mere description of existing conditions*.”* (SFFAC 3, par. 32).

TVA not only discusses the risk of high water temperatures, but also explains how this could limit its ability to operate certain facilities.

Another risk factor familiar to all federal agencies is a potential change in laws or regulations. The below example is a brief qualitative discussion of forward-looking information that explains how new environmental laws, regulations, or orders may financially affect TVA‘s financial condition such as “*a substatial increase in TVA’s cost of operations or significant capital expenditure.”*

> ***New laws, regulations, or administrative orders, or congressional action or inaction, may negatively affect TVA's cash flows, results of operations, and financial condition, as well as the way TVA conducts its business.***
>
> **TVA may become subject to additional environmental regulation.**
>
> New environmental laws, regulations, or orders may become applicable to TVA or the facilities it operates, and existing environmental laws or regulations may be revised or reinterpreted in a way that adversely affects TVA, including substantially increasing TVA's cost of operations or requiring significant capital expenditures. Possible areas of future laws or regulations include, but are not limited to, GHGs, CCRs, water quality, renewable energy portfolio standards, and natural gas production and transmission.

In addition to supporting the principles in SFFAC 3, paragraph 31 and 32, utilizing the 10-K, 1A Risk Factor model will help to prevent additional burden to the agency because the focus is on a qualitative discussion.

Therefore, **staff recommends** using the 10-K, section 1A Risk Factors as a model for examples to illustrate how risk events can affect financial statement elements.

QUESTION 4: Does the Board want to use the 10-K, Section 1A Risk Factors as a model for examples to illustrate how risk events can affect financial statement elements?

Staff also notes that the language in SFFAC 3, paragraph 31 and 32, is language traditionally used in standards rather than concepts. Therefore, **staff also recommends** incorporating language from SFFAC 3, paragraph 31 and 32, into SFFAS 15, with the possibility of rescinding SFFAC 3, paragraph 31 and 32.

QUESTION 5: Does the Board want to incorporate language from SFFAC 3, paragraph 31 and 32 into SFFAS 15?

D. DISTINGUISH BETWEEN SFFAS 15, PARAGRAPH 3 AND 4

1. **IQ #4:** Would a distinction between SFFAS 15, paragraph 3 (financial effects) & SFFAS 15, paragraph 4 (non-financial activities) help to make it clear that the standards request different information? If yes, why?

2. **RESPONDENT ANSWERS**

Doug Glenn: Specifically stating the difference between SFFAS 15, paragraph 3 and 4 in the Interpretation would be very helpful.

Energy: It would be helpful if the Interpretation clearly distinguished between the two paragraphs to clarify that paragraph 3 is about the future and paragraph 4 addresses how an agency is going down a path, experiences a problem, and how to address that problem.

Labor: It would be beneficial to distinguish between performance and financial effects; performance information should be supported by financial information.

VA: As it currently reads, it is unclear how SFFAS 15, paragraph 3 and 4 require substantially different information. Clarification is needed on what specifically the Board is requesting.

SFFAS 15, paragraph 3 is interpreted to be the identification of future demands, events, conditions, and trends, while SFFAS 15, paragraph 4 is interpreted to be the actions planned and/or taken to address those problems identified.

SFFAS 15 does not currently request financial effects in the forward-looking information of the MD&A.

Paragraphs 3 and 4 from SFFAS 15 state: [See Appendix C for entire Statement]

Paragraph 3:

MD&A should include forward-looking information regarding the possible future effects of the most important existing, currently-known demands, risks, uncertainties, events, conditions and trends. MD&A may also include forward-looking information about the possible effects of anticipated future demands, events, conditions, and trends.[3] Forward-looking information may comprise a separate section of MD&A or may be incorporated with the sections listed above.

Footnote 3 - The word “anticipated” is used in a broad, generic sense in this document. In this context the term may encompass both “probable” losses arising from events that have occurred, which should be recognized on the face of the basic or “principal” financial statements, as well as “reasonably possible” losses arising from events that have occurred, which should be disclosed in notes to those statements. “Anticipated” may include the effects of future events that are deemed probable, for which a financial forecast would be appropriate. The term may also encompass hypothetical future trends or events that are not necessarily deemed probable, for which financial projections may be appropriate. Such information about the possible effects of anticipated future demands, events, conditions and trends, if presented, should include the term or label “projected” or “projection,” and the key hypothetical underlying assumptions should be explained. As with other information presented in MD&A, no examination of this information by the auditor is now routinely included within the scope of an audit of a federal entity’s financial statements; however, preparers and auditors may find useful background information in the AICPA’s Statements on Standards for Attestation Engagements Nos. 1 and 4, codified as section 200, “Financial Forecasts and Projections,” of the AICPA’s Codification of Statements on Standards for Attestation Engagements.

Paragraph 4:

MD&A should discuss important problems that need to be addressed, and actions that have been taken or planned. Actions needed, taken, and planned may be discussed within the sections listed above or in a separate section of MD&A.

3. STAFF NOTES

All four respondents agree that guidance should include a distinction between paragraph 3 and 4 to clarify that paragraph 3 is about future financial effects and paragraph 4 addresses how an agency experiences and addresses a problem.

The following examples—originally presented at the December 2018 Board meeting—concur with respondent answers and show that agencies are more familiar with discussing non-financial performance problems and activities/behaviors to fix them over the next budget cycle, as opposed to future financial effects of risks.

HHS

The Message from the Acting Secretary addresses one of the most pressing issues facing the American public—the ongoing opioid crisis. Acting Secretary Hargan took action on October 26, 2017, by declaring a nationwide public health emergency. According to the CDC, more than 175 Americans die every day from drug overdoses, with 91 of those deaths occurring specifically from opioids. HHS developed a five-point strategy to combat opioids, which includes the following steps:

- Improve access to prevention, treatment, and recovery support services;
- Target the availability and distribution of overdose-reversing drugs;
- Strengthen public health data and reporting;
- Support cutting-edge research on addiction and pain; and
- Advance the practice of pain management.

HUD

Forward Looking Information

Numerous external factors shape HUD's operating environment. Understanding their influence is essential for mitigating risk and achieving performance objectives. These external factors include funding levels, economic conditions, unemployment rates, financial markets, tax codes, and other federal, state and local conditions. HUD's new *2018–2022 Strategic Plan* responds to these factors by reimagining the way HUD works. The plan's reforms include careful use of evidence, employee empowerment, clear communication, and enhanced controls that are all crucial to more efficient and effective mission delivery.

Constrained federal funding levels affected most HUD programs during FY 2017 and are likely to continue in the foreseeable future. Financial constraints increase demand by Public Housing Authorities (PHAs) for administrative and operational flexibility. HUD is implementing such flexibilities through the Rental Assistance Demonstration, which gives PHAs access to private capital, and by working toward an evidence-based expansion of housing agencies participating in the Moving to Work program.

LABOR

WORKER PROTECTION PROGRAMS

Occupational Safety and Health Administration (OSHA)

Looking Forward: In FY 2018, OSHA's effort to promote Safety and Health Programs (SHP) and move employers along the path to safety excellence will unite the various programmatic components of the agency in a common, proactive, and positive message addressing the agency's core mission. Companies that adopt a SHP improve both their safety culture and safety performance. In addition, OSHA cooperative program participants often reach stakeholders that OSHA may not otherwise interact with through dissemination of safety and health information locally, within their company, or industry. OSHA will also refine current enforcement strategies and implement new programs to target inspection resources to the most egregious employers and serious hazards.

Mine Safety and Health Administration (MSHA)

Looking Forward: MSHA will use the following strategies in pursuit of achieving this target: increasing inspection and enforcement effectiveness, strengthening and modernizing training and education, strengthening health and safety regulations, and increasing efforts to protect miners from discrimination.

Wage and Hour Division (WHD)

Looking Forward: To protect fair and vigorous competition, WHD addresses compliance issues systemically and prevents violations through compliance assistance to reach a broader audience. The combination of compliance assistance and enforcement increases compliance with the laws. Moving forward, WHD is focused on the challenge of advancing effective enforcement while identifying areas for increased efficiency. To ensure a level playing field for all employers, WHD will conduct its business smarter and more effectively by assessing existing evidence and generating new knowledge to achieve agency goals. Compliance assistance to the employer community is a central component of WHD's efforts to meet its mission and the demand for accessible information about the laws WHD enforces remains high. WHD will expand on efforts to modernize compliance assistance information and reach and inform a broader audience.

Members agreed at the December 2018 Board meeting that the original intention was for MD&A to provide a balanced discussion about non-financial performance issues affecting program missions as well as the financial effects of risk.

4. STAFF RECOMMENDATION

Therefore, **staff recommends** the Board provide guidance to distinguish between SFFAS 15, paragraphs 3 and 4 to balance the discussion between non-financial and financial effects of risk. The 10-K, Section 1A examples analyzed above in IQ#3 provide a good model for a balanced discussion between non-financial and financial effects of risk.

QUESTION 6: Does the Board want to distinguish between SFFAS 15, paragraph 3 and 4 to strengthen and balance the discussion between non-financial and financial effects of risk?

E. TIME HORIZONS

1. **IQ # 5:** Would an explanation of time horizons help to distinguish between how to discuss short-term and long-term financial effects? If yes, why?

2. **RESPONDENT ANSWERS**

Doug Glenn: Guidance on the time horizon of changes in risks would be helpful to understand how to discuss whether a risk will grow or shrink with time, as well as actions taken or actions that could be taken if other assumptions occur, for example, if additional funding is denied or received.

Energy: An explanation would clarify how to discuss short-term effects and long-term financial effects. An example of what time horizons FASAB considers short- and long-term would help too.

Labor: Each agency has different time horizons. At Labor, most products are related to inspections that happen in the short term.

Financial information time horizons may already be defined. The accounting standards for social insurance require a 25-year projection period for Black Lung and a 10-year projection period for unemployment insurance.

VA: The addition of this information to current reporting requirements would be overly burdensome and would further add to the ever-increasing length of the document.

3. **STAFF NOTES**

Two of the four respondents agree that an explanation about time horizons would be helpful.

One of the respondents made a pertinent point that time horizons will depend on an agency's mission and noted that time horizons might already be defined for specific projections, such as Black Lung.

The remaining respondent is concerned with creating additional reporting burden.

As shown in the above examples, current forward-looking MD&A discussions focus on short-term, non-financial problems and actions to take in the next budget cycle.

4. **STAFF RECOMMENDATION**

Therefore, **staff recommends** that the Board amend SFFAS 15 to include long-term time horizon principles that are flexible to reflect an agency's program mission(s).

QUESTION 7: Does the Board want to amend SFFAS 15 to include long-term time horizon principles that are flexible in relation to an agency's program missions?

F. ESTIMATES

1. **IQ #6:** Would a discussion about estimates as part of forward-looking information help? If yes, why?

2. **RESPONDENT ANSWERS**

Doug Glenn: Due to the uncertainty of risk, estimating a range of likelihood and amount would be helpful in understanding the potential financial impact.

Energy: Quantifying the financial effects of risk in the MD&A would not be helpful. Attempting to do so would likely delay OMB clearance of the AFR. Also, some programs will continue far into the future and the impact of financial effects may be impractical and pre-decisional.

Labor: Actuarial estimates (calculated according to actuarial standards) are already included in notes to the financial statements, such as Note 1-M Energy Employees Occupational Illness Compensation Benefits, and therefore, are not necessary to include in MD&A as forward-looking information.

VA: No, the use of estimates is covered at length in the notes to the financial statements.

3. **STAFF NOTES**

Three of our four respondents do not support including estimates in MD&A. They instead support a qualitative discussion over a quantitative discussion. Two of those respondents stated that estimates in MD&A are not necessary since they are already included in the financial statement notes.

As respondents pointed out, agencies are already required to provide actuarial estimates for certain financial statement notes. Therefore, projecting or forecasting estimates for uncertain risks is not an efficient or effective use of preparers' time. A qualitative discussion would be more beneficial for users in understanding the potential financial effects of risk factors. Therefore, due to the uncertainty of risk, staff agrees with the three respondents and does **not recommend** including estimates or projections in MD&A for reporting of existing or anticipated risk factors

However, staff **does support** including quantitative amounts that are **known** for the following two situations: a) the most important existing, currently-known risks

[SFFAS 15, par. 3] and b) risks that have occurred and affected amounts reported in the financial statements and supplemental information [SFFAC 3, par. 31].

The following discusses both of these recommendations.

4. STAFF RECOMMENDATIONS

a. REPORTING ONLY KNOWN AMOUNTS FOR FORWARD- LOOKING INFORMATION

The following paragraph from TVA's 10-K provides an excellent qualitative discussion about the risks of a potential future nuclear incident.

In addition to the qualitative discussion about expected damages that could occur in the event of a nuclear incident., TVA's forward-looking information identified <u>known</u> amounts of funds to be obligated—"up to $133 million per year and a total of $891 million per nuclear incident under the Price-Anderson Act."

> **Operating nuclear units subjects TVA to nuclear risks and may result in significant costs that adversely affect its cash flows, results of operations, and financial condition.**
>
> TVA has seven operating nuclear units. Risks associated with these units include the following: Nuclear Risks. A nuclear incident at one of TVA's facilities could have significant consequences including loss of life, damage to the environment, damage to or loss of the facility, and damage to non-TVA property. Although TVA carries certain types of nuclear insurance, the amount that TVA is required to pay in connection with a nuclear incident could significantly exceed the amount of coverage provided by insurance. Any nuclear incident in the U.S., even at a facility that is not operated by or licensed to TVA, has the potential to impact TVA adversely by obligating TVA to pay up to $133 million per year and a total of $891 million per nuclear incident under the Price-Anderson Act. Any such nuclear incident could also negatively affect TVA by, among other things, obligating TVA to pay retrospective insurance premiums, reducing the availability and affordability of insurance, increasing the costs of operating nuclear units, or leading to increased regulation or restriction on the construction, operation, and decommissioning of nuclear facilities. Moreover, federal legislation could impose revenue-raising measures on the nuclear industry to pay claims exceeding the limit for a single incident under the Price-Anderson Act. Further, the availability or price of insurance may be impacted by TVA's acts or omissions, such as a failure to properly maintain a facility, or events outside of TVA's control, such as an equipment manufacturer's inability to meet a guideline, specification, or requirement.

The Price-Anderson Act provides specific quantitative information that was known to TVA; therefore, TVA was able to reference this in this forward-looking discussion.

Staff recommends this model for providing qualitative information for risk factors with KNOWN quantitative information about the potential financial effects. This model should not address reported contingent liabilities.

Staff also recommends rescinding SFFAC 3, paragraph 35 (this paragraph reads more like standards than concepts) and amending SFFAC 15, paragraph 3, footnote 3[3] to clearly state guidance for including a qualitative discussion about risk factors with forward-looking known amounts,

> **SFFAC 3, par. 35**
> 35. Where appropriate, the description of possible future effects of both existing and anticipated factors **should include quantitative forecasts* or projections***. Such forecasts or projections can show the implications of existing policies and conditions in light of anticipated or reasonably possible future conditions. For example, for MD&A of the Government-wide financial statements, long-term projections of the deficit or surplus may be important indicators of financial condition and sustainability. For insurance programs, this kind of projection—which actuaries sometimes call "dynamic analysis"—would consider possible interactions among current assets, reserves, policies in force, expected future business or populations covered by the insurance, and potential behavioral changes such as adverse selection and moral hazard, if appropriate. Some programs are inter-related among themselves and/or with conditions in the private sector. For example, flood insurance programs and disaster assistance programs may be related to such an extent that analysis of programs individually would not provide a good idea of their potential impact on the Government. To the extent feasible, projections should consider the potential implications of such relationships. (**Emphasis** added)

QUESTION 8: Does the Board want to rescind SFFAC 3, paragraph 35 and amend SFFAS 15, paragraph 3, footnote 3 to remove the guidance about *quantitive projections or forecasts,* and replace it with guidance that clearly states the expectation for including a qualitative discussion about risk factors with known quantitative amounts?

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[3] Please see page 17 of this memo or Appendix C for SFFAS 15, paragraph 3, footnote 3.

b. REPORTING QUANTITATIVE AMOUNTS FOR RISKS THAT HAVE OCCURRED AND CAUSED MATERIAL IMPACTS TO FINANCIAL STATEMENT AMOUNTS

The following analysis is related to known quantitative information about material changes to financial statement elements that resulted from risk factors. These are not projections or estimates as illustrated in the following TVA example about their change in fuel expense.

> **Fuel**
>
> Fuel expense decreased $120 million for the year ended September 30, 2018, as compared to the prior year.
> The impact of lower effective fuel rates, driven by lower market prices for natural gas and changes in the mix of generation resources, including more nuclear, natural gas, and hydroelectric generation and less coal-fired generation, contributed $234 million to the decrease. As an indication of the general market direction, the average Henry Hub natural gas spot price for the year ended September 30, 2018, was approximately three percent lower than the price for the prior year. Partially offsetting this decrease was a $114 million increase in fuel expense driven by a five percent increase in generation from TVA-operated resources to meet increased
> sales during the period.

TVA explains what risk factors had a significant financial impact on fuel expense from the prior year.

Staff supports this type of financial analysis as part of risk reporting to understand what risk factors have occurred and have had a significant financial effect on financial statement balances. However, the only guidance staff could find to support this type of financial analysis was in SFFAC 3, paragraph 31, which reads more like standards than concepts:

> Current Demands, Risks, Uncertainties, Events, Conditions, and Trends—MD&A should describe important existing, currently-known demands, risks, uncertainties, events, conditions and trends--both favorable and unfavorable--that affect the amounts reported in the financial statements and supplementary information...

In addition, this type of analysis could also help reporting entities to assess risk factors and any future risk mitigation, creating a bridge between ERM and reporting the financial effects of risk.

Therefore, **staff recommends** rescinding SFFAC 3, paragraph 31 and amending SFFAS 15 to include guidance that clearly states what to report for risks that have occurred and have affected material changes in financial statement balances.

QUESTION 9: Does the Board want to rescind SFFAC 3, paragraph 31and amend SFFAS 15 to provide guidance that clearly states what to report for risks that have occurred and affected material changes in financial statement balances?

G. **RISK MANAGEMNT INFORMATION**

1. **IQ #7:** Are you familiar with the new **A-11** (2018) requirements to include <u>risk management information</u>? If yes, will this help with identifying risks that may be discussed in forward-looking information. Why or why not?

2. **RESPONDENT ANSWERS**

Doug Glenn: Forward-looking information should focus on agency identified risks.

AFRs and budget documents should not be out of sync. Budgetary and financial operations should be encouraged to use the same source/system of risk tracking to avoid having duplicate systems that need reconciliation or the publication of different information.

Energy: Energy utilizes OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*, to develop its risk profile (includes risk appetite) and integrates risks with internal control evaluations as part of its ERM program. Risks and results of evaluations support the development of management priorities, which include forward-looking information, and are included in Energy's *Analysis of Systems, Controls, and Legal Compliance* section of the AFR.

Labor: Labor is developing its ERM process. Labor staff conducts quarterly review sessions with management, and ERM information is being built into the operating plan.

However, Labor is concerned about the challenge of where risks will be reported. For example, Labor is concerned about internal versus external reporting in relation to what is disclosed to the OIG and Congress.

VA: VA is not intimately familiar with the new A-11 (2018) requirements. However, the summary of changes for A-11 outlines updates made to agency goals, performance plans, and annual performance reporting. These performance-based requirements are separate from those included in the AFR. The AFR is meant to highlight at a summary level any performance, goals and objectives for a given year. As the current iteration of OMB Circular A-136 requires, "The MD&A should serve as a brief overview of the PAR or AFR and include the most important matters that could:

- Lead to significant actions or proposals by top management of the reporting entity;

- Be significant to the management, budgeting, and oversight functions of Congress and the Administration; or

- Significantly affect the judgment of citizens about the efficiency and effectiveness of the Government."

The emphasis throughout the MD&A requirements of OMB Circular A-136 is that the discussion be brief. To include A-11's risk management information requirements in what is required for forward-looking Information would further complicate what should be a high-level management overview.

3. STAFF NOTES

Staff asked IQ#7 to understand the maturity level of agencies' ERM processes and how that might help with reporting risk in their MD&A forward-looking information. The information received from all respondents was similar to the information the Board heard at the February 2018 ERM education session. Each agency is at a different maturity level with developing its ERM processes

Ms. Timberlake aptly summarized this in her major point #3:

> *[Guidance] should not dictate what agencies should say. Instead the guidance should be dynamic enough to allow the discussion to evolve over time as agencies develop and mature ERM processes over time.*

4. STAFF RECOMMENDATION

Therefore, **staff recommends** amending MD&A standards to provide principles that encourage a discussion of agencies most significant risks as identified by their risk management processes.

To reduce burden, agencies should be able to reference documents with more specific risk management information from the forward-looking information in their MD&As.

QUESTION 10: Does the Board agree that guidance should be dynamic enough to allow agency discussions to develop over time as their risk management processes develop?

V. SUMMARY

The above memo reviews and summarizes the interview questions, respondent answers, staff notes, and recommendations concerning risk reporting and forward-looking information in MD&A. After a thorough analysis of interviewee responses and a review of current guidance in SFFAC 3 and SFFAS 15, staff is recommending a number of rescissions to SFFAC 3 and amendments to SFFAS 15. This includes examples that model the SEC 10-K Section 1A Risk Factors, which would address the following preparer concerns:

- Add a specific definition for “financial effects”
- Avoid repeating contingent and other liabilities already stated in the financial statements and notes
- Avoid creating unnecessary audit work to map to accounts/notes
- Avoid creating additional reporting burden
- Provide examples to guide agencies to include information for citizens regarding the future of the agency instead of technical information found in internal (ERM) documents
- Avoid calculating/estimating/projecting specific related costs where uncertainty is prevalent
- Focus on qualitative rather than quantitative information
- Distinguish clearly between SFFAS 15, paragraph 3 and 4 to understand how to discuss forward-looking information in relation to financial and non-financial effects within time horizons that map to an agency’s mission
- Provide guidance that encourages dynamic risk reporting and forward-looking discussions that improve with the maturity of the agency’s ERM process.

The Board’s approval of recommended changes will help to clarify what is expected for risk reporting and forward-looking information in MD&A.

QUESTIONS for the BOARD:

QUESTION 1: Does the Board agree to include a forward-looking summary to help users understand how risk and uncertainty may have a material financial effect on operating results and financial statement balances different from historical results?

QUESTION 2: Does the Board want to amend SFFAS 15 to add the word “financial” to “effects” to clearly state “financial effects?”

QUESTION 3: Does the Board want to include a definition of financial effects?

QUESTION 4: Does the Board want to use the 10-K, Section 1A Risk Factors as a model for examples to illustrate how risk events can affect financial statement elements?

QUESTION 5: Does the Board want to incorporate language from SFFAC 3, paragraph 31 and 32 into SFFAS 15?

QUESTION 6: Does the Board want to distinguish between SFFAS 15, paragraph 3 and 4 to strengthen and balance the discussion between non-financial and financial effects of risk?

QUESTION 7: Does the Board want to amend SFFAS 15 to include long-term time horizon principles that are flexible in relation to an agency’s program missions?

QUESTION 8: Does the Board want to rescind SFFAC 3, paragraph 35 and amend SFFAS 15, paragraph 3, footnote 3 to remove the guidance about *quantitive projections or forecasts,* and replace it with guidance that clearly states the expectation for including a qualitative discussion about risk factors with known quantitative amounts?

QUESTION 9: Does the Board want to rescind SFFAC 3, paragraph 31and amend SFFAS 15 to provide guidance that clearly states what to report for risks that have occurred and affected material changes in financial statement balances?

QUESTION 10: Does the Board agree that guidance should be dynamic enough to allow agency discussions to develop over time as their risk management processes develop?

NEXT STEPS

Begin drafting the amendments approved by the Board to SFFAC 3 and SFFAS 15 to improve risk reporting and MD&A forward-looking information.

MEMBER FEEDBACK

Please provide responses to the above questions to Ms. Gilliam by **Wednesday, April 17, 2019,** at gilliamr@fasab.gov with a cc to Ms. Payne at paynew@fasab.gov and Ms. Valentine at valentinem@fasab.gov

If you have any questions, please contact Ms. Gilliam at 202-512-7356 or gilliamr@fasab.gov

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RISK REPORTING

ATTACHMENT 1

Interview Preparation Document

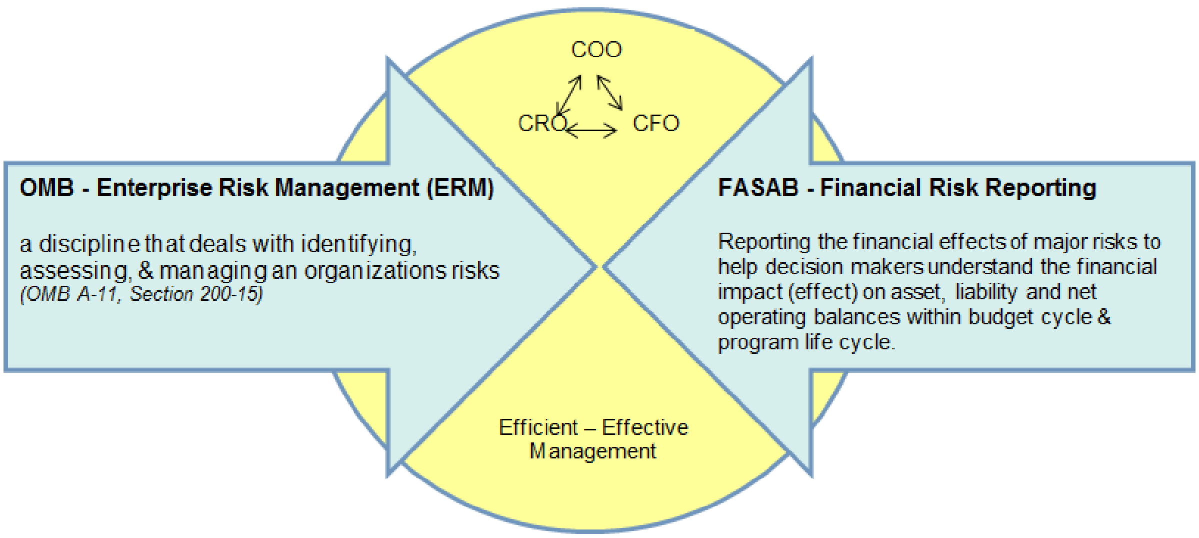
April 2019

FASAB Interview Preparation Document for Developing Statement of Federal Financial Accounting Standards (SFFAS) 15, *Management Discussion and Analysis* par. 3, *Forward-Looking Information* INTERPRETATION

Contents

FASAB Risk Reporting - Role/Scope

The following is a diagram of FASAB's role in relation to an agency's ERM process agreed to by the Board at the December 2018 meeting



MD&A Forward- Looking – SFFAS 15, par. 3 Gap Analysis

The following is a diagram of the gap analysis from SFFAS 15, par. 3, to an Interpretation that the Board agreed to develop at the December 2018 meeting

AS IS

SFFAS 15 – par. 3

MD&A should include forward-looking information regarding the possible future effects of the most important existing, currently-known demands, risks, uncertainties, events, conditions and trends. MD&A may also include forward-looking possible effects of anticipated future demands, events, conditions, and trends.

GAP

INTERVIEWS

Interview experts & agency preparers

Note: The Board preferred individual agency interviews to a task force.

TO BE

INTERPRETATION

FASAB intention for Forward-Looking Information:

Discuss future **financial effects** of risk events; what financial statement balances may materially be impacted

- For next budget cycle
- Over life-cycle of program – mission focused

Risk Reporting: SFFAS 15, par.3 Interpretation Interview Questions

Agency answers to the following questions will help staff to develop a draft Interpretation of SFFAS 15, par. 3 for the Board

1. What do you think MD&A should convey regarding risks and the financial effects of risk?

2. Would a **definition** of "effects" be helpful to understand how risk events can cause financial effects? If yes, why?

3. Would **examples** help to illustrate how risk events can impact financial statement balances? If yes, why?

4. Would a **distinction** between SFFAS 15, par 3 (financial effects) & SFFAS 15, par. 4 (non-financial activities) help to make it clear that the standards request different information? If yes, why?

5. Would an explanation of **time horizons** help to distinguish between how to discuss short-term and long-term financial effects? If yes, why?

6. Would a discussion about **estimates** as part of forward-looking information help? If yes, why?

7. Are you familiar with the new **A-11** (2018) requirements to include risk management information in budget submissions?

    a. If yes, will this help with identifying risks that may be discussed in forward-looking information.

    b. Why or why not?

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RISK REPORTING

ATTACHMENT 2

Pilot Interview Meeting Notes

April 2019

On January 17, 2019, staff met with **Courtney Timberlake**, who has nearly 25 years of Federal budget, credit and financial management expertise, **to pilot the SFFAS 15, par. 3 Interview Preparation document.** Ms. Timberlake said the diagram on page two was a good representation of FASAB's role in relation to the ERM process at agencies. And, she also noted that the questions were appropriate for agencies.

The rest of our discussion was about the current state of agency enterprise risk management (ERM) processes in relation to the budget cycle to help staff understand what guidance to provide in the Interpretation.

Ms. Timberlake explained that while agencies are making progress with their ERM processes, many are still learning to develop risk profiles, i.e., what to put on risk lists in light of a variety of many uncertain circumstances including agency goals that might change from year to year, depending on who is running the organization, changes in government-wide guidance, etc. As a result it is likely that many agencies are developing risk profiles at a high strategic performance level and not necessarily at a program level, or are in the early stages of developing program level risk profiles.

Another challenge is projecting what could happen in the future since many agencies and their processes are geared toward the reporting within a budget cycle, and funding levels for programs and activities can change based on changing national priorities.

Another challenge is projecting out program performance and financial effects because of timing issues related to the budget cycle. For example, when the Agency Financial Report is issued on November 15th – the current fiscal year has already begun, and agencies are in talks with OMB about the next budget cycle. Program goals for the current fiscal year have been set, and proposed budget numbers for the upcoming fiscal year are not yet available. And, although some agencies like Education may be better able to plan for changes in student loans, it is because those programs have different funding structures and reporting requirements.

Ms. Payne asked about agencies' capacity to discuss metrics in relation to a forward-looking discussion. Can agencies understand a concentration of risk, such as a change in market share for guaranteed loans, due to a change in demographics? For example, if younger people delay buying homes how could that impact the amount in an organization's mortgage portfolio.
Ms. Timberlake explained that because each agency has its own mission, it will also have its own related metrics based on program goals, which can themselves change. For example, metrics for education credit loans are different from metrics for housing loans, which are different from metrics for agriculture loans.

- **She said that including guidance for how to discuss metrics to understand how past performance could impact financial effects going forward would be helpful.**

It is easier for agencies to discuss how a portfolio got to its current financial position over a certain amount of time, like the past three years, than to project a significant drop in volume for a portfolio going forward.

For example, in the case of capital planning, agencies should be able to discuss what was needed three years ago and if they have made the progress they expected since then. If not, why not? What assumptions, risks, and or trends prevented that progress? Have needs or goals changed, and if so, why? How have the budget and financial accounts been affected? What is core to the program that contributed to the change? Then, what intuitively could financially impact the future?

She pointed out a number of universal risks that impact all agencies.

The first risk is the **risk of technological change**. This risk could result in changes to the original budgeted plan because an agency might have to pay more to update to new technology, or have to revisit previous decisions because it does not work anymore with new technology.

The second risk is **reputational risk** – **risk of integrity**. Program integrity, at least in theory, should bolster program performance. But it is very difficult for agencies to quantify and justify future cost of this risk from a budget perspective.

For example, take the **risk of not participating in cost avoidance**. Cost avoidance is how much money it would cost up front to prevent a negative performance effect. For example, for every dollar spent at the IRS to ensure that an actual tax payer is filing a return rather than a single person who is running a tax return mill, in theory, might save the IRS (government) $10 in improper refunds (improper payments). As a result, there could be a potential for increased costs after the Balance Sheet date if cost avoidance was not practiced.

- **An Interpretation that teaches agencies how to discuss the risk of not participating in cost avoidance would be helpful to relevant agencies.**

A third risk applicable to all agencies is appropriation Risk.

- **The Interpretation could help agencies to discuss how a potential change in appropriations could impact program financing and as a result program performance.**

In summary, Ms. Timberlake believed that the 2018 updated A-11 will help agencies to understand how to integrate ERM processes into their strategic performance framework. Therefore, as ERM processes become more engrained, the capacity for agencies to talk about the financial effect on future years will be easier.

- **As a result, the Interpretation should not dictate what agencies should say. Instead the guidance should be dynamic enough to allow the discussion to evolve over time as agencies develop and mature ERM processes over time.**

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RISK REPORTING

APPENDIX A

Project History and Milestones

April 2019

PROJECT OBJECTIONS

The issuance of Statement of Federal Financial Accounting Standards (SFFAS) 51, Insurance Programs, on January 18, 2017, effectively concluded the first phase of risk assumed. For the history of the risk assumed project and milestones for phase I, please see http://www.fasab.gov/ra-insurance-programs/.

In phase II, the Board will holistically review significant risk events other than adverse events covered by SFFAS 51, Insurance Programs, to determine accounting standards that provide concise, meaningful, and transparent information regarding the potential impact to the fiscal health of the federal government.

HISTORY OF BOARD DELIBERATIONS

October 19-20, 2016 Board Meeting

At the October 19, 2016, Board meeting, the risk assumed – phase II began.

The Board reviewed staff's high-level gap analysis presented in table 1: Analysis of Federal Accounting Standards in Relation to the IMF [International Monetary Fund] Recommendations for Disclosing Fiscal Risks and table 2 from the Australian Statement 8: Statement of Risks.

The Board agreed that an extensive gap analysis is necessary to determine the risk information that the consolidated financial report of the U.S. Government includes and how it is presented, the extent to which FASAB can align with enterprise risk management (ERM) as prescribed by The Office of Management and Budget Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*, and the Board's preference for presenting risk assumed information going forward.

For the gap analysis, the Board agreed to determine the following:

- If federal government reporting is transparent enough for estimates and uncertainty around significant risks with a focus on broad risk categories, such as an economic downturn where revenues go down and benefit program costs go up
- If there is a significant gap in reporting to be addressed for individual risk items, such as treaties, commitments by the federal government, and intergovernmental dependencies with state and local governments
- How to present summarized risk events at the government-wide level for cross-cutting agency efforts, such as disaster relief, with access to detail at the agency level

December 19-20, 2016

At the December 20, 2016, Board meeting, the Board approved a framework for the risk assumed gap analysis. Members agreed that categories should not be a laundry list of events but instead should be principle-based and broad enough to encompass current and future significant risk events. The scope will include past and future events and whether uncertainty is adequately explained. Staff will review past financial reports to understand what was included before and after recent large events, such as the 2008 financial crisis, at the agency and government-wide levels.

Staff will utilize roundtable discussions to discover if current disclosures are clear, relevant, and add value in relation to the available standards. If roundtable participants do not feel that current disclosures are clear, relevant, or valuable, the group will discuss what is missing and should be included.

Staff will work on the gap analysis over the next several months and present findings and recommendations to the Board upon completion.

June 21-22, 2017

Members did **not** want to include discussions that

- predict unforeseen catastrophes and their potential financial effect;
- trends for using emergency funding as an indicator of fiscal exposure to risk shocks;
- comparisons of estimates to actuals;
- how past risk events were managed; or
- a separate risk section [as presented in the USAFacts 10-K Report -risk section—Item 1A Risk Factors] within federal financial reports.

Members **did want to**

- include past events that affect the current financial position;
- include and define major risk events with a relationship to long-term sustainability that are not already reported;
- use the principle-based broad risk categories as a foundation for continuing the gap analysis; and
- present meaningful streamlined information as a broad analysis rather than specific details.

October 25-26, 2017

According to the project objective, the risk assumed project strives … to determine accounting standards that provide concise, meaningful, and transparent information regarding the potential impact to the fiscal health of the federal government. However, understanding what risks affect U.S. financial sustainability and why they do is very challenging. Therefore, as part of the ongoing gap analysis, staff reviewed SFFAS 2, Accounting for Direct Loans and Loan Guarantees, to learn how risk is currently disclosed in the financial statements.

Staff conducted research with the Department of Education, Department of Housing and Urban Development, Small Business Administration, and the Government Accountability Office and learned that agencies cannot specifically identify their users. In addition, reporting is inconsistent, extremely detailed, and burdensome. This not only affects preparers, but also users.

On October 26, 2017, staff presented these findings at the Board meeting to determine if members wanted to pilot amendments to SFFAS 2 to develop a framework for how to address risk assumed holistically.

Members agreed and requested that staff

- identify user groups to analyze risk factors, beyond those used to calculate credit subsidy reestimates, to help build a risk profile;
- develop a framework for how to discuss measurement uncertainty;
- consider how to discuss the "why" behind the "what" of risk;
- present sensitivity analysis at a future meeting; and
- pilot amendments to SFFAS 2 to develop a model/framework for how to address risk assumed holistically.

FEBRUARY 21-22, 2018

The Board hosted an **ERM risk profiling education session**. The panel discussed the following:

- Ms. SallyAnne Harper, a founding member and immediate past president of the Association for Federal Enterprise Risk Management (AFERM), provided a high-level review of federal ERM.
- Mr. Tom Brandt, the Chief Risk Officer at the Internal Revenue Service (IRS) and AFERM President Elect, presented a review of IRS's risk profiling

processes, including risk identification, categorization, assessment, quantification, measurement, and modeling.

- Mr. Mike Wetklow, Deputy Chief Financial Officer (CFO) and Division Director for Financial Management, National Science Foundation (NSF), presented NSF's ERM implementation process, including a discussion about risk appetite as an integral part of risk profiling.

- Mr. Daniel Fodera, Lead Management Analyst, Program Management Improvement Team, Directors of Field Services, Federal Highway Administration (FHWA), explained the tools used in ERM risk profiling, including the use of a heat map at FHWA.

The Board learned the following main points:

- Risk assessment is integrated into strategic planning and investment decision making to determine priorities and objectives.

- Senior management is responsible for setting risk appetite to determine the most significant risks that could impact the organization's strategic mission.

- Risk appetite includes an analysis of both the likelihood and impact of events.

- Most agencies are just beginning to develop their ERM processes; a few are moving into a more mature model.

Directly following the education session, the Board discussed whether to leverage ERM risk profiling as identified in OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*.

The Board agreed that staff should explore how to incorporate OMB A-123 risk profiling in the project; however members noted the following concerns:

- The Board should determine what type of risks to focus on: performance/programmatic—MD&A and/or financial impact—disclosure notes.

- The Board should determine what risks are not currently included in financial reports through working groups and determine the consequences of not including certain risks.

- The Board should consider producing best practices guidance if the standards are complete and agencies need additional help.

- The Board should prevent risk identification from turning into a compliance exercise that might affect the ERM process.

- The Board should consider how agency internal ERM processes might be affected by external financial reporting and the related audit.

APRIL 25-26, 2018

During the April 2018 meeting, staff presented the gaps for reporting RA as identified from the nine round tables conducted over the past year. Many round table participants were interested in reporting on full program costs, including key risk factors and assumptions. Some believed a **clearer understanding of uncertainties regarding estimates** would help facilitate better management decisions and **an understanding of financial performance**. These gaps will help to establish a framework for reporting RA holistically in the financial reports. This framework may include new or updated note disclosures and improvements to management's discussion and analysis (MD&A).

For MD&A improvements the RA and MD&A Improvements projects collaborated to present recommendations to improve MD&A. The projects collaborated because the findings from the separate round tables were the same—**financial statement users want to understand the financial performance for major programs and not have to sift through dense, duplicative strategic performance information that can be found in the agency performance report**. As a result, staff recommended a new Statement that would maintain the current principles but rescind Statement of Federal Financial Accounting Concepts (SFFAC) 3, *Management's Discussion and Analysis*, and Statement of Federal Financial Accounting Standards (SFFAS 15), *Management's Discussion and Analysis.*

The Board directed staff to consider previously discussed concerns regarding MD&A, review existing MD&A concepts and standards, and determine what changes might be needed. Staff will also collaborate with the Office of Management and Budget to determine whether form and content guidance could help guide improvements.

JUNE 27-28, 2018

The RA and MD&A Improvements projects continued to collaborate to request a more integrated format for MD&A.

Members agreed to remove the requirement to segment information in the MD&A. SFFAS15 currently requires management to discuss topics in discrete sections of the MD&A. Removing this requirement would allow flexibility in formatting MD&A and facilitate an integrated discussion about financial performance. The discussion should include the rationale for material changes in accounting elements, such as assets, liabilities, and/or net costs.

Staff originally presented a framework that would include a financial performance discussion for each responsibility segment presented in the statement of net cost. The discussions would inform users on the financial impact of key risks to the segment. However, the Board determined that key risk factors may affect entities at different levels and requested staff to present an alternative framework. The framework should be flexible enough to integrate risks that had or will have a significant financial impact at the level best defined by management.

Members requested that staff develop principle-based standards to address the different types of risks that may have a significant financial impact on the government-wide financial position, condition, or results of operations. To tell the entire financial story, members believed that management should discuss what actions are being taken to address current and future risk drivers, as well as forward-looking information.

August 29-30, 2018

To better reflect the objectives, the risk assumed – phase II project was **renamed to the risk reporting project.**

The Board reviewed the measurement uncertainty framework it had requested at the October 2017 meeting. Because measurement uncertainty affects a number of estimates throughout the financial statements, the Board revisited the status of the risk assumed project. Members noted that the focus on risk assumed improved decisions in a number of projects despite the challenge of identifying specific risk measures as implied by the term "risk assumed."

Members agreed that the risk assumed project should continue but is not likely to result in a specific measure of "risk assumed." To avoid this expectation, the Board decided to change the project name to "risk reporting." Members directed staff to work with the project leads of the reporting model phase I: MD&A and stewardship investments improvements project and the note disclosures project. Through this collaboration, the risk reporting project could address the principles needed for reporting financial and non-financial risks as well as the principles needed to account for measurement uncertainty.

December 19-20, 2018

At the December 2018 meeting, members discussed the current status of risk reporting under SFFAS 15, paragraph 3 on forward-looking information. During the meeting, the Board discussed the intent of SFFAS 15 in relation to the forward-looking information provided by agencies' in their 2017 MD&As.

Members agreed that the original intent for forward-looking information was to focus on the financial effects of risks on amounts in the financial statements even though the word "financial" was not specifically included in SFFAS 15, paragraph 3. However, this is not the information that agencies are providing.

Members also agreed that forward-looking information should include a discussion of the short-term financial effects, as well as the possible long-term material financial effects of financial statement balances. Short-term effects relate to the budget cycle, while long-term effects may be defined by an agency's life cycle to complete program missions.

Members agreed that staff should prepare an Interpretation to clarify how to discuss risk in MD&A and explain what is meant by financial effect and time horizon. Additional guidance may be included in the Interpretation, such as sensitivity tests and/or best practices.

To develop the Interpretation, staff will conduct a number of agency interviews to understand what guidance preparers need to discuss short- and long-term financial effects of risks.

Members agreed that the Interpretation addressing forward-looking information discussed in SFFAS 15, paragraph 3 will be separate from the Interpretation that will address MD&A structure. This is to avoid losing the risk reporting clarification within the formatting clarification.

TAB B

RISK REPORTING

APPENDIX B

SFFAC 3

Management's Discussion and Analysis

[Concepts]

April 2019

Statement of Federal Financial Accounting Concepts 3: Management's Discussion and Analysis

Status

Issued	June 8, 1999
Interpretations and Technical Releases	
Affects	SFFAC 1, paragraph 181, by providing guidance on MD&A
Affected by	SFFAS 27, paragraph 39, amends paragraph 26

See pages 6-7 for the preamble to Statements of Federal Financial Accounting Concepts (www.fasab.gov/pdffiles/handbook_preamble.pdf).

Summary

This document describes the concepts on which the Board relied in recommending standards for Management's Discussion and Analysis (MD&A) to be included in general purpose federal financial reports (GPFFR).[1] Concepts Statements are not authoritative in the sense that they do not establish standards or principles. Preparers may find them useful, but these concepts are not "prescribed guidelines" for required supplementary information as discussed in section 558 of the *Codification of Statements on Auditing Standards* published by the American Institute of Certified Public Accountants. No standards or prescribed guidelines for MD&A are presented in this statement of concepts.

MD&A is an important vehicle for (1) communicating managers' insights about the reporting entity, (2) increasing the understandability and usefulness of the GPFFR, and (3) providing accessible information about the entity and its operations, service levels, successes, challenges, and future. Some federal agencies also refer to MD&A as the "overview."

The basic concept that underlies the standards for MD&A is:

> Each general purpose federal financial report (GPFFR) should include a section devoted to management's discussion and analysis (MD&A). It should address the reporting entity's performance measures, financial statements, systems and controls, compliance with laws and regulations, and actions taken or planned to address problems. The discussion and analysis of these subjects may be based partly on information contained in reports other than the GPFFR. MD&A also should address significant events, conditions, trends and contingencies that may affect future operations.

[1]The term general purpose financial report, abbreviated "GPFFR," is used as a generic term to refer to the report that contains the entity's financial statements that are prepared pursuant to federal accounting principles.

A separate document titled *Standards for Management's Discussion and Analysis* presents the standards for MD&A. The standards for MD&A say that MD&A should address:

- the entity's mission and organizational structure;
- the entity's performance goals and results;
- the entity's financial statements;
- the entity's systems, controls, and legal compliance; and
- the possible future effects on the entity of existing, currently-known demands, risks, uncertainties, events, conditions and trends.

The discussion and analysis of these subjects may be based on information in other discrete sections of the GPFFR or it may be based on reports separate from the GPFFR. The standards require MD&A to be included in each GPFFR as required supplementary information (RSI).

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Statement Of Concepts

Basic Concept

1. Each general purpose federal financial report (GPFFR, see figure 1 on 7) should include a section devoted to management's discussion and analysis (MD&A).[1] MD&A should address the reporting entity's program and financial performance measures, financial statements, systems and controls, compliance with laws and regulations, and actions taken or planned to address problems. The discussion and analysis of these subjects may be based partly on information contained in reports other than the GPFFR. MD&A also should address significant events, conditions, trends and contingencies that may affect future operations.

Discussion and Rationale

2. A typical GPFFR is a highly summarized profile of a complex entity. It is based on conditions that exist at the reporting date and events that occurred in the preceding period. It shows what has happened, but it does not explain why it happened or what may reasonably be expected to happen in the future.

3. Financial reports have two key roles. One is a feedback role to provide information used for evaluating past decisions, expectations, and trends. Another is a predictive role to provide information used for formulating expectations and making decisions about the future. Both roles can be enhanced by insights and interpretations from an entity's management.

4. The managers of an entity have detailed knowledge of the transactions, events, and conditions reflected in the entity's financial report and of the policies that govern the entity's operations. The managers also have informed expectations regarding the future based on that knowledge. As a part of their stewardship responsibility, managers should explain the significance of key financial and nonfinancial information shown in the report, the strategies

[1]The term general purpose federal financial report, abbreviated "GPFFR," is used as a generic term to refer to the report that contains the entity's financial statements that are prepared and audited pursuant to the CFO Act of 1990, as amended. entities may refer to these reports using different terms, such as "Annual Report," "Accountability Report," "Financial Management report," etc. Paragraphs 54-112 and Appendix 1 of Statement of Federal Financial Accounting Concepts 2, *Entity and Display*, describe and illustrate the contents of the GPFFR. For more information on the "Accountability Report" see paragraph 59 and the glossary. (Other words defined in the glossary are marked with an asterisk.) See also *Toward a Report to Citizens on the State of their Nation and the Performance of Their Government: proceedings of the AGA Task Force on a Report to Citizens on the State of the Nation*, Association of Government Accountants, 1994.

that led to the results reported, and the implications for future operations of events that have occurred or are likely to occur. The distinction between “financial” and “nonfinancial” information is arbitrary and often tenuous, but in this context “nonfinancial information” can include information on systems, controls, compliance with laws and regulations, and performance.

5. A Federal reporting entity’s GPFFR should be understandable and useful to a wide audience, not just members of the entity’s management and specialized analysts working for special interest groups, corporations, and other entities affected by the Government’s actions. Therefore, the report should be accompanied by a concise narrative discussion and analysis. Even insiders and specialized analysts often need such a discussion and analysis to understand the report. Communication with a wide audience may require effective use of colors, graphs, photographs, and charts. Reporting understandable, accessible information on the Government’s actions and the effects of its actions helps assure accountability and provides a more “level playing field” on which the public interest can best be served.

Background

6. The Securities and Exchange Commission (SEC) has for many years recognized the importance of such a narrative discussion of the financial statements. To serve the interests of investors and creditors, the SEC requires such a narrative discussion and analysis from management of companies under its purview. The SEC wants MD&A to help readers understand the entity’s financial position and results of operations with the benefit of management’s understanding and perspective. The SEC also wants MD&A to go beyond the basic financial statements, to include relevant forward-looking information. Research on MD&A for companies registered with the SEC shows that MD&A adds value to the financial statements. Forward-looking information, for example, can be an important contribution.[2]

7. Several factors suggest that MD&A may be even **more** important for Federal reporting entities than for those in the private sector and may need to be more extensive in scope. These factors include the complexity of Federal operations, the myriad objectives they pursue, and the diverse nature of the groups affected by and interested in the Government’s activities. Fundamentally, the Government’s objective is to provide for the common defense and to promote the general welfare, not to earn a profit. Therefore, reporting on performance and other matters in a way that is understandable to diverse audiences is

[2]Research on MD&A in private sector financial reporting suggests that forward-looking information in MD&A, in particular, is a significant source of added value for financial analysts. See Stephen H. Bryan, “Incremental Information Content of Required Disclosures Contained in Management Discussion and Analysis,” *The Accounting Review* Vol. 72 No. 2, (April 1997), pp. 285-301.

important. For these reasons, both SFFAC 1, *Objectives of Federal Financial Reporting*, and SFFAC 2, *Entity and Display*, refer to MD&A in concept as part of the general purpose federal financial report.

8. Page 7 presents a schematic diagram of a sample GPFFR. It is schematic because the information called for by the statements of federal financial accounting standards should be located in the report in a logical sequence, not necessarily in the order shown. MD&A for the reporting entity as a whole normally will be located immediately after the agency head's letter. Reporting entities that organize their GPFFR by responsibility segment may combine MD&A regarding each segment; alternatively, they may have MD&A for each responsibility segment located separately in each of the respective subsections of the report. Preparers have flexibility to structure their report in the manner most appropriate under the circumstances. This diagram, the entire statement of concepts, and the accompanying standards for MD&A are intentionally written in general terms, in light of the evolving practice of performance reporting and accountability reporting in the federal government. The standards for MD&A define in general terms required supplementary information that should accompany financial statements prepared in conformance with federal accounting principles.

FIGURE 1: Schematic Diagram of a Sample General Purpose Federal Financial Report

Agency Head's Letter					
Management's Discussion and Analysis (RSI)					
<----- Other Elements of the General Purpose Federal Financial Report ----->					
1. Basic financial statements and notes, with auditor's report if audited	2. Required Supplementary Stewardship Information (RSSI)	3. Required Supplementary Information (RSI)	4. Performance Information	5. Other Accompanying Information (OAI)	6. Management's assertions and reports on controls, compliance, and corrective actions under FMFIA and FFMIA (or portions of these assertions and reports)

The GPFFR is represented by MD&A plus columns 1-6 of the diagram. (The agency head's letter is part of the GPFFR by general practice, though it is not required by federal accounting principles.) This is not a literal depiction of the organization of a report. Information should be presented in a logical arrangement. MD&A will address major issues that are typically reported in more detail in the discrete sections of the GPFFR or in other publicly available reports that the GPFFR incorporates by reference. Incorporating another report by reference does not, by itself, mean that the separate report is subject to audit.

Unless law or managerial action requires more extensive audit review or examination of the material incorporated by reference, the FASAB expects that the auditor of the financial statements will treat the material incorporated by reference as other accompanying information, although it does not physically accompany the GPFFR. OMB has authority to provide specific guidance on the auditor's minimum responsibility regarding this material. OMB may, for example, direct auditors to treat the material incorporated by reference as if it were other accompanying information in an auditor-submitted document.

SFFAC 2 (paragraphs 106-111 and Appendix 1-F) calls for a "Statement of Performance Measures" as part of the GPFFR, but FASAB has not yet recommended standards for it. Other titles may be used for this section of the GPFFR. Performance indicators included in the GPFFR will either be those in the entity's annual performance report under the Government Performance and Results Act of 1993 (GPRA or the Results Act) or a subset of them.

Alternatively, that report may be incorporated by reference. Until further guidance is available, the agency should select the indicators to report in consultation with OMB.

The assertions and report on control called for by the Federal Managers Financial Integrity Act (FMFIA or Integrity Act) would not be stated in full in MD&A. They would be reported in a discrete section of the GPFFR or incorporated in the GPFFR by reference. They are within the scope of MD&A because highly important aspects of systems, compliance, and internal controls should be discussed in MD&A. "Highly important" in this context may imply a higher threshold than "materiality" for the financial statements.

If the report also includes financial statements for component entities (bureaus, responsibility segments, etc.), management should use its judgment in organizing the report. The component entities' financial statements may be discussed in separate sections of the report or as subsections of MD&A of the consolidated entity.

9. MD&A should address:

- the entity's structure, mission, goals, and objectives, with indicators[3] of its performance;
- actions taken or planned to improve performance, when appropriate;
- the financial statements;
- systems, internal controls*[4] and legal compliance, including corrective action taken or planned; and
- the future effects of existing, currently- known demands, risks, uncertainties, events, conditions and trends. MD&A may also address the possible future effects of anticipated* future demands, events, conditions, trends, etc. that management believes would be important to the reader of the report.

10. MD&A should address these subjects even if, as will be true for many Federal reporting entities, separate documents report much of the information in more detail. Information about these subjects is essential to address the objectives of federal financial reporting regarding performance, stewardship, budgetary integrity, and systems and controls.

    The following paragraphs explain the implications of this.

11. Regarding the entity's mission and performance, MD&A should inform the reader how well the reporting entity is doing. This means that it should tell the reader what the reporting entity and its programs have accomplished, and how well the entity is managing its programs. To do this, MD&A should answer such questions as:

    - What do we need to know to gauge operating success?
    - How do we measure what we accomplished?
    - What do the measurements show?

12. To understand the information on performance, systems, controls, and legal compliance, it typically is necessary to understand something about the reporting entity's organizational structure, mission, and strategic plan. Accordingly, MD&A should concisely inform the reader about these topics.

13. Reporting information that helps people assess the performance of the Government's programs and organizations is an important objective of Federal financial reporting. For

[3]This document uses the terms "performance measure" and "performance indicator" synonymously. Some people use the term "performance indicator" instead of "performance measure" because the performance of government programs typically involves several factors or dimensions, and many of these dimensions of performance cannot be measured precisely.

[4]Words marked with * are defined in the glossary.

governmental entities, in contrast to profit-seeking entities, the financial result of governmental-type activities is rarely an adequate indicator of performance. (For a few governmental entities, mainly those that conduct primarily business-type instead of governmental-type activities, the financial results of operations may be an important, albeit rarely sufficient, performance indicator.) To assess performance, people need additional information on the consequences of the Government's activities. For a competitive, profit-seeking entity, the value of its products or services is measured by the amount of money customers are willing voluntarily to pay for them. In such a situation, the traditional income statement reports on both the efforts (measured by expenses incurred) and the accomplishments (measured by revenue earned) of the entity. For government, expense reflects efforts, as it does in the private sector, but indicators other than revenue must be used to report on accomplishments. A discrete section of the GPFFR therefore presents indicators of accomplishments (such as indicators of outputs and outcomes) and other indicators of performance. Alternatively, the GPFFR incorporates performance indicators by reference to a separate report such as the Annual Performance Report required by the Results Act. Either way, performance information is an integral part of the GPFFR and should be discussed in MD&A. Management's discussion and analysis should therefore address the most important facets of performance as well as the financial statements and supplementary information.

14. Regarding the financial statements, MD&A should answer questions such as the following, to the extent that they are relevant and important for the entity:

- What is the entity's financial position? What is its financial condition?[5] How did this come about?
- What were the significant variations:
  - from prior years?
  - from the budget?[6]
  - from performance plans, long-term plans, or other relevant plans in addition to the budget?
- What is the potential effect of these factors, of changed circumstances, and of expected future trends? In other words, to the extent that it is feasible to project the effects of these factors, will future financial position, condition, and results, as reflected in future financial statements, probably be different from this year's and, if yes, why? (Any such discussion should acknowledge that the future is unpredictable and will be

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[5]The traditional concepts of "financial position" and "financial condition" are typically applicable to revolving funds, Government corporations, and other reporting entities that are intended to be self-financing. The concepts may be less relevant, or may require some qualification or modification, for other kinds of Federal reporting entities.

[6]Management should use its judgment to decide what variances are relevant for MD&A. It will not always be essential or appropriate to discuss all variances.

influenced by factors outside the reporting entity's control, including actions by Congress.)

15. Regarding systems and controls, MD&A should tell the reader whether internal accounting and administrative controls (some authorities prefer the term "management controls") are adequate to ensure that:

- transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the purposes authorized, and are recorded in accordance with Federal accounting standards;
- assets are properly acquired and used, safeguarded to deter theft, accidental loss or unauthorized disposition, and fraud; and
- performance measurement information is adequately supported.

16. Reporting information that helps people assess the condition of the entity's management systems and of the relevant internal controls is an important objective of Federal financial reporting. The relevant internal controls for this purpose are those that support reporting on financial and operating performance and reporting on compliance with applicable laws.[7] The great diversity of people (often with competing interests) affected by governmental action, and the fact that governments function within and by means of a framework of laws, mean that more attention to these matters is necessary than in financial reports for profit-seeking entities.

17. An entity's ability to prepare auditable financial statements and other reliable reports for management from the entity's books and records is a positive signal about the finance-related systems and controls of that entity. By themselves, however, the financial statements of a governmental entity do not provide adequate information about the status of the entity's management systems and internal controls that support reporting on financial and operating performance and reporting on compliance with applicable laws. For these reasons, the GPFFR of a Federal reporting entity should include information about systems, internal controls, and legal compliance, in addition to the basic financial statements. This information—like the information on performance—is presented in a discrete section of the GPFFR; alternatively it may be incorporated in the GPFFR by reference to separate reports such as those required by the Integrity Act. MD&A should therefore address the most important facets of this information on systems, controls and legal compliance, as well as the financial statements, supplementary information, and performance information.

[7]Internal controls are also relevant to other objectives. For example, controls help management assure efficient and effective use of resources for the purpose intended. They also support preparation of performance reports pursuant to GPRA. See, for example, paragraph 40.

Relationship to Other Reports

18. The information in the GPFFR about systems, internal controls, and legal compliance (column 6 in figure 1) may include the assertions and a summary of the reports on controls, legal compliance, and corrective actions pursuant to the Integrity Act and the Federal Financial Management Improvement Act (FFMIA), or those reports may be incorporated by reference. This information should be presented in conformance with guidelines published by OMB. MD&A, in turn, should discuss the most important aspects of the information on these topics. Referring to separately-issued reports on systems and controls does not eliminate the need to discuss these topics in MD&A.[8]

19. The performance information (column 4 in figure 1) may include the indicators in an entity's performance report pursuant to the Results Act or a selection of the most important performance indicators. Alternatively, a separate performance report may be incorporated by reference. This information should be presented in conformance with guidelines published by OMB. MD&A, in turn, will discuss the most important aspects of the performance information. Reference to a separately-issued performance report does not eliminate the need to discuss performance in MD&A.

20. The performance reports required by the Results Act may be voluminous for some agencies. In such cases, it may not be desirable to include all this information in the GPFFR. It is necessary to include at least some information about performance with the financial statements, however, so that people who use the GPFFR can understand why the costs reported in the financial statements were incurred and the consequences of doing so.

21. In the same way, the GPFFR by itself may not provide a comprehensive report on systems, controls and legal compliance. There may be voluminous reports from management and auditors on these topics. It is necessary to include at least some information about these topics, however, so that users of the GPFFR can understand whether the resources on which it reports were properly safeguarded and used for the purposes intended, whether reliable reports can be prepared, and whether the other objectives of internal controls are being met. This information is important both to provide a basis for understanding the financial statements themselves and to address the objectives of federal financial reporting.

22. Combining information on these topics adds value by putting the information about performance, internal controls, and systems in the context of audited financial statements. For example, the quality of information on the cost of outputs and outcomes of programs is

[8]Note that the purpose of the pilot Accountability Reports is to eliminate the need for numerous separate reports and to include the information required by those reports in a single report. For example, the Integrity Act requires an assertion on controls by the agency head. Pilot agencies are including this assertion in the Accountability Report.

enhanced by linking these indicators to the audited Statement of Net Cost. This is true even though the Statement of Net Cost may be too highly aggregated to identify separately all the programs reported on for the Results Act. Similarly, the auditor's tests of transactions and controls in connection with the audit of the financial statements provide information about the condition of the systems and controls used to safeguard resources and to assure that they are used for the intended purposes, in conformance with law. (Paragraphs 15 and 40-49 say more about the discussion and analysis of systems, controls, and performance.)

Authoritative Status of Accounting Concepts

23. This Statement of Federal Financial Accounting Concepts describes ideas and goals to guide the Board in its work. Concepts are not authoritative in the sense that they do not constitute accounting standards or principles for federal reporting entities. In particular, they are not "prescribed guidelines" for required supplementary information as discussed in section 558 of the Codification of Statements on Auditing Standards published by the American Institute of Certified Public Accountants.

Topics For MD&A

24. This section provides specific suggestions for the content of MD&A. Like the other sections of this document, this material does not constitute accounting standards or principles for federal reporting entities. Except to the extent that OMB may issue supplementary mandatory guidance regarding the content of MD&A, the following items should be read as suggestions to be considered, not as prescriptive rules that must be followed.

Mission and Organizational Structure

25. MD&A should contain a brief description of the mission(s) of the entity and describe its related organizational structure.

Discussion and Analysis of the Financial Statements

26. Financial Results, Position and Condition[9]—MD&A should help those who read it to understand the entity's financial results and financial position and the entity's effect on the financial position and condition of the Government.[10] It should give readers the benefit of management's understanding of the significance and potential effect from both a short- and a long-term perspective of:

- the variations discussed in paragraph 14 in terms of major changes in types or amounts of assets, liabilities, costs, revenues, obligations and outlays;
- particular balances and amounts shown in the basic financial statements, including the notes, such as those dealing with funds from dedicated collections, if relevant to important financial management issues and concerns; and
- the entity's required supplementary stewardship information (because RSSI describes economic conditions that cannot be expressed in the basic financial statements).

27. Only those variations, balances and amounts, and stewardship matters of potential interest to readers who are not part of agency management should be discussed. Not all changes that are material to the GPFFR are sufficiently important to be included in MD&A. A line-by-line analysis of the financial statements is not generally appropriate. Instead, MD&A should summarize the most important items, explain the relevant causes and effects, and place them in context.

28. Budgetary Integrity—MD&A should concisely explain how budgetary resources have been obtained and used, instances in which their acquisition and use were not in accordance with legal authorization, the status of budgetary resources, and how information on the use of budgetary resources relates to information on the cost of program operations. MD&A should explain when major support for cost of a program or activity is provided outside the reporting entity's budget and when the entity's budget supports a program primarily reported by another entity. The discussion should describe major financing arrangements, guarantees, and lines of credit, including those not recognized in the basic financial statements.

[9]For many readers program performance information is more important than the financial statements. The order in which topics are discussed in this document does not imply that performance information is of secondary importance. See paragraphs 43 and following.

[10]Materiality of effects to be discussed should be evaluated in the context of the specific reporting entity, not the Government as a whole.

29. MD&A should explain major changes during the period to the budget originally approved, major failures to comply with finance-related laws, and other matters management believes necessary. These could include:

- unfunded liabilities that may require appropriations;
- assets that could be sold to augment future budgetary resources;
- amounts of payments that have not been matched with obligations;
- anticipated increases in the cost to complete long-term projects in progress that may require additional obligations or appropriations.

30. Use of Estimates—MD&A should concisely explain the use of estimates where that is important to understand issues discussed in MD&A, such as the major risks and uncertainties mentioned in paragraph 31 or the key forward-looking information discussed in paragraph 32. For example, the future expenses and the long term obligations[11] associated with major social insurance programs such as Social Security and Medicare should be discussed in MD&A of the financial report of the relevant reporting entities. These estimates are inherently imprecise and sensitive to several assumptions. Such factors would, therefore, be worthy of discussion in MD&A.

31. Current Demands, Risks, Uncertainties, Events, Conditions, and Trends—MD&A should describe important existing, currently-known demands, risks, uncertainties, events, conditions and trends--both favorable and unfavorable--that affect the amounts reported in the financial statements and supplementary information. The information called for by this paragraph and paragraph 32 is closely related. Preparers should combine the presentation of this information in whatever fashion is appropriate under the circumstances that apply to the reporting entity.

32. Future Effects of Current Demands, Risks, Uncertainties, Events, Conditions and Trends—The discussion of these current factors should go beyond a mere description of existing conditions, such as demographic characteristics, claims, deferred maintenance, commitments[12] undertaken, and major unfunded liabilities, to include a discussion of the possible future effect of those factors. (This discussion of possible future effect of existing, currently-known factors is required pursuant to the standards in *Standards for Management's Discussion and Analysis*.)

33. Future Effects of Anticipated Future Events, Conditions, and Trends—To the extent feasible and appropriate, the discussion should also encompass the possible future effects of

[11]The term "obligations" is used here in the customary sense, not as it is used in budgetary accounting.

[12]The term "commitments" is used here in the customary sense, not as it is used in budgetary accounting.

anticipated future events, conditions, and trends, although this additional information is not required by the standards for MD&A.[13] For example, MD&A might discuss the possible future effect of anticipated trends in the cost of inputs that may significantly affect future output costs. Other examples include the future effect of anticipated demographic trends, such as declining mortality rates, and the future effects of potential changes in behavior that may be caused by changes in Government programs. Such behavioral changes can greatly affect the future cost of some Governmental programs. For example, such effects can arise if subsidized insurance encourages the people or entities most at risk to participate in insurance programs ("adverse selection") or encourages risky behavior ("moral hazard").

34. An anticipated condition such as a prospective demographic trend or potential behavioral change may not, in itself, constitute a contingency or assumed risk that must be recognized, disclosed, or reported pursuant to SFFAS 5. Likewise, it may not be something that must be discussed in MD&A pursuant to the *Standards for Management's Discussion and Analysis*. Even so, if there is a reasonable prospect of a major effect on the reporting entity due to the anticipated condition, then MD&A should include this information to the extent feasible.

35. Where appropriate, the description of possible future effects of both existing and anticipated factors should include quantitative forecasts* or projections*. Such forecasts or projections can show the implications of existing policies and conditions in light of anticipated or reasonably possible future conditions. For example, for MD&A of the Government-wide financial statements, long-term projections of the deficit or surplus may be important indicators of financial condition and sustainability. For insurance programs, this kind of projection—which actuaries sometimes call "dynamic analysis"—would consider possible interactions among current assets, reserves, policies in force, expected future business or populations covered by the insurance, and potential behavioral changes such as adverse selection and moral hazard, if appropriate. Some programs are inter-related among themselves and/or with conditions in the private sector. For example, flood insurance programs and disaster assistance programs may be related to such an extent that analysis of programs individually would not provide a good idea of their potential impact on the Government. To the extent feasible, projections should consider the potential implications of such relationships.

36. The future implications of current or anticipated factors often can better be expressed as a range of possible outcomes and associated probabilities than as a single point estimate. Sometimes the implications may best be discussed in nonfinancial as well as financial

[13]Some projections that could involve consideration of anticipated factors would be presented as required supplementary stewardship information pursuant to the standards exposed for comment in FASAB's exposure draft Accounting for Social Insurance, February, 1998.

terms. Forward-looking information can be highly useful, but management should avoid turning this part of MD&A into mere "lobbying" for more budgetary authority.

37. Understanding Financial Reporting—MD&A should make federal financial statements understandable to a wide audience, not just to users who are specialized analysts or members of the entity's management. There may be many potential sources of misunderstanding. Management should try to identify those sources of misunderstanding that may be important and deal with them in MD&A. Some of these are general and pervasive, such as those that may arise in the minds of new users of federal financial statements. New users may have been budget-oriented rather than accrual-accounting oriented, or may be accustomed to seeing financial statements prepared on the basis of private sector accounting standards. A general discussion and reference to the Statement of Financing and the basis of accounting footnote may be sufficient for such users, although more specific treatment may be appropriate where the resulting differences in the reported amounts may be important to the understanding of users.

38. Emphasis that may be given in the financial statements to the costs of suborganizations and programs may require cautionary discussion of the relevance and utility of cost information. When MD&A itself discusses the cost of program outcomes, the problems of associating costs with outcomes may need to be discussed. In addition, the possible imprecision of cost information should be mentioned when it could be relevant to users' understanding. Similarly, any account-level discussion in MD&A of variations, balances, and amounts in the basic and stewardship information made in response to paragraphs 26 and 27 may require mention of the imprecision of amounts cited.

39. Exceptions and disclaimers in the auditor's report should be mentioned in MD&A, and management should respect the auditor's professional judgment if management expresses disagreement with auditor's findings. (This does not mean that management must refrain from stating views that differ from the auditor's; e.g., different views as to whether a weakness in control is material.) There may be other sources of misunderstanding. Management should be sensitive to them and guide the user to a better understanding when the problem could significantly affect the conclusions and judgments of substantial numbers of users.

Discussion and Analysis of Systems, Controls and Legal Compliance

40. The schematic diagram of a sample GPFFR on page 7 includes a discrete section that reports on the status of the entity's management systems and internal controls that support (1) preparation of financial statements and performance information in accordance with Federal Accounting Standards and management's criteria, respectively, and (2) the entity's

compliance with applicable laws.[14] That section also describes material problems revealed by audits or otherwise known to management, and the corrective actions taken or planned regarding material problems.

41. Where relevant, management should discuss the results of audits of non-Federal entities such as those pursuant to the Single Audit Act as amended and OMB Circular A-133. MD&A should also discuss actions taken, in progress, or planned to address systemic problems in program design that contributed to the audit findings. Where relevant, management should describe the methods used to limit, detect, and recover improper payments; to assure that grantees and other nonfederal recipients of Federal funds use the funds as intended; and to assure that Federal and nonfederal entities comply with finance-related laws and regulations. MD&A should include a concise description of any major problems in these areas and of the corrective action taken or planned.

Discussion and Analysis of Performance

42. Performance Measurement—The objectives and needs of the Federal Government are markedly different from the objectives and needs of non-governmental organizations. This difference extends to the needs of those who use financial statements of governmental organizations. Their needs are different in many ways from the needs of investors, which the SEC's requirements address. In particular, reporting on the performance of governmental programs, organizations, and activities requires information that goes beyond the change in net assets and, indeed, beyond financial information.

[14]These responsibilities are defined in numerous laws and administrative requirements, including the Federal Financial Management Improvement Act, OMB Circulars A-123 and A-127, and OMB Bulletin 98-08. A law of special importance in this connections is the Federal Managers' Financial Integrity Act of 1982 (FMFIA or the Integrity Act). The Integrity Act requires, in part, that "internal accounting and administrative controls of each executive agency shall be established.. and shall provide reasonable assurance that --
(i) obligations and costs are in compliance with applicable law;
(ii) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
(iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets.

43. The actual outcomes, accomplishments, or degree to which predetermined objectives are met provide indicators or measures of some aspects of effectiveness.[15] MD&A should objectively discuss the entity's program results and indicate the extent to which its programs are achieving their intended objectives.[16] Efficiency and effectiveness are important elements of performance measurement, and measuring cost is an integral part of assessing the efficiency and effectiveness of programs. Relating outputs (the quantity of services provided) to inputs (the cost incurred to provide the services) provides an indicator or measure of one aspect of efficiency. Information about effectiveness is often combined with cost information to help assess "cost effectiveness."

44. The entity's financial performance should be summarized to provide significant indicators of its financial operations for the reporting period. Indicators of financial performance are presented in notes and supplementary information as well as on the face of the principal financial statements, e.g., information about management of loans and accounts receivable. Financial performance is only one aspect of performance for governmental entities. Financial performance should be discussed to the extent relevant for the entity, in a way that appropriately balances the discussion of financial and nonfinancial performance relevant to the program or other reporting entity.

45. The discussion of performance should relate to major goals and objectives from the agency's strategic plan and to the indicators reported pursuant to the Results Act. It should explain what key performance indicators say about program performance. The summary discussion of performance in MD&A should:

- discuss the strategies and resources the agency uses to achieve its performance goals;
- provide a clear picture of actual and planned performance across the agency; and
- explain the procedures that management has designed and followed to provide reasonable assurance that the reported performance information is relevant and reliable.

46. The discussion of performance should:

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[15]SFFAC 1, paragraph 206 notes that, to the extent feasible and practical, effectiveness evaluation should focus on program results or effects in the sense of "impacts[*]," i.e., the difference between what actually occurred and what would have occurred in the absence of the program. Assessing impacts of Governmental action in this sense typically requires program evaluations or other techniques that transcend annual performance reporting, although these techniques often will avail of information i the annual performance reports. Valid and reliable evaluations of program impacts are not feasible for some programs. When they are conducted, they often require several years of data, are expensive, and typically are not performed on an annual basis for a given program.

[16]Paragraphs 106-111 and Appendix 1-F of Statements of Federal Financial Accounting Concepts 2, *Entity and Display*, discuss and illustrate reporting on performance in the GPFFR.

- include both positive and negative results;
- present historical and future trends, if relevant (see paragraphs 31-36 regarding projections of the financial effects of known and anticipated demands, commitments, events, risks, uncertainties or trends for which a material financial effect is reasonably possible);
- be illustrated with charts and graphs, whenever helpful, for easy identification of trends;
- explain the significance of the trends;
- provide comparison of actual results to goals or benchmarks;
- explain variations from goals and plans; and
- provide other explanatory information that management believes readers will need to understand the significance of the indicators, the results, and any variations from goals or plans.

47. To further enhance the usefulness of the information, agencies should include an explanation of what needs to be done and what they plan to do to improve program performance.

48. <u>Understanding Performance Reporting</u>—Important limitations and difficulties associated with performance measurement and reporting should be noted to the extent relevant to the vital performance indicators discussed in MD&A. The relevant limitations will vary from program to program, but some common factors that may need to be discussed include the following:

- performance usually cannot be fully described by a single indicator;
- indicators of performance do not, by themselves, say why performance is at the level reported; and
- focusing exclusively on quantifiable indicators can sometimes have unintended consequences.

49. For these and other reasons, performance indicators generally need to be accompanied by suitable explanatory information. Explanatory information helps report users understand reported indicators, assess the reporting entity’s performance, and evaluate the significance of underlying factors that may have affected the reported performance. Explanatory information may include, for example, information about factors substantially outside the entity’s control, as well as information about factors over which the entity has significant control.

This Statement of Recommended Concepts was adopted unanimously by the eight members of the Federal Accounting Standards Advisory Board serving on the Board in April 1999.

Appendix A: Basis For Conclusions

This Statement may be affected by later Statements. The FASAB Handbook is updated annually and includes a status section directing the reader to any subsequent Statements that amend this Statement. Within the text of the Statements, the authoritative sections are updated for changes. However, this appendix will not be updated to reflect future changes. The reader can review the basis for conclusions of the amending Statement for the rationale for each amendment.

Background and Project History

50. The Board identified MD&A as a topic for its agenda shortly after the Board's inception. The Board deferred work on this topic, however, until it completed recommendations for an initial set of basic accounting standards. FASAB published an initial exposure draft on MD&A in January, 1997. The Board received comment letters on the initial exposure draft from the following sources:

	Federal (internal)	**Nonfederal (external)**	**Total**
Users, Academics and Others[17]		4	**4**
Auditors	7	3	**10**
Preparers and Financial Managers	16		**16**
Total	**23**	**7**	**30**

51. The basic rationale for MD&A has not changed since the initial exposure draft. As a result of its deliberations after receiving comments on the 1997 exposure draft, however, the Board made certain changes. The more significant changes are discussed below.

Concepts and Standards

52. The initial exposure draft was presented as a statement of recommended concepts. The Board proposed that it would deal with MD&A conceptually, with the understanding that OMB would provide authoritative guidance on MD&A to implement the concepts. This approach would have been similar to the one used to deal with the topics of entity and

[17]This category include representational organizations, retired federal employees, federal employees responding as individuals, and federal contractors, as well as academics and other GPFFR users.

display. The Board dealt with those topics conceptually in SFFAC 2. OMB then provided authoritative guidance in its Bulletin on Form and Content. The 1997 exposure draft asked respondents whether all or part of its provisions should be issued as recommended standards rather than recommended concepts. Responses were mixed; most of those who commented on this question favored concepts, but a significant number expressed the view that standards would be appropriate.

53. The Board concluded that, given the importance of MD&A as an integral part of the GPFFR, it would be appropriate to recommend standards for MD&A. At the same time, however, the Board concluded that for now this information should be treated as required supplementary information. The Board also agreed that no detailed requirements or guidelines for MD&A should be incorporated in federal accounting standards at this time beyond those proposed in the subsequent exposure draft (discussed below) titled *Standards for Management's Discussion and Analysis*. In other words, the Board agreed, a discussion and analysis that addresses the topics listed in the proposed standards should be an essential part of a complete GPFFR. At the same time, management should have great discretion about what to say regarding those topics, subject only to the criteria proposed in the exposure draft *Standards for Management's Discussion and Analysis* and the pervasive requirement that MD&A not be misleading. Because of this change, the Board decided to expose separately for further comment the proposed new standards and concepts. The exposure drafts were issued in October 1998; responses were requested by January 1999.

Responses to Second Exposure Draft

54. The Board received comment letters on the second exposure draft from the following sources:

	Federal (internal)	**Nonfederal (external)**	**Total**
Citizens, Users, Academics and Others		3	**3**
Auditors[18]	3	3	**6**
Preparers and Financial Managers	11		**11**
Total	**14**	**6**	**20**

[18]Includes the AICPA's Federal Accounting and Auditing Subcommittee and the Comptroller General's Advisory Council on Government Audit Standards.

55. Most comments were generally favorable, but comments were mixed regarding some points. A few auditors and preparers expressed some concern about requiring forward-looking information as RSI. Others expressed support for doing so. After considering these responses, the Board agreed to defer the recommended implementation date of the standard by one year and to make minor editorial changes to the standards and concepts that were exposed for comment.

Incorporation of Guidance in OMB Bulletin 97-01

56. This document, like both exposure drafts, integrates some of the guidance in OMB Bulletin 97-01 for preparing the "Overview" of the financial report with some of the guidance proposed in FASAB's initial exposure draft for MD&A. Some portions of the guidance regarding performance measurement in 97-01's discussion of the "Overview" have been omitted. As an interim step prior to implementation of the Results Act, OMB and many agencies used the Overview as a major vehicle for reporting on performance, not just as a summary and analysis. With the full implementation of the Results Act in FY 1999, however, it will be appropriate to implement the financial reporting model contemplated in SFFAC 2. This contemplates a discrete section of the GPFFR focused on performance. Alternatively, performance information may be incorporated in the GPFFR by reference to another report or reports.

Management's Assertions

57. Senior management of the reporting unit is responsible for the content of the GPFFR, including MD&A. Consistent with that, the initial exposure draft included the following paragraph:

> MD&A should include a discrete section with management's explicit assertions that it is responsible for maintaining internal accounting and administrative controls that are adequate to ensure that
>
> - transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the purposes authorized, and are recorded in accordance with Federal accounting standards;
> - assets are properly safeguarded to deter fraud, waste, and abuse; and
> - performance measurement information is adequately supported. [footnote omitted]

58. This paragraph, which was based on the language of objective four in SFFAC 1, was modified after the first exposure. The Board concluded that such assertions should be

presented in a separate section of the GPFFR, not in MD&A. Alternatively, management's assertions about internal control and related information about systems, controls, and compliance may be incorporated in the GPFFR by reference to another report or reports. (As noted previously, pilot agencies are including these assertions in their accountability reports.) FASAB expects to consider whether a new statement of standards is needed to assure that Federal financial reports adequately address objective four of Federal financial reporting, "Systems and Controls." As noted in paragraph 41, MD&A should include a description of any major deficiencies in the management systems and internal controls designed to provide reasonable assurance that management responsibilities are satisfactorily carried out. It also should describe the corrective action planned.

Accountability Reports

59. The Board notes that the concept and practice of the "Accountability Report" continue to evolve through the pilot project voluntarily undertaken by several agencies. The Board supports this evolution and encourages agencies to participate in the pilot project. The concepts and standards FASAB recommends are intended to be applicable to the GPFFR of Federal entities, whether those reports are prepared pursuant to the Chief Financial Officers Act, the Government Management Reform Act, or some future law that might establish a statutory basis for Accountability Reports. In the event of such future legislation, OMB will need to resolve any questions about how to apply existing Federal accounting standards in the context of new legislative requirements.

Incorporation by Reference

60. Some respondents were disturbed by the notion of providing program performance information through reference. Some were concerned that, if readers are merely directed to other reports for this information, the GPFFR will become irrelevant. They believe that the GPFFR should contain information about program performance, systems, and controls, not only in MD&A but also in discrete sections, such as the Statement of Program Performance discussed and illustrated in SFFAC 2, paragraphs 106-111 and Appendix 1-F.

61. The Board agrees that, as is stated in paragraph 20, "it is necessary to include at least some information about performance with the financial statements . . . so that people who use the GPFFR can understand why the costs reported in the financial statements were incurred and the consequences of doing so."

62. The Board acknowledges that SFFAC 2 calls for and illustrates a Statement of Program Performance Measures. (Footnote 13 in SFFAC 2 explains that this statement is not "basic" information as that term is used in audit standards: "The Statement of program performance

measures is not a basic financial statement. Nevertheless, it is an important component of the financial reports.") The Board continues to believe that performance information is a vital, integral part of general purpose financial reporting. It should be noted, however, that SFFAC 1 and SFFAC 2 were issued before the performance planning and reporting requirements of GPRA became effective. The Results Act creates an elaborate new planning and reporting environment that is still evolving. Some details of the reporting model that were envisioned conceptually in SFFAC 2 may accordingly need to be revised slightly.

63. This statement of concepts is intended to be consistent with the previously stated goals and concepts of the Board, while recognizing that some details of how best to achieve those goals in the new context still need to be defined. OMB will play a key role in this process; FASAB may also provide further guidance in future projects. FASAB agrees that the GPFFR should not address performance, systems, and controls only by means of reference to other reports. The standards for MD&A require that MD&A do more than refer to other documents.

64. Others expressed concern that, if MD&A is to be regarded as RSI, audit problems might arise from "incorporation by reference" in MD&A of information drawn from other sources that might not be subject to audit or review as basic or required supplementary information, and for which authoritative guidance had not been provided by a standard setter. The Board noted that most of those who commented, including most auditors, did not appear to be greatly concerned about this potential problem. The Board concluded, therefore, that any such problems were not likely to be insurmountable. The Board did, however, agree to defer by one year the implementation date of the standard to allow OMB and GAO time to resolve any audit issues that may arise.

Appendix B: Glossary

See Consolidated Glossary in “Appendix E: Consolidated Glossary.”

TAB B

RISK REPORTING

APPENDIX C

SFFAS 15

Management's Discussion and Analysis

[Standards]

April 2019

Statement of Federal Financial Accounting Standards 15: Management's Discussions and Analysis

Status

Issued	August 12, 1999
Effective Date	For fiscal periods beginning after September 30, 1999
Interpretations and Technical Releases	
Affects	None.
Affected by	None.

Summary

This document establishes standards for preparing Management's Discussion and Analysis (MD&A). MD&A is an important vehicle for (1) communicating managers' insights about the reporting entity, (2) increasing the understandability and usefulness of the general purpose federal financial report (GPFFR),[1] and (3) providing understandable and accessible information about the entity and its operations, service levels, successes, challenges, and future. Some federal agencies also refer to MD&A as the "overview."

> The basic concept that underlies the standards for MD&A is:
>
> Each general purpose federal financial report (GPFFR) should include a section devoted to management's discussion and analysis (MD&A). It should address the reporting entity's performance measures, financial statements, systems and controls, compliance with laws and regulations, and actions taken or planned to address problems. The discussion and analysis of these subjects may be based partly on information contained in reports other than the GPFFR. MD&A also should address significant events, conditions, trends and contingencies that may affect future operations.

A separate document titled *Concepts for Management's Discussion and Analysis* explains the conceptual basis for the role and importance of MD&A, the general content of the GPFFR, and the elements of MD&A. The concepts provide a foundation for the standards presented in this document. The concepts include suggestions about the contents of MD&A, but those suggestions are not accounting standards or principles for federal reporting entities. In particular,

[1]The term "general purpose federal financial report," abbreviated GPFFR, is used as a generic term to refer to the report that contains the entity's financial statements that are prepared and audited pursuant to the CFO Act of 1990, as amended. Entities may refer to these reports using different terms, such as "Annual Report," "Accountability Report," "Financial Management Report," etc. Paragraphs 54-112 and Appendix 1 of Statement of Federal Financial Accounting Concepts 2, Entity and Display, describe and illustrate the contents of the GPFFR.

the concepts are not “prescribed guidelines” for required supplementary information as discussed in section 558 of the *Codification of Statements on Auditing Standards* published by the American Institute of Certified Public Accountants (AICPA). The only standards and prescribed guidelines for MD&A are in paragraphs 1-8 of this document.

The standards require MD&A to be included in each GPFFR as required supplementary information (RSI). MD&A should address:

- the entity’s mission and organizational structure;
- the entity’s performance goals and results;
- the entity’s financial statements;
- the entity’s systems, controls, and legal compliance; and
- the future effects on the entity of existing, currently-known demands, risks, uncertainties, events, conditions and trends.

The discussion and analysis of these subjects may be based on information in other discrete sections of the GPFFR or it may be based on reports separate from the GPFFR. The standards are effective for reporting periods that begin after September 30, 1999.

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Management's Discussion And Analysis

Statement Of Standards

1. A report that presents a Federal reporting entity's financial statements in conformance with Federal accounting principles should include management's discussion and analysis (MD&A) of the financial statements and related information. MD&A should provide a clear and concise description of the reporting entity and its mission, activities, program and financial performance, systems, controls, legal compliance, financial position, and financial condition. MD&A should provide a balanced presentation that includes both positive and negative information about these topics. MD&A should be regarded as "required supplementary information" as that term is used in auditing standards.[2]

2. MD&A should contain sections that address the entity's:

   - mission and organizational structure;
   - performance goals, objectives, and results;
   - financial statements; and
   - systems, controls, and legal compliance.

3. MD&A should include forward-looking information regarding the possible future effects of the most important existing, currently-known demands, risks, uncertainties, events, conditions and trends. MD&A may also include forward-looking information about the

[2]See section 558, "Required Supplementary Information," in *Codification of Statements on Auditing Standards*, American Institute of Certified Public Accountants (AICPA)

possible effects of anticipated future demands, events, conditions, and trends.[3] Forward-looking information may comprise a separate section of MD&A or may be incorporated with the sections listed above.

4. MD&A should discuss important problems that need to be addressed, and actions that have been taken or planned. Actions needed, taken, and planned may be discussed within the sections listed above or in a separate section of MD&A.

5. Because MD&A must be concise if it is to be useful, management must select the most important matters to discuss. This means that some items that are material to the financial statements, notes, and other sections of the GPFFR may not be discussed in MD&A.

6. MD&A should deal with the "vital few" matters; i.e., the most important matters that will probably affect the judgments and decisions of people who rely on the GPFFR as a source of information. (The specific topics mentioned in *Concepts for Management's Discussion and Analysis* are examples of items that might be relevant for MD&A of a given entity.) Matters to be discussed and analyzed are those that management of the reporting entity believes it is reasonable to assume could:

   - lead to significant actions or proposals by top management of the reporting unit;
   - be significant to the managing, budgeting, and oversight functions of Congress and the Administration; or
   - significantly affect the judgment of citizens about the efficiency and effectiveness of their Federal Government.

7. Management of the reporting unit is responsible for the content MD&A.

8. The standards are effective for reporting periods that begin after September 30, 1999.

[3]The word "anticipated" is used in a broad, generic sense in this document. In this context the term may encompass both "probable" losses arising from events that have occurred, which should be recognized on the face of the basic or "principal" financial statements, as well as "reasonably possible" losses arising from events that have occurred, which should be disclosed in notes to those statements. "Anticipated" may include the effects of future events that are deemed probable, for which a financial forecast would be appropriate. The term may also encompass hypothetical future trends or events that are not necessarily deemed probable, for which financial projections may be appropriate. Such information about the possible effects of anticipated future demands, events, conditions and trends, if presented, should include the term or label "projected" or "projection," and the key hypothetical underlying assumptions should be explained. As with other information presented in MD&A, no examination of this information by the auditor is now routinely included within the scope of an audit of a federal entity's financial statements; however, preparers and auditors may find useful background information in the AICPA's Statements on Standards for Attestation Engagements Nos. 1 and 4, codified as section 200, "Financial Forecasts and Projections," of the AICPA's *Codification of Statements on Standards for Attestation Engagements.*

This Statement of Recommended Standards was adopted unanimously by the eight members of the Federal Accounting Standards Advisory Board serving on the Board in April 1999.

Appendix A: Basis For Conclusions

This Statement may be affected by later Statements. The FASAB Handbook is updated annually and includes a status section directing the reader to any subsequent Statements that amend this Statement. Within the text of the Statements, the authoritative sections are updated for changes. However, this appendix will not be updated to reflect future changes. The reader can review the basis for conclusions of the amending Statement for the rationale for each amendment.

Background, Rationale, and Project History

9. The Board identified MD&A as a topic for its agenda shortly after the Board's inception. The Board deferred work on this topic, however, until it completed recommendations for an initial set of basic accounting standards.

10. FASAB published an initial exposure draft on MD&A in January, 1997. It was presented as a statement of recommended concepts rather than standards. The Board proposed that it would deal with MD&A conceptually, with the understanding that OMB would provide authoritative guidance on MD&A to implement the concepts. This approach would have been similar to the one used to deal with the topics of entity and display. The Board dealt with those topics conceptually in SFFAC 2. OMB then provided authoritative guidance in its Bulletin on Form and Content.

11. The Board received comment letters on the initial exposure draft from the following sources:

	Federal (internal)	**Nonfederal (external)**	**Total**
Citizens, users, academics and others[4]		4	4
Auditors	7	3	10
Preparers and financial managers	16		16
Totals	23	7	30

[4]This category includes representational organizations, retired federal employees, federal employees responding as individuals, and federal contractors, as well as academics and other GPFFR users.

Concepts and Standards

12. The first exposure draft asked respondents whether all or part of the exposure draft's provisions should be issued as recommended standards rather than recommended concepts. Responses were mixed; most of those who commented on this question favored concepts, but a significant number expressed the view that standards would be appropriate. The Board concluded that, given the importance of MD&A as an integral part of the GPFFR, it would be appropriate for federal accounting principles to include standards for MD&A.

13. At the same time, the Board concluded that MD&A should be treated as required supplementary information. The Board agreed that it would recommend no detailed requirements or guidelines for MD&A at this time, beyond those in paragraphs 1-8. In other words, a discussion and analysis by management that addresses the listed topics should be required, because it is an essential part of a complete GPFFR. At the same time, management should have great discretion regarding what to say about those topics, subject only to the criteria in paragraphs 1-8 and the pervasive requirement that MD&A not be misleading. The standard itself, therefore, is not extremely prescriptive.

14. Because of this change from what was originally exposed for comment, the Board decided to expose separately the proposed standards and concepts for further comment. The exposure drafts were issued in October, 1998; responses were requested by January 1999. The proposed standard, like the final recommended standard, would require the auditor to note the omission of MD&A or the failure to address the specified topics. At the same time, RSI status for MD&A—coupled with the lack of specific, detailed, prescriptive standards for the content of MD&A—would minimize the requirement for the auditor to scrutinize MD&A. This, the Board believed, would provide the flexibility appropriate for dealing with topics such as performance measurement at this point in the evolution of federal financial reporting.

Responses to Second Exposure Draft

15. The Board received comment letters on the second exposure draft from the following sources:

	Federal (internal)	Nonfederal (external)	Total
Citizens, users, academics and others		3	3
Auditors[5]	3	3	6
Preparers and financial managers	11		11
Totals	14	6	20

16. Most comments were generally favorable, but comments were mixed regarding some points. A few auditors and preparers expressed some concern about requiring forward-looking information as RSI. Others expressed support for doing so. After considering these responses, the Board agreed to defer the recommended implementation date of the standard by one year and to make minor editorial changes to the standards and concepts that were exposed for comment.

17. Although the resulting standard differs from private sector standards, the Board expects that, in practice, the effect on auditors will not be greatly different.[6] In the private sector, corporations frequently include with their annual financial report the MD&A that they are required to file with the SEC. Because it is required by the SEC rather than by accounting standards, the auditor engaged to audit the corporation's financial statements normally treats MD&A as "accompanying information" that is not audited in the context of the audit of the financial statements. The auditor also may review the submission to the SEC and may have certain responsibilities in that regard, but the auditor's usual role regarding MD&A is, nevertheless, fairly limited.

18. Because this standard defines MD&A for federal reporting entities as RSI, auditors will have certain responsibilities regarding it; however, both the accounting standards specified here and the auditing standards specified by the AICPA (and incorporated in Government Audit Standards) for RSI are rather general. Therefore, the Board does not expect that this standard will cause the auditor to be deeply involved in reviewing the contents of MD&A.

[5]Includes the AICPA's Federal Accounting and Auditing Subcommittee and the Comptroller General's Advisory Council on Government Audit Standards.

[6]The standard itself differs from the SEC's guidance for MD&A in ways that reflect the unique federal reporting environment. This will affect what financial statement preparers must do to comply with the standard. For example, reporting on performance of governmental programs requires measures in addition to net income or net cost.

19. More specific requirements regarding the content of MD&A may be added later by OMB acting on its own authority or pursuant to future FASAB recommendations. For example, OMB might at some time in the future require preparers to address certain of the suggested items in Concepts for Management's Discussion and Analysis. OMB also may provide more specific guidance regarding the auditor's responsibility for MD&A. That guidance may call for more extensive review of all or parts of MD&A than the minimum contemplated by this accounting standard in the context of current auditing standards. For example, OMB might at some time in the future decide that the minimum scope of engagements to audit federal financial statements should be expanded to include a review or examination of all or parts of MD&A, consistent with attestation guidelines published by the AICPA.[7]

Accountability Reports

20. The Board notes that the concept and practice of the "Accountability Report" continue to evolve through the pilot project voluntarily undertaken by several agencies.[8] The Board supports this evolution and encourages agencies to participate in the pilot project. The concepts and standards FASAB recommends are intended to be applicable to the GPFFR of Federal entities, whether those reports are prepared pursuant to the Chief Financial Officers Act, the Government Management Reform Act, or some future law that might establish a statutory basis for Accountability Reports. In the event of such future legislation, OMB will need to resolve any questions about how to apply existing Federal accounting standards in the context of new legislative requirements.

Forward-looking Information

21. MD&A should include forward-looking information regarding the future effects of <u>existing</u>, currently-known demands, risks, uncertainties, events, conditions and trends. This kind of

[7]See Statement on Standards for Attestation Engagements No. 8, *Management's Discussion and Analysis,* issued by the Auditing Standards Board of the AICPA, March 1998.

[8]Accountability reports are broader in scope than traditional general purpose financial reports. As explained by OMB: "Six pilot agencies volunteered to produce an 'Accountability Report' for FY 1995 to provide more useful information to decision makers by linking together information required by several management statutes... Accountability Reports integrate the following information: the FMFIA report, the CFOs Act Annual Report (including audited financial statements); management's Report on Final Action as required by the IG Act; Civil Monetary Penalty and Prompt Payment Act reports; and available information on agency performance compared with its stated goals and objectives, in preparation for implementation of GPRA." *Federal Financial Management Status Report and Five Year Plan,* June 1996, pp. 33-34. Twelve agencies produced accountability reports for FY 1997; eighteen plan to do so for FY 1998; the number will increase to 23 for FY 2000. (The requirement to include Civil Monetary Penalty and Prompt Payment Act reports has been deleted.)

forward-looking information is required when management believes it would be important to people who read the financial report. Though not required, MD&A may also include forward-looking information about the possible effects of anticipated future demands, events, conditions, and trends. FASAB encourages management to include forward-looking information about the possible effects of anticipated future demands, events, conditions, and trends to the extent management believes such information would be useful and relevant. This information can be highly useful, but management should avoid turning this part of MD&A into mere “lobbying” for more budgetary authority.

Incorporation by Reference

22. Some respondents expressed concern that, if MD&A is to be regarded as RSI, audit problems might arise from “incorporation by reference” in MD&A of information drawn from other sources that might not have been subject to audit or review as basic or required supplementary information, and for which authoritative guidance had not been provided by a standard setter. The Board noted that most of those who commented, including most auditors, did not appear to be greatly concerned about this potential problem. The Board concluded, therefore, that any such problems were not likely to be insurmountable. The Board did, however, agree to defer by one year the implementation date of the standard to allow OMB and GAO time to resolve any audit issues that may arise.