



August 28, 2006

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Dear Ms. Comes:

On behalf of the Association of Government Accountants (AGA), the Financial Management Standards Board (FMSB) appreciates the opportunity to provide comments on the exposure draft (ED) of a proposed statement of Federal Financial Accounting Concepts, entitled *Definition and Recognition of Elements of Accrual-Based Financial Statements*. The FMSB, comprising 21 members with accounting and auditing backgrounds in federal, state and local government, academia and public accounting, reviews and responds to proposed standards and regulations of interest to AGA members. Local AGA chapters and individual members are also encouraged to comment separately.

The FMSB has responses to the questions for respondents and some additional comments. Our responses are in bold text. The text in italics is from the FASAB document.

1. Two principles underlie the FASAB’s approach to defining and recognizing elements of accrual-basis financial statements of the federal government.

The two principles identified below are not articulated as principles in the proposed ED. The two statements are not highlighted as foundational assumptions (principles) for the ED. If they rise to the level of “principles, they should be identified as such in the document.

The first principle is that the definitions of assets and liabilities should derive from identifying the fundamental or essential characteristics that all assets and liabilities, respectively, share. The definitions of net position, revenues, and expenses should derive from the definitions of assets and liabilities.

Does the use of the word “or” in “fundamental or essential” above imply that the 2 words are equivalent or is the word “or” meant to imply “either/or” as either “fundamental or essential?”

a) Should the definitions of assets and liabilities derive from their fundamental or essential characteristics? Please provide the reasons for your position and any alternative approach(s) you would take to define assets and liabilities.

The definitions should derive from their fundamental or essential characteristics for consistency with accounting guidance and education. (As noted, this statement is not identified as a “principle” in the ED.)



b) Should the definitions of net position, revenues, and expenses derive from the definitions of assets and liabilities? Please provide the reasons for your position and any alternative approach(s) you would take to define net position, revenues, and expenses?

Yes, we think that this position is logical and reasonable.

The second principle is that definition and recognition are separate concepts. An item that meets the definition of an asset is an asset but to be recognized the asset also must meet the recognition criteria. Thus, meeting the definition of an element is a necessary but not a sufficient condition for an item to be recognized in financial statements. An asset that is not recognized in the body of a financial statement would be a candidate for disclosure in the notes. **The ED mentions several times that assets or liabilities not recognized in the body of the financial statements would be “a candidate for disclosure in the notes or in supplemental information. Should the ED discuss how the decision to disclose should be made?”**

c) If an item meets the definition of an asset is it an asset even if it is not recognized in the body of a financial statement because, for example, it is not measurable or its amount is not material? Please provide the reasons for your position.

We agree that an asset can be defined as an asset without being sufficiently measurable or material to be in the body of the financial statement. Having said that, we think it would be helpful if the ED provided more examples of assets that may not be sufficiently measurable or material to be in the body of the financial statement.

In summary, we agree with the two statements, but recommend that the ED clearly articulate that these are principles and foundational assumptions of the ED; they appear to be logical and workable.

2. The proposed Concepts Statement defines five elements of accrual-basis financial statements: assets, liabilities, net position, revenues and expenses. **The proposed ED can’t seem to “make up its mind” about whether “net position” is an element. Net position is not mentioned in paragraph 2 or paragraph 9 which “identify” the elements. The other references noted in this question (e.g., paragraphs 35-37 and 56) do not really define the elements; they refer to a limited number of the elements.**

a) Are there additional elements of accrual-basis financial statements that should be defined in the Concepts Statement? If so, what are they and what are their essential characteristics? Alternatively, what are they and how would you define them?

The only additional elements that should be defined might be “gains or losses” as discussed below.

Some constituents believe that because of the unique nature of the federal government additional elements are needed for certain transactions and other events. For example, certain intangible resources, long-term social obligations, and other commitments are viewed by these constituents as requiring a different element or elements than those identified in this proposed Concepts Statement. **The ED does not discuss these beliefs so that we cannot judge whether they are realistic or valid.**

b) Do you agree or disagree that there are additional elements that need to be defined? If you agree, what are the essential characteristics of these elements? Please provide examples of the types of transactions that align with these additional elements.

An additional element could be “gains or losses”. Paragraphs 55 and 56 make the point that “gains or losses” are merely sub-sets of revenues and expenses. However, in most cases, gains or losses are not reported as either revenues or expense. Gains or losses represent a composite entry on financial statements, generally the net result of a transaction primarily affecting assets or liabilities. The gain or loss is the “remainder” of such a transaction. For example, if an entity sells an asset at less than recorded value – it records a loss. Conversely, if it sells an asset at more than recorded value it records a gain. However, the entity does not record the receipt of cash as revenue and the value of the underlying asset as an expense. Thus, the gain or loss is not a subset or revenues and expenses – it is the result of an asset or liability transaction and thus could be considered as another element.

3. The proposed Concepts Statement addresses the government’s ability to change laws in the future as stated in paragraph 44 as follows:

To meet the definition of a liability, the federal government’s contract or other agreement to provide assets or services to another entity must be based on existing conditions, including current law, because an essential characteristic of a liability is that the government has a present obligation, even if conditions may change before settlement is due. For example, the Congress may change a law under which the federal government has incurred a present obligation and erase the obligation or otherwise enable the government to avoid settlement. Alternatively, the government may be able in the future to renegotiate the obligation with the payee or recipient of the promised services. However, liabilities and all other elements of accrual-basis financial statements are based on transactions or events that already have occurred. The government’s power to change existing conditions does not preclude what otherwise would be a present obligation and recognized as a liability.

Members with an alternative view believe that the government’s power to modify the law to change or withdraw future benefits related to nonexchange transactions could affect the existence of a present obligation. Consequently, these Board members believe that the government’s ability to change the law may provide additional evidence about whether a present obligation exists and, in some instances, may preclude recognition of a liability. Therefore, they disagree with paragraph 44.

a) Do you agree with the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the potential effect of the government’s ability to change laws on the recognition of a liability? Please explain the reasons for your position.

We agree with the proposed Concept Statement (1). The existence or non-existence of a liability should be based on the law at the time. Congress can always modify legislation in a way that will affect the existence of liabilities (or assets). If and when that happens the financial statements should be modified with appropriate disclosure of the reasons for the changes in the financial statements. Law takes precedence over accounting rules and regulations, and one takes the action(s) necessary to abide by the law. It is not reasonable to second guess or predict what law(s) will change. Therefore, we agree with the position as stated in the ED, since it is the realistic approach. An example of where the government could change the law and cause a change in the liability recognition follows. The DoD accounts for environmental clean-up of its ranges under current law requiring clean up to a specified depth, three feet below the surface. There are

Members of Congress who would like to see the law changed and the depth of the clean-up increased to, say, nine feet below the surface. This would dramatically impact the clean-up costs and the liability that the DoD would have to accrue.

We also wish to point out that the AV relates only to non-exchange transactions. Can not the federal government change the law so as to affect liabilities arising from exchange transactions? Also, since the AV is the only mention of non-exchange transactions, is it necessary for the ED to define exchange and non-exchange transactions?

4. The proposed Concepts Statement identifies two, and only two, characteristics that are fundamental or essential to all federal government assets: (a) An asset embodies economic benefits or services that can be used in the future and (b) the government can control access to the economic benefits or services and therefore, can obtain them and deny or regulate the access of other entities.

This is not the definition of an asset per paragraph 17. That paragraph says that “an asset is a resource that embodies economic benefits or services that the government can control”. That definition does not embody the concept of future benefits. Other references to the definition are mixed about embodying the concept of future benefits – for example, see the Executive Summary, the Glossary, paragraphs 21, 22, 25. We recommend that each mention of economic benefits or services refer to “future” economic benefits or services.

a) Do you agree that these two characteristics are essential characteristics of all federal government assets? If not, please give an example of a resource that you believe is an asset but does not possess one or both of these characteristics.

We think the two characteristics are reasonable. Statement of Financial Accounting Concepts (SFAC) #6 states that, “Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” If the entity (i.e., the government) does not have control of the asset, it would be difficult to claim it as an asset. Also, if the second part of the definition is removed, it may open up the financial statements to additional “assets”. At present, we cannot think of what those assets might be, but having the control characteristic in the guidance limits potential “frivolous” assets to be considered.

b) Are there any additional characteristics that are fundamental or essential to all federal government assets?

Not that we can think of.

5. The proposed Concepts Statement identifies two, and only two, characteristics that are fundamental or essential to all federal government liabilities: (a) A liability is a present obligation to provide assets or services to another entity and (b) the federal government and the other entity have an agreement or understanding as to when settlement of the obligation is to occur.

a) Do you agree or disagree that these two characteristics are essential characteristics of all federal government liabilities? Please provide the reasons for your views. If you disagree, please give an example of an obligation or commitment that you believe is a liability but does not possess one or both of these characteristics.

SFAC #6 state that, “Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.” We think both parts of the definition are necessary. If the federal government has a liability, but there is no “due date” or no action that will precipitate a due date, in essence the government does not have a liability.

b) Are there any additional characteristics that are fundamental or essential to all federal government liabilities?

Not that we can think of.

6. As indicated in Question 1a), the first principle of the Board’s approach to defining elements is that the definitions of assets and liabilities should derive from their essential characteristics, and the definitions of net position, revenues, and expenses should derive from the definitions of assets and liabilities.

a) Do the definitions of assets and liabilities adequately convey the essential characteristics from which they are derived? If not, how would you modify the definitions?

Yes.

b) Do the definitions of net position, revenues, and expenses adequately convey their relationship to assets and liabilities? If not, how would you modify the definitions?

Yes. Conceptually, we believe the definitions convey the essential characteristics. We also suggest that “gains and losses” should be a separate element – see above.

7. The proposed concepts statement establishes two conditions (“recognition criteria”) that should be met for an item to be recognized in the body of a financial statement: (1) The item must meet the definition of an element and (2) the item must be measurable.

a) Are there other criteria that should be established as conditions for recognition? If so, what recognition criteria would you add or delete?

No. We have no other proposed criteria.

8. The proposed Concepts Statement neither explicitly requires nor precludes an assessment of probability when deciding whether an item meets the definition of an element, nor does the Statement establish an explicit threshold of probability at the definition stage. Rather, the Statement indicates that conclusions about the existence of an element require judgment as to whether, based on the available evidence, an item possesses the essential characteristics of an element. The Statement indicates that when an element is considered for recognition, measurement of the element may require an assessment of the probability of future inflows or outflows of resources to or from the element to enhance the reliability of amounts recognized in the financial statements. In addition, the Statement explicitly acknowledges that assessments of the materiality and benefit versus cost of recognizing the results of the measurement of elements may constrain recognition. Members believe that this framework permits future standard setters to adequately address uncertainty with respect to recognition decisions in establishing future standards.

*Members with an Alternative View believe that, in deciding whether an item meets the definition of an element and considering related uncertainties, there is implicitly an assessment of the probability of whether an item meets the definition of an element and that, because there is a decision to be made, that there is implicitly a probability threshold where an item would not meet the definition of an element. These members believe that the proposed Concepts Statement should explicitly state that (1) the probability that an item meets the definition of an element should be assessed as part of determining whether an item meets the definition of an element (“existence probability”), and (2) there exists a threshold where such probability is so low that an item would not meet the definition of an element. Thresholds to be applied would, as appropriate, be established in specific standards. In the view of these members, the lack of an explicit acknowledgement of the need for an existence probability assessment and a probability threshold at the definition stage would be likely to result in many more items being recognized in the financial statements, including items with a low probability of being assets or liabilities. **It would be helpful if the proponents of the AV provided examples of the types of items that may be recognized that have a low probability of being assets or liabilities.***

a) Do you agree with the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the need for an explicit requirement for an assessment of probability and a related probability threshold when determining whether an item meets the definition of an element? Please explain the reasons for your position.

It seems to us that the proposed ED adequately addresses the need for judgment in determining the existence of an asset or liability and the amount of such asset or liability. As stated in the AV, the need for an assessment and a threshold is implicit in the ED. We are concerned that if the ED explicitly requires an assessment and a threshold, preparers would be “forced” by auditors to specifically examine and document the existence and value of each asset and liability separately from the ordinary course of business. When there is a significant question about existence or value of an asset, such documentation is appropriate. However, new and separate documentation should not be required. Therefore, while we do not have a major problem with explicitly stating the need for such an assessment, we prefer the ED to imply the need (as written) with any explicit requirements included in separate standards as required.

9. The proposed Concepts Statement defines “measurable” as “means quantifiable in monetary units.” (par. 5) The proposed Concepts Statement does not explicitly discuss an assessment of probability when deciding whether, based on the available evidence, an item is measurable or that there is a point or threshold at which an item is not measurable. The Statement does discuss the consideration of uncertainty, cost-benefit and materiality and how these factors influence standard setting.

Members with an Alternative View believe that, in deciding whether an item is measurable and considering related uncertainties, there is implicitly an assessment of the probability of whether an item is measurable and that, because there is a decision to be made, that there is implicitly a probability threshold where an item would not be measurable. These members believe that the proposed Concepts Statement should explicitly state that (1) the probability that an item is measurable should be assessed as part of determining whether an item is measurable (“measurability probability”), and (2) there exists a threshold where such probability is so low that an item would not be measurable. Thresholds to be applied would, as appropriate, be established in specific standards. In the view of these members, the lack of an explicit acknowledgement of the need for a measurability probability assessment and a probability threshold would be likely to result in many more items being recognized in the financial statements, including items with a low probability of being assets or liabilities.

a) Do you agree with the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the need for an explicit requirement for an assessment of probability and a probability threshold when determining whether an item is measurable? Please explain the reasons for your position.

As per our response to question 8, it seems that the position taken in the proposed concepts statement is most appropriate. Again, we would appreciate more examples from the authors of the AV of items that could be added to the financial statements if the need for assessment is not explicit.

10. SFFAC 1, Objectives of Federal Financial Reporting, par. 156, states that “Financial reporting is the means of communicating with those who use financial information. For this communication to be effective, information in financial reports must have these basic characteristics: understandability, reliability, relevance, timeliness, consistency, and comparability.” These six characteristics are defined in SFFAC 1 and are not altered by this Statement. Members supporting the proposed Concepts Statement do not believe that repeating the qualitative characteristics in this Statement would be useful and doing so could cause confusion regarding the status and application of the characteristics. These members believe that if the application of the characteristics requires explanation, the explanation should be approached in a comprehensive manner.

The members expressing an alternative view point out that the proposed Concepts Statement does not include a consideration of the qualitative characteristics of financial statements as part of determining whether an item meets the recognition criteria. Members with an alternative view believe that the ED should require a consideration of all of the qualitative characteristics of financial reporting in determining whether an item meets the recognition criteria; i.e., meets the definition and is measurable. In the view of these members, the lack of a consideration of the qualitative characteristics in determining whether an item meets the recognition criteria will likely result in the recognition of items that do not meet the qualitative characteristics (e.g., not relevant or reliable.)

a) Do you agree with the position taken in (1) the proposed Concepts Statement or (2) the Alternative View concerning the need for a consideration of the qualitative characteristics of financial statements as part of determining whether an item meets the recognition criteria? Please explain the reasons for your position.

We agree with the proposed Concepts Statement (1). As noted above, we have no problems with general statements that qualitative characteristics be considered, but see no real “need” to place that statement in this standard. In addition, we would like to see examples of the types of items that might be included as assets or liabilities if the qualitative factors are not considered.

Additional Comments

Paragraph 6 – recommend giving example or two (maybe in a footnote) where an item is measurable but still does not meet definition of an element and thus should be excluded.

Paragraphs 7 and 8 – the incorporation of the judgment concept as opposed to certainty and the concept of materiality and benefit versus cost are good ones.

We do not see the relevance of the entire section on “Entity Concept” in this ED. We suggest that paragraphs 10 to 16 be eliminated. The only value to be obtained from these paragraphs is that

the term “entity” includes individuals (paragraph 16), and if these paragraphs were to be eliminated, the definition of “entity” could easily be placed elsewhere in the ED.

Paragraph 36 – We recommend giving an example within this paragraph for the purpose of (1) clarity and (2) consistency with previous paragraphs where examples are provided for clarification. Such examples greatly enhance reader understandability. In addition, we suggest adding examples in paragraph 24, 29, 36 and 37 and throughout the Alternative View.

The Executive Summary is not consistent with the ED. For example, the ED does not refer to future benefits from assets. The ED also says that “measurement of an item would include an assessment of the probability of future flows of resources or services from an item”, we don’t think the ED has that requirement. In fact, such a statement in the ED is what the authors of the AV are seeking. The Exec Summary also says that the “Concepts Statement would (emphasis added) include a discussion of the effects of uncertainty...” It probably should say “Concepts Statement includes”

The ED seems to vacillate between discussing and defining “elements” or “items which make up a element” For example, paragraph 2 says “This Statement focuses on the broad classes (e.g., the elements) and their characteristics instead of defining particular assets, liabilities or other items” Paragraph 4 also relates recognition to “recording or incorporating an element into the financial statements” Then paragraph 5 goes on to discuss “recognition criteria are the conditions an item (emphasis added) should meet” The ED should be consistent in whether it is referring to an “element” or an “item.”

We are not sure that the example in paragraph 2 is relevant since the federal government does not claim that outer space is a federal asset.

Paragraph 28, we suggest that the sentence starting “In exercising control” should also include the concept that the federal government can fulfill its responsibilities to provide services to the public (as in free parks, museums, etc.)

We suggest that the word “obligation” not be used to describe a liability. While the ED tries to clarify that the word is not being used in its budgetary sense (footnote 6), there is a significant opportunity to misread the word “obligation” as a budgetary term. Perhaps the word “responsibility” can be used in lieu of “obligation”.

We are concerned with the definitions of revenues and expenses in that both exclude borrowing (receipts and repayments) in the respective definitions. The ED does not discuss why borrowing is excluded or how borrowing is to be treated. We assume that borrowing is excluded from the definitions of revenues and expenses since borrowing represents only changes in assets and liabilities. However, many other transactions represent changes in just assets and liabilities but those transactions are not excluded for the definition of revenues and expenses (for example, sale of an asset, paying invoices from a vendor (unless that is “borrowing”). More discussion of why borrowing is excluded may be appropriate.

We are also concerned about the definitions of revenues and expenses since it is unclear how accruals for things like bad debts will be handled. The definition of revenue is “an increase in assets, a decrease in liabilities or a combination of both from providing good and services, levying taxes or other impositions, receiving donations or any other activity performed during the

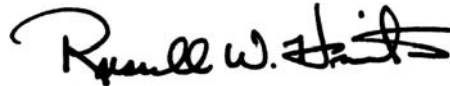
reporting period.” (The definition of expenses is similar.) However, an accrual for bad debts (for example) does not fall into any of these categories, unless that accrual is considered a valuation issue.

Paragraph 57 is unclear about its impact and effect.

The example in footnote 12 seems to be a contingent liability for which there are adequate standards and therefore does not require additional discussion in this ED.

No members of the FMSB objected to the issuance of this comment letter. We would be pleased to discuss this letter with you at your convenience. You can contact me at hintonrw@audits.state.ga.us or (404) 656-2174 or Anna D. Gowans Miller, CPA, AGA’s Technical Manager and facilitator for this project, at amiller@agacgfm.org or (703) 684-6931, ext. 313.

Sincerely,

A handwritten signature in black ink that reads "Russell W. Hinton". The signature is stylized with a large, sweeping initial "R" and a long horizontal stroke at the end.

Russell W. Hinton, CGFM, Chair,
AGA Financial Management Standards Board

cc. Jeffrey S. Hart, CGFM, CFE
AGA National President

**Association of Government Accountants
Financial Management Standards Board**

July 2006 – June 2007

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