



Federal Accounting Standards Advisory Board

December 2, 2004

TO: Members of FASAB
FROM: Penny Wardlow, Consultant
THROUGH: Wendy Comes, Executive Director
SUBJECT: Elements of the Financial Statements: Nonexchange Transactions

NOTE: FASAB staff prepares memos and other materials to facilitate discussion of issues at Board meetings. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

INTRODUCTION

At the December 2004 meeting, the Board will continue deliberations begun at previous meetings as to whether the essential characteristics of liabilities identified by the FASB in its Concepts Statement 6 for private-sector entities are also essential characteristics of federal liabilities, and/or whether federal liabilities have other essential characteristics. The characteristics of a liability identified by the FASB are (par. 36):

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

Topics Previously Discussed

Based on discussions at previous meetings, the FASAB members agree that a liability is an obligation of a specific federal entity to another (different) entity or entities and that

the obligation exists as a result of a past event. In that sense, the obligation is a “present” one, or an existing one, at the time an assessment of its existence is made.

Members also agree that the federal government may have a liability for goods and services, not just for financial obligations. However, they are concerned about adopting a definition of liability that might constitute a “slippery slope,” whereby general policy statements or ongoing activities of the government, such as the provision of defense or education, with no specific obligating event, could result in accounting liabilities.

Members agree that liabilities resulting from contracts and other *exchange transactions* are incurred when the exchange occurs. In contrast, members have not reached consensus on when liabilities resulting from *nonexchange transactions* are incurred. Some believe that an entity has no liability in a nonexchange transaction until settlement is due. Others believe that a liability could be incurred earlier, for at least some kinds of nonexchange transactions. However, they are not sure what kinds of events (“obligating events”) would give rise to a liability before settlement became due.

Members also have discussed whether the government is liable only for legally-based obligations (contracts, constitutional or statutory requirements) or whether constructive obligations also can give rise to liabilities. A majority of the Board accept, at least tentatively, that accounting liabilities are not limited to legally-based obligations. However, they would like to consider a definition of constructive obligations that would be narrower or more specific than the FASB’s use of the term in Concepts Statement 6 or the definitions used by some other standard-setting bodies.

December Meeting Focus

As the above summary suggests, there continues to be a range of topics that the Board would like to discuss further as part of its consideration of the essential characteristics of a federal liability. The focus of this paper is on nonexchange transactions and the kinds of obligating events, other than the due date for settlement, that give rise to a liability and an expense, according to various standard-setting authorities. The discussion may assist the FASAB in determining (a) the kinds of obligating events in nonexchange transactions that give rise to federal liabilities (regardless for the moment of whether those liabilities should be recognized or disclosed in the financial statements) and (b) whether the classification of a transaction as exchange or nonexchange is an essential characteristic of a liability. If such classification is an essential characteristic, then it should affect the definition of a liability. But if not, the FASAB should adopt the same definition of a liability for all transactions.

NONEXCHANGE TRANSACTIONS

The various accounting pronouncements or proposals discussed in this section are standards or proposed standards for nonexchange transactions, not concepts statements. As standards, they all address the point at which elements of the financial statements should be *recognized* in the financial statements on the accrual basis of accounting. In

contrast, in its Elements project, the FASAB is currently deliberating when the federal government *incurs* a liability, not when (or whether) it should be recognized or disclosed.

The distinction is important because (a) the definitions of elements adopted in existing concepts statements of standard-setting authorities do not distinguish between exchange and nonexchange transactions (e.g., the definition of a liability is the same regardless of whether the transaction is exchange or nonexchange) and (b) the decision to recognize an element involves considerations beyond whether the item meets the definition of that element, including issues of probability, measurability, and materiality. Under the current plan, the FASAB will consider recognition criteria after it has reached agreement on the essential characteristics of the elements of the financial statements and definitions based on those characteristics.

FASAB Statement No. 5

In SFFAS 5,¹ the Board defines a nonexchange transaction as one that “arises when one party to the transaction receives value without directly giving or promising value in return. There is a one-way flow of resources or promises” (par. 24). Paragraph 25 cites “many grants and certain entitlement programs” as examples of nonexchange transactions. Statement 5 requires that “[for] federal nonexchange transactions, a liability should be recognized for any unpaid amounts due as of the reporting date” (par. 24).

Statement 5 does not distinguish between meeting the definition of a liability (concept) and stipulations for recognizing liabilities in the financial statements (standards). The Board defines a liability in paragraph 19 as “a probable future outflow or other sacrifice of resources as a result of past transactions or events.” The same paragraph includes recognition requirements for four types of transactions or events: past exchange transactions, government-related events, government-acknowledged events, and nonexchange transactions.²

Consistent with its definition of a liability, the Board states that, for the first three types, “[g]eneral purpose federal financial reports should recognize [as liabilities] probable and measurable future outflows or other sacrifices of resources arising from” those transactions or events. However, for the fourth type—nonexchange transactions—the assessment that there is a “probable future outflow or other sacrifice of resources” is not sufficient to recognize a liability; recognition is required only for amounts that “according to current law and applicable policy, are unpaid amounts due as of the reporting date.” Effectively, the definition of a liability is not needed for nonexchange transactions. If a preparer determines that a transaction is not an exchange, he or she

¹ Statement of Federal Financial Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government*, issued December 20, 1995, effective for fiscal years beginning after September 30, 1996.

² Per SFFAS 5, “*Government-related events* are nontransaction-based events that involve interaction between the federal government and its environment.” Examples include cleanup of hazardous waste resulting from federal operations and damage to private property caused by federal entities. *Government-acknowledged events* are defined as “those nontransaction-based events that are of financial consequence to the federal government because it chooses to respond to the event.” Examples include toxic waste damage caused by nonfederal entities and natural disasters. [SFFAS 5, pars. 27, 28, 30, and 31]

need only look at whether there are amounts due and payable at the reporting date; he or she need not consider whether there are probable and measurable future outflows other than those amounts.

Based on the explanations provided in the text and basis for conclusions to Statement 5, the Board appears to base its recognition requirements for both exchange and nonexchange transactions primarily on whether and, if so, when there is an enforceable legal claim against the government.³ As previously noted, SSFAS 5 does not distinguish between definition and recognition and does not address whether the government may have incurred a liability that does not meet recognition criteria. The implication is that there is no liability unless there is an enforceable legal claim.⁴

Thus, in the Basis for Conclusions the Board states that:

129. Obligations become legally enforceable claims against the federal government in different ways and at different points within transaction cycles that relate to various programs. An important factor in distinguishing between various programs is whether an exchange is involved. For example, the federal government may not contract for and receive goods or services and then arbitrarily decide not to honor the contract. Similarly, under existing law, the federal government may be financially responsible for certain damage and injury it causes.
130. In other cases, the obligation may be more a matter of what is perceived as equitable and good public policy than a legally enforceable claim. Although there may be a high probability that a grant, a subsidy, or an income transfer will be made or will continue in future years, the recipients of such grants, subsidies, or transfers do not have a right to receive such payments in the future from the federal government as do those who receive payments in exchange for service they have performed.

Paragraph 131 acknowledges that future amounts may be estimated and should be disclosed because of their relevance to certain decisions. However, “in the context of the Board’s definition . . . estimates of future nonexchange payments should not be recognized as a current period liability. On the other hand, any payments due as a result of past events but unpaid at the end of the period constitute a liability.”

³ There may have been other considerations as well, including the issue of when costs should be assigned to accounting periods. Also, as indicated below, the Board was willing to make exceptions for transactions involving employee benefits.

⁴ At the October 2004 meeting, Board members were reluctant to include a notion of legal enforceability as an essential characteristic of a liability. Several members, however, were interested in a notion of “legally based” obligations. Staff believes that the references to legally enforceable obligations in SFFAS 5 could be read as “legally based” obligations without changing the intent of the Board at that time.

The Board, in SFFAS 5, does make some exceptions to the requirement that recognized liabilities be legally enforceable, most notably, liabilities for employee benefits. The reason appears to be the belief that the exchange transaction involves a promise of benefits for employee services, and the cost of those benefits should, therefore, be assigned to each period of service. However, the Board makes reference also to the high probability of payment, thereby relying on the Board's earlier definition of a liability for guidance, rather than on the notion of legal enforceability. The issues are discussed as follows:

132. In the case of federal liabilities, some future outflows of resources are so likely that they should be recognized as accounting liabilities in general purpose federal financial reports before all the other events necessary to create a legally enforceable claim against the government exists.⁵ Two important examples of such substantive accounting liabilities are the pensions and retirement health care promised federal workers in return for their service.
133. An exchange can in substance be said to have occurred in such cases, even if the government has not yet made an outlay of cash or other financial resources. Service has been exchanged for a promise of future payment or health care. Such charges are properly assignable to the current period in financial reports. This exchange implies, for example, that general purpose federal financial reports should recognize the financial effects of the promise to provide health care to retired federal workers as that obligation accrues during their years of service, regardless of whether the budget includes a provision for this item. This is true even though unfunded liabilities of the federal government reported on the financial statements cannot be liquidated without the enactment of an appropriation. Also, as a sovereign entity, the payment of all liabilities other than for contracts can be abrogated by the federal government.

It would appear that, if an exception to a requirement for a legal basis for liabilities can be made for some transactions, it also could be made for others, especially when the reasons given for the exceptions are the existence of a high probability of future cash outlays and a desire to associate accrual-basis expenses with the appropriate period. Those considerations also may apply to many nonexchange transactions. It therefore seems inadequate simply to invoke the classification of a transaction as "not an exchange" to justify a conclusion that no cost or liability is incurred before settlement is due. One would need to go further and explain what characteristics support a conclusion that the only costs incurred in the period of the transaction are those corresponding to payments due in the same period. It also would be appropriate to examine whether those characteristics are common to all kinds of nonexchange transactions or only to some kinds.

⁵ Footnote 64 to this paragraph reads: "Notwithstanding an expectation that the appropriations will be made, whether they in fact will be made is completely at the discretion of the Congress."

FASB Statement No. 116

The FASB uses the term *nonreciprocal transfer* with essentially the same meaning as the FASAB's use of the term *nonexchange transaction*. In Statement 116,⁶ the FASB defines a nonreciprocal transfer as “[a] transaction in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange” (par. 209)

Statement 116 does not address exchange transactions, but it does include voluntary transactions that involve unequal exchanges as well as those that have no elements of an exchange. Involuntary nonreciprocal transfers, such as corporate taxes, are not within the scope of the Statement.

Four additional terms are important to understanding the FASB's position on contributions and when they should be recognized in the financial statements: *contributions*, *promises to give*, *donor-imposed conditions*, and *donor-imposed restrictions*:

5. A contribution is an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer to another entity acting other than as an owner. Other assets include securities, land, buildings, use of facilities or utilities, materials and supplies, intangible assets, services, and unconditional promises to give those items in the future.
6. A promise to give is a written or oral agreement to contribute cash or other assets to another entity. . . .
7. A donor-imposed *condition* on a transfer of assets or a promise to give specifies a future and uncertain event whose occurrence or failure to occur gives the promisor a right of return of the assets transferred or releases the promisor from its obligation to transfer assets promised. In contrast, a donor-imposed *restriction* limits the use of contributed assets; it specifies a use that is more specific than broad limits resulting from the nature of the organization, the environment in which it operates, and the purposes specified in its articles of incorporation or bylaws or comparable documents for an unincorporated association. [Italics added for emphasis]

Statement 116 requires that contributions made

. . . shall be recognized as expenses in the period made and as decreases of assets or increases of liabilities depending on the form of the benefits

⁶ FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, issued June 1993, effective for fiscal years beginning after December 15, 1994.

given. For example, gifts of items from inventory held for sale are recognized as decreases of inventory and contribution expenses, and unconditional promises to give cash are recognized as payables and contribution expenses. . .” (par. 18)

However, for promises to give to be recognized in the financial statements, there must be “sufficient evidence in the form of verifiable documentation that a promise was made and received.” When a communication does not indicate clearly whether it is a promise, it is “considered an unconditional promise to give if it indicates an unconditional intention to give that is legally enforceable” (par.6).

A federal government announcement of its intent to provide particular benefits would seem to be conceptually similar to a promise to give. The FASAB may wish to consider bounds similar to those established by the FASB; namely, that there be verifiable documentation of the issuance and receipt of the relevant communication, in those instances where the commitment is not included in a statute or otherwise legally based.

Statement 116 defines conditional promises to give as those “which depend on the occurrence of a specified future and uncertain event to bind the promisor” (par. 22). They should be recognized when the conditions are substantially met (i.e., the promise becomes unconditional).

The Statement also indicates that “a conditional promise to give is considered unconditional if the possibility that the condition will not be met is remote” (par. 22). The FASB gives the example of a stipulation that the donee must provide an annual report to receive subsequent annual payments on a multiyear promise to give. In other words, because the possibility that the donee will not comply with the condition is remote, the liability would encompass amounts promised for future years, as well as the amount promised for the current year.

Again, the FASAB may wish to consider whether there is a parallel concept here for multiyear programs that have certain eligibility requirements beyond those initially required. For some of those requirements, the possibility that they would not be met might be remote, so that an expense and a liability would be incurred upon satisfaction of the initial eligibility requirements. In contrast, satisfaction of other requirements to renew eligibility might be more problematic, suggesting that the expense and liability be limited to the amounts payable for the first year of eligibility.

These possibilities would need to be explored with particular federal programs in mind as examples. However, the point to be made here is that not all nonexchange transactions are alike, and for some kinds of transactions an expense and a liability may be incurred a year or more before the amounts arising from the transaction are due for settlement.

GASB Statement No. 33

GASB Statement No. 33⁷ was developed in anticipation of a new financial reporting model (GASB Statement No. 34⁸) that would require accrual-basis financial reporting in government-wide statements for all activities of state and local governments. Although guidance was already available from the GASB and other sources for recognizing and reporting *exchange* transactions on an accrual basis, practically no guidance existed for accrual-basis recognition of *nonexchange* transactions, especially for key government revenues, such as taxes and grants. Before Statement 33 became effective, most nonexchange transactions of state and local governments were commonly recognized on a cash or near-cash basis. This continues to be the case for reporting in the governmental funds. However, Statement 34 requires accrual-basis recognition in the government-wide statements.

In Statement 33, the GASB divides accounting transactions of state and local governments into two major groups (par. 1, emphasis added):

. . . (a) *exchange* and *exchange-like* transactions, in which each party receives and gives up essentially equal values, and (b) *nonexchange* transactions, in which a government gives (or receives) value without directly receiving (or giving) equal value in exchange.

A footnote to paragraph 1 explains that

The difference between exchange and exchange-like transactions is a matter of degree. In contrast to a “pure” exchange transaction, an exchange-like transaction is one in which the values exchanged, though related, may not be quite equal or in which the direct benefits may not be exclusively for the parties to the transaction. Nevertheless, the exchange characteristics of the transaction are strong enough to justify treating the transaction as an exchange for accounting recognition.

Thus, exchange-like transactions are excluded from the scope of Statement 33. An example of an exchange-like transaction is given in Appendix D to Statement 33: A city gives land valued at \$10 million to a developer to construct an industrial park. The developer installs roads, sewers, and other infrastructure at its own expense. When the industrial park is completed, the developer gives the infrastructure (excluding the land), which has an approximate total cost of \$9.5 million, to the city. This transaction should be treated as an exchange transaction; the city should recognize assets and revenue when the exchange of infrastructure for land occurs.

⁷ GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, issued December 1998, effective for periods beginning after June 15, 2000.

⁸ GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, issued June 1999, effective for periods beginning after June 15, 2001, 2002, or 2003, depending on a government’s total annual revenues.

The philosophy underlying Statement 33 is that the recognition of transactions should be based on their principal characteristics, rather than on what the transaction is commonly called, because terms such as “tax” and “grant” are used for a range of transactions with varying characteristics. For example, the term *tax* is used for transactions that are exchanges (e.g., franchise taxes) as well as for those that are nonexchanges (e.g., sales and income taxes). Similarly, some grants are exchange or exchange-like transactions—for example, research grants where the grantee retains rights to patent or otherwise obtain exclusive benefits from resulting products for at least a period of time.

Also, many transactions that governments have commonly considered to be nonexchange transactions (and previously recognized on a cash basis) have elements of an exchange, even if they are not pure exchanges. For example, fees for all regulatory and professional licenses and permits used to be considered nonexchange transactions and accounted for on a cash basis. While some licenses and permits may not be exchanges, the GASB indicates that drivers’ licenses and business permits should generally be accounted for as exchange or exchange-like transactions because the cost of a license or permit generally does not exceed the value of the services and rights received in exchange (the cost of processing the license or permit and the value of the right to drive on public roads or conduct business).⁹

In examining the characteristics of a wide variety of transactions in which state and local governments engage, the GASB concluded that transactions vary along a continuum, from pure exchange to pure nonexchange. Because accrual-basis recognition principles for exchange transactions are well established, the Board sought to use the concept of an exchange to establish recognition criteria for as many kinds of transactions as possible. This approach reduced the number of different kinds of transactions for which the Board would need to determine the obligating event without the aid of exchange concepts. As already noted, exchange-like transactions are technically nonexchange transactions but, in the GASB’s view, have sufficient elements of an exchange that exchange-based recognition criteria can be applied to them without undermining the reliability (representational faithfulness) of the reporting.

The GASB grouped all nonexchange transactions (other than exchange-like transactions) into four classes, based on characteristics shared by each class that affect the timing of recognition (par. 7):

1. *Derived tax revenues*, which result from assessments imposed on exchange transactions (for example, income taxes, sales taxes, and other assessments on earnings or consumption)
2. *Imposed nonexchange revenues*, which result from assessments imposed on nongovernmental entities, including individuals, other than assessments on exchange transactions (for example, property taxes and fines)

⁹ GASB Implementation Guide. *Guide to Implementation of GASB Statement 34 and Related Pronouncements; Questions and Answers*, 2001. Question 150.

3. *Government-mandated nonexchange transactions*, which occur when a government at one level provides resources to a government at another level and requires the recipient to use the resources for a specific purpose (for example, federal programs that state or local governments are mandated to perform)
4. *Voluntary nonexchange transactions*, which result from legislative or contractual agreements, other than exchanges, entered into willingly by the parties to the agreement (for example, certain grants and private donations).

For derived tax revenues, the GASB determined that the appropriate point at which to recognize assets and revenues is when the exchange on which the tax is levied occurs. For the other three classes, the Board applied concepts of legal enforceability and satisfaction of eligibility requirements. For example, a government should recognize *assets* for property taxes (imposed tax revenues), when it has an enforceable legal claim, as specified in enabling legislation (e.g., on the lien date or assessment date). A government should recognize *revenue* from property taxes in the year *for which the taxes were levied*, because the tax is levied to finance that year's expenditures. This approach matches property tax revenues and the expenditures financed from those revenues to the same accounting period.

Of the remaining two classes of nonexchange transactions (government-mandated and voluntary), voluntary nonexchange transactions are the more similar to federal transactions that could give rise to an expense and a liability. However, both classes of transactions have the same recognition standard: assets or liabilities and revenues or expenses should be recognized in the period when all applicable eligibility requirements have been met.

The GASB's notion of *eligibility requirements* is broader than simply a potential recipient's conformity to certain characteristics. Eligibility requirements are similar in concept to *conditions* in FASB Statement 116, in that they must be met before a transaction can be recognized. (Resources provided in advance would be recognized as assets by the provider entity and as liabilities by the recipient until the conditions were met.)

Eligibility requirements in GASB Statement 33 comprise the following (par. 20):

- a. *Required characteristics of recipients*. The recipient (and secondary recipients, if applicable) has the characteristics specified by the provider. (For example, under a certain federal program, recipients are required to be states and secondary recipients are required to be school districts.)
- b. *Time requirements*. Time requirements specified by enabling legislation or the provider have been met. (The period when

the resources are required to be used [sold, disbursed, or consumed] or when use is first permitted has begun, or the resources are being maintained intact, as specified by the provider.)¹⁰

- c. *Reimbursements*. The provider offers resources on a reimbursement (“expenditure-driven”) basis and the recipient has incurred allowable costs under the applicable program.
- d. *Contingencies* (applies only to voluntary nonexchange transactions). The provider’s offer of resources is contingent upon a specified action of the recipient and that action has occurred. (For example, the recipient is required to raise a specific amount of resources from third parties or to dedicate its own resources for a specified purpose and has complied with those requirements.)

As previously noted, eligibility requirements must be met before a voluntary nonexchange transaction can be recognized. In other words, and in the context of the FASAB’s current discussion of “obligating events,” meeting all applicable eligibility requirements is the obligating event that triggers recognition of an expense and a liability by the provider (and an asset and a revenue by the recipient, assuming Statement 33 applies to both parties).

The eligibility requirements are often “legally based” (e.g., established in enabling legislation or otherwise legally enforceable). Time requirements may be of particular interest to those concerned about appropriately matching expenses and revenues of particular periods, because the objective of time requirements is to assure that revenues and expenses are recognized in the periods stipulated in legislation (or by a private donor, if applicable). Often, the intent of such stipulations is to “match” certain revenues to expenditures of particular periods. For example, state governments often stipulate the fiscal year when the funding they provide to school districts may or must be used. If so, then under Statement 33, the school districts cannot recognize revenues until the stipulated year begins, even if the funds are provided to them earlier.

Time requirements, thus, differ from restrictions on asset use. Time requirements refer to *when* (which period) the assets must be used or when use can begin. Restrictions affect how the resulting assets or net assets are displayed in the financial statements; they do *not* affect the timing of recognition in the financial statements.¹¹ In contrast, conditions (for FASB) and eligibility requirements, including time requirements, (for GASB) affect recognition; there is no transaction to recognize until the conditions or eligibility

¹⁰ The reference to maintaining resources intact applies to permanent endowments and term endowments.

¹¹ Both the FASB and the GASB have rejected the notion (prevalent at one time in both state and local government and not-for-profit accounting) that when there is a purpose restriction, the recipient should defer recognition of a revenue (and the provider of an expense) until the resources are expended for the intended purpose. Instead, the existence of restrictions is reported through display.

requirements are met. (For resources provided in advance, the provider reports an asset and the recipient reports a liability until the conditions are met.)

Staff believes that that conditions or eligibility requirements (in the GASB's use of the term) are useful concepts for the FASAB to consider in establishing a framework for identifying obligating events that give rise to federal liabilities and expenses. The following excerpts from the Basis for Conclusions to FASB Statement 116 expand on the effects of conditions on the timing of recognition and may contribute to the FASAB's discussion of potential obligating events. The excerpts focus on uncertainty, and they include references to the essential characteristics of assets and liabilities per FASB Concepts Statement 6 as well as to the concept of constructive obligations.

76. Uncertainty is inherent in a transfer of assets with a conditional promise to contribute those assets. Until the specified condition occurs, it is uncertain whether the transfer will become a right to retain those assets or an obligation to relinquish them. Several factors affect whether a condition will be met. They include whether the condition of the promise is an event outside the organization's control and whether work necessary to meet the condition requires additional funding from other sources. These factors make it difficult to determine reliably when, if at all, the conditional promise will become a right giving the promisee sufficient control of the promised asset and a duty making the promisor unable to avoid future sacrifice.

77. Uncertainties about meeting a condition typically diminish over time. Makers of conditional promises generally can avoid a future sacrifice of assets if they provide promisees with timely notification of the cancellation of their conditional promise. However, as time passes that ability diminishes. Case law and public policy suggest that once a promisee has begun efforts in reliance on a conditional promise, both parties should be held to their promises. Promisors generally are not allowed to escape their promises until and unless a reasonable period of time has elapsed for the promisee to meet the condition, and promisees generally are held to their part of the agreement, which includes meeting the condition. However, until the specified future and uncertain event that is the subject of the condition occurs or fails to occur, a promisee does not have an unconditional right to retain the assets transferred or to demand payments.

IFAC-PSC, Invitation to Comment—Nonexchange Revenues

The IFAC-PSC's Invitation to Comment (ITC) on Nonexchange Revenues¹² proposes recognition and measurement standards for nonexchange revenues (taxes) and for what

¹² International Federation of Accountants, Public Sector Committee, Invitation to Comment, *Revenue from Non-Exchange Transactions (Including Taxes and Transfers)*, issued January 2004.

the PSC refers to as “transfers”—appropriations, grants, goods and services, debt-forgiveness, gifts and donations, and fines. Of most relevance to the issues discussed in this paper are the proposals for transfers and what can be inferred from them with respect to obligating events for the incurrence of liabilities and expenses.

Key definitions proposed in the ITC are as follows (pp. 11 and 12):

An exchange transaction is one in which one entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of cash, goods, services, or use of assets) to another entity in exchange.

A non-exchange transaction is a transaction that is not an exchange transaction. In a non-exchange transaction, an entity either receives value from another entity without directly giving approximately equal value in exchange or gives value to another entity without directly receiving approximately equal value in exchange.

Stipulations are terms imposed upon the use of transferred assets by entities external to the entity.

Restrictions are stipulations that limit or direct the purposes for which transferred assets may be used, but do not specify that the assets must be returned to the contributor if not deployed as specified.

Conditions are stipulations that specify that transferred assets must be returned to the contributor if not deployed as specified, or if a specified future event occurs or does not occur.

Time requirements are stipulations that prohibit the use of transferred assets until a specified point in time.

Control of an asset arises when the entity can use or otherwise benefit from the asset in pursuit of its objectives and can exclude or regulate the access of others to that benefit.

Also, the PSC uses the definitions of assets, liabilities, and revenue established in the PSC’s existing standards (IPSASs):

Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

Revenue is the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners.

Note that the PSC's proposed definition of *stipulations* is similar to the FASB's and the GASB's concept of *restrictions* on the *use* of resources; they are limitations placed on resources by parties *external* to the entity. For the FASB, however, restrictions also may include specifications about *when* resources can be used. In contrast, and similar to the GASB, the PSC proposes the notion of *time requirements* to denote stipulations about when a resource may be used. Finally, the term *conditions* has a similar meaning to the same term used by the FASB and to the GASB's use of the term *eligibility requirements*.

For both transfers and tax revenues, the PSC proposes the general principle that inflows of resources (1) be recognized as assets when they meet the definition of an asset and (2) be recognized as revenues at the same time unless certain stipulations (conditions) have not been met, in which case the recipient entity should recognize a liability.

Tax Revenues

The PSC proposes (par. 3.6) that taxes should be recognized as assets and revenues when the *taxable event* occurs. "The taxable event is the past event that the government, legislature, or other authority has determined will be subject to taxation." Resources must also meet the criteria for recognition as an asset; control of assets arising from taxation transactions occurs when the taxable event occurs. The PSC proposes that, unless otherwise specified in legislation, the taxable event is the following for the taxes indicated (par. 6):

- (a) income taxes—the earning of assessable income during the taxation period by the taxpayer;
- (b) value added taxes—the undertaking of taxable activity during the taxation period by the taxpayer;
- (c) good and services—the purchase or sale of taxable goods and services during the taxation period;
- (d) customs duties—the movement of dutiable goods or services across the customs boundary;
- (e) death duties—the death of a person owning taxable property;
- (f) property taxes—the passing of the date on which taxes are levied, or the period for which the tax is levied if the tax is levied on a periodic basis.

Note that proposals (a) and (c) are similar to the GASB's requirements in Statement 33 for derived tax revenues, and item (f) is similar to the GASB's requirements for property taxes, assuming that the levy occurs in the period that the property tax is intended to finance. If not, GASB Statement 33 requires different recognition points for property taxes receivable (levy or assessment date—the date that gives rise to an enforceable legal claim against the taxpayer) and property tax revenues (recognize in the year for which the tax was levied).

The PSC notes (par. 3.17) that taxes do not result in a liability of the government to provide goods and services directly to the taxpayer in exchange for the resources. Therefore, "governments will not incur present obligations to taxpayers as a consequence of taxpayers paying taxes," except for: (1) liabilities for refunds of overpaid taxes (par. 3.18) and (2) liabilities for prepaid taxes until the revenue recognition criteria are met (par. 3.19).¹³

The PSC also addresses whether the "right to tax" is an intangible asset that should be recognized in the financial statements. The Committee states that the right to tax "cannot be recognized as an asset because it is not possible to establish the cost or fair value of the asset; therefore it fails the criteria for recognition as an asset" (par. 3.31). The PSC does not, however, state that the right to tax does not meet the definition of an asset; simply that it cannot be recognized as an asset.

Transfers

As previously noted, the PSC calls "transfers" all non-exchange transactions other than taxes—for example, appropriations and grants. The PSC notes that determining when a transfer results in an inflow of resources is "a matter of judgment based on the facts" (par. 4.24). For example, with some appropriations, the recipient has the right to receive the appropriated resources, whereas with others, the appropriation confers only the right to expend resources up to the limit of the appropriation, so that the inflow of resources to the entity does not occur until the entity expends the resources. Although the "contributor" side of the transaction is not the subject of the ITC, it would seem logical for the second kind of appropriation that, if the recipient does not have an asset and a revenue until it expends the resources, the contributor does not have an expense and a liability until the recipient demonstrates that it has expended resources consistent with the terms of the appropriation. If so, then the "obligating event" would be the expenditure of resources for the intended purposes.

The PSC notes that judgment also is required to assess the effect of stipulations on an entity's ability to control an asset and, therefore, on when the definition of an asset is met (PSC View 11, page 45). For example, whereas, for most grants, agreement by the parties to the terms of the grant is the past event that gives rise to the recipient's control of an asset, in some cases there may be stipulations in the agreement that "may limit the

¹³ The ITC on Nonexchange Revenues does not include social benefits in its scope. Social benefits are covered in a companion ITC, discussed in the next subsection of this paper.

recipient's ability to recognize assets, and/or may require the recipient to recognize liabilities in respect of the grant" (par. 4.25). Also:

In many cases, laws or transfer agreements will not give the recipient control over assets until the receipt of cash or another asset. These types of laws and agreements often specify that the recipient must meet eligibility criteria, that is, satisfy certain stipulations, before assets will be transferred. In such circumstances the recipient reporting entity will analyze the agreement in light of the proposals on stipulations in this chapter [PSC View 11, cited above] to determine when a net increase in assets and revenue are to be recognized (par. 4.26).

Again, the contributor side is not directly addressed, but it would seem that the contributor would not have an expense and a liability until the recipient had satisfied the eligibility criteria included in the terms of the grant.

IFAC-PSC, Invitation to Comment—Social Policy Obligations

Although some inferences can be drawn from the IFAC- PSC's ITC on Nonexchange Revenues about when governments incur expenses and liabilities in certain nonexchange transactions, the IFAC-PSC's ITC on Social Policy Obligations¹⁴ addresses the topic more directly and more completely. The ITC builds on the requirements of IPSAS 19,¹⁵ which addresses recognition criteria for provisions, contingent liabilities, and contingent assets, but excludes certain transactions. Among the exclusions are nonexchange transactions through which a government provides "social benefits." IPSAS 19 does not define exchange or nonexchange transactions. The ITC on Social Policy Obligations uses the definition of nonexchange transactions proposed in the ITC on Nonexchange Revenues. (See previous subsection of this paper.)

The ITC on Social Policy Obligations indicates that readers should refer to IPSAS 19 for guidance on how to account for liabilities arising from nonexchange transactions other than social policy obligations. Generally, IPSAS 19 requires a provision (liability) to be recognized when three conditions are met (par. 22):

- (a) An entity has a present obligation (legal or constructive) as a result of a past event;

¹⁴ International Federation of Accountants, Public Sector Committee, Invitation to Comment, *Accounting for Social Policies of Governments*, issued January 2004.

¹⁵ International Federation of Accountants, Public Sector Committee, International Public Sector Accounting Standard No. 19, *Provisions, Contingent Liabilities and Contingent Assets*, published February 2003. IPSAS 19 is based in International Accounting Standard No. 37, *Provisions, Contingent Liabilities and Contingent Assets*, which is currently under review by the International Accounting Standards Board (ITC on Social Policy Obligations, par. 3.3).

- (b) It is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; and
- (c) A reliable estimate can be made of the amount of the obligation.

Note that these are conditions for *recognition* of a liability, and therefore go beyond what would be required to meet a *definition* of a liability. Assuming that a notion of probability is included in recognition or measurement criteria, rather than at the definition stage, then only condition (a) above should be met for an entity to conclude that it has a liability. However, condition (a) includes several notions. The following definition of a *past event that leads to a present obligation*, from IPSAS 19 (par. 25) is reproduced in the ITC on Social Policy Obligations (par. 3.6):

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity have no realistic alternative to settling the obligation created by the event. This is the case only:

- (a) where the settlement of the obligation can be enforced by law; or
- (b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

Thus, the proposal is that “no realistic alternative” is an essential characteristic of a liability, and the situation of the entity having “no realistic alternative” can result either from an enforceable legal requirement or from a constructive obligation, when the entity’s action or other event creates valid expectations in other parties that the entity will discharge the obligation.

Appendix C to IPSAS 19 provides some examples of applying to nonexchange transactions the above two conditions for obligating events and, where applicable, recognition criteria (b) and (c) (probability and reasonable estimate, respectively).

When reading the following examples, the FASAB members may wish to consider whether they would agree or disagree with the stated conclusions, if the circumstance applied to a federal entity, and what the principal reasons would be for their views.

Example 6: Legal Requirement to Fit Air Filters (pp. 637–638)

Under new legislation, a local government entity is required to fit new air filters to its public buildings by 30 June 2005. The entity has not fitted the air filters.

Analysis

(a) At the reporting date of 31 December 2004

Present obligation as a result of a past obligating event—There is no obligation because there is no obligating event either for the costs of fitting air filters or for fines under the legislation.

Conclusion—No provision is recognized for the cost of fitting the filters . . .

(b) At the reporting date of 31 December 2005

Present obligation as a result of a past obligating event—There is still no obligation for the costs of fitting air filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliance of the public buildings).

An outflow of resources embodying economic benefits or service potential in settlement—Assessment of probability of incurring fines and penalties for non-compliance depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion—No provision is recognized for the costs of fitting air filters. However, a provision is recognized for the best estimate of any fines and penalties that are more likely than not to be imposed . . .

Example 9: A Single Guarantee (p. 639)

During 2004, a provincial government gives a guarantee of certain borrowings of a private sector operator providing public services for a fee, whose financial condition at that time is sound. During 2005, the financial condition of the operator deteriorates and at 30 June 2005 the operator files for protection from its creditors.

Analysis

(a) At 31 December 2004

Present obligation as a result of a past obligating event—The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits or service potential in settlement—No outflow of benefits is probable at 31 December 2004.

Conclusion—No provision is recognized . . . The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote . . .

(b) At 31 December 2005

Present obligation as a result of a past obligating event—The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits or service potential in settlement—At 31 December 2005, it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation.

Conclusion—A provision is recognized for the best estimate of the obligation . . .

Example 11B: Refurbishment Costs—Legislative Requirement (p. 641)

A government cartography service is required by law to overhaul its aircraft used for aerial mapping once every three years.

Analysis

Present obligation as a result of a past obligating event—There is no present obligation.

Conclusion—No provision is recognized . . .

The costs of overhauling aircraft are not recognized as a provision . . . Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions—the entity could avoid the future expenditure by its future actions, for example by selling the aircraft.

PSC's Proposed Criteria for Incurrence of a Liability for a Social Policy Obligation

The PSC proposes several criteria that must be met for an entity to incur a liability for a social policy obligation, and an additional criterion that must be met for recognition to

occur. The following sequence is derived from the ITC on Social Policy Obligations, Figure 4.1, par. 4.1:

1. The past (obligating) event has occurred.
2. There is no realistic alternative to settling the obligation.
Therefore,
3. *A present obligation exists.*
4. Settlement of the obligation is expected to result in an outflow of resources embodying economic benefits or service potential.
Therefore,
5. *A liability has been incurred.*
6. The expected outflow is probable and measurable.
Therefore,
7. *The liability should be recognized in the financial statements.*

The PSC points out, in the ITC on Social Policy Obligations, that a “present obligation” (point 3. above) may be a legal obligation or a constructive obligation. A *legal obligation* is defined as one that derives from a contract (through its explicit or implicit terms), legislation, or other operation of law. A *constructive obligation* is one that derives from an entity’s actions where (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities. (IPSAS 19, par.18)

In its general discussion of obligations arising from past events, the PSC includes concepts of both legal enforceability and satisfaction of eligibility requirements. With respect to legal obligations, the PSC states (emphasis added):

4.15 Legal obligations are recognized when a present obligation *enforceable through the legal system or other binding process* arises, and the obligation meets the recognition criteria in relevant IPSASs. This is often the point at which the obligation is due to be paid but it may be earlier. Where a matter is subject to court judgment or other binding process and the outcome is certain, there may be a contingent liability rather than a liability.

4.16 In the context of a benefit provided by way of cash transfer where eligibility criteria are specified in legislation, a legal obligation arises *at the point that an individual satisfies all eligibility criteria, including the right to receive payment.** This would often be at the point that the benefit is due and payable but for certain benefits in some jurisdictions could occur at an earlier point.

*Footnote to par. 4.16: *Where benefits are not specified in legislation, benefits may still be legal obligations if an individual could take legal*

action to enforce payment of the benefit. An individual's right to take legal action will depend on the common law which has developed within a particular jurisdiction. For financial reporting purposes, the classification of an amount due and payable as a legal obligation or a constructive obligation is not significant. Both would normally meet the criteria for recognition in the financial statements.

In paragraph 4.17, the PSC indicates that the amount that is due and payable will depend on how the entitlement was expressed. Thus, it would be necessary to review relevant documentation to decide, for example, whether the amount should be restricted to the current year or should include payments in future years.

Arrangements can vary considerably between types of benefits and between jurisdictions. In each case, the entitlement criteria, approval processes, and details of any ongoing validation or review requirements need to be considered to establish when entitlement to a benefit commences and subsequently ceases. For example, individuals may be required to confirm eligibility for certain benefits at set intervals such as once a month or every six months. Depending on the nature of a benefit and the way in which a policy expresses entitlement, an individual may be entitled to a benefit on a day-to-day basis or for a set period.

The PSC also points out a relationship between meeting eligibility requirements and the ability to enforce performance of promised services.

4.17 Where eligibility criteria for entitlement to services are specified in legislation, an individual would not normally have a right to the service or be able to take action against the government to enforce performance of the service until the service was due to be provided. *The existence of a legal obligation would also depend on the likelihood of the individual receiving a favorable and enforceable judgment* in regards of their right to the service.

PSC Options

The PSC developed three options or approaches to the identification of the past event or events that give rise to a constructive obligation for benefits (goods, services, or cash) to be provided to individuals (e.g., persons, groups, entities) (pars. 4.32, 4.35, and 4.37).

Option 1 (satisfy all eligibility criteria)

In the absence of a legal obligation, a past event giving rise to a present obligation occurs when an individual satisfies all applicable eligibility criteria.

In the case of ongoing benefits which are subject to regular satisfaction of eligibility criteria, the maximum amount of the present obligation is the benefit that the individual is entitled to from the current point in time until the next point in time at which eligibility criteria must be satisfied.

Where validation of eligibility criteria is required only once, the present obligation is for all future benefits to be provided to that individual as a result of that validation.

Option 2 (satisfy threshold eligibility criteria)

In the absence of a legal obligation, a past event giving rise to a present obligation occurs when an individual meets the eligibility criteria for the first time (the threshold criteria). The present obligation is for all benefits to be provided to the individual in future periods regardless of whether the individual is required to satisfy eligibility criteria again in future periods.

Option 3 (key participatory events)

In the absence of a legal obligation, a past event, or series of past events, giving rise to a present obligation occurs prior to the point at which an individual meets threshold eligibility criteria (where threshold criteria are applicable).

The present obligation arises when key participatory events have occurred that lead an individual to have a reasonable expectation of eventually satisfying eligibility criteria for a benefit and, as a result, the individual has relied on that expectation over a period of time leaving the government with no realistic alternative but to settle the obligation in the future.

The present obligation is for all benefits to be provided to the individual in future periods regardless of whether the individual is required to satisfy eligibility criteria again in future periods.

The Board will note that similar to most of the other standards discussed earlier, the ITC contemplates different obligating events for different kinds of nonexchange transactions. Also similar to other standards, all three options use the notion of *eligibility criteria* (or conditions, as the term is used by the FASB), with some additional considerations, particularly in Option 3.

The PSC indicates that it is more difficult to determine the obligating events that give rise to constructive obligations than the obligating events that give rise to legal obligations. The PSC views the three options quoted above as “key points on a potentially wide spectrum” and believes that they “provide useful benchmarks against which to test the principles.” Clearly, these options may be useful to the FASAB’s discussion of potential

obligating events for federal liabilities and expenses and the FASAB has discussed and continues to discuss some of the possible events in the Social Insurance project.

Other options also may be useful for nonexchange transactions in general. Some of those options may depend on how “constructive obligation” is defined for federal reporting purposes. Therefore, staff believes that further examination of potential obligating events for nonexchange transactions should be deferred until the FASAB has agreed on a definition and criteria for constructive obligations in the federal environment. Staff anticipates a future paper on that issue.

SUMMARY AND STAFF RECOMMENDATIONS

The purpose of this paper is to assist the Board in determining (a) the kinds of obligating events in nonexchange transactions that give rise to federal liabilities (regardless for the moment of whether those liabilities should be recognized or disclosed in the financial statements) and (b) whether the classification of a transaction as exchange or nonexchange is an essential characteristic of a liability. If such classification is an essential characteristic, then it should affect the definition of a liability. But if not, the FASAB should adopt the same definition of a liability for all transactions.

In SFFAS 5, the Board essentially establishes that the obligating event for nonexchange transactions does not occur until settlement is due. Other standard setters, however, including the FASB, the GASB, and the IFAC-PSC, have established or proposed that liabilities and expenses from nonexchange transactions may be incurred before the due date for settlement. Generally, establishing possible obligating events appears to be less problematic if the definition of a liability only incorporates legal liabilities, i.e., those established by contract or legislation. However, the FASB and the IFAC-PSC also include constructive liabilities in their definitions of liability. The GASB so far has not formally defined liability, but in practice state and local governments apply a definition that is similar to the FASB’s definition.

Recommendation 1

The FASB, GASB, and IFAC-PSC all refer to two concepts to help determine obligating events for different classes of nonexchange transactions: *legal enforceability* and *satisfaction of conditions* (FASB term) or *eligibility requirements* (GASB and IFAC-PSC term). Staff recommends that the FASAB also consider these concepts as a way to develop some general criteria for determining when obligating events occur in nonexchange transactions.

To do this, it may be necessary to group federal nonexchange transactions in some manner, using characteristics that different groups may have in common, as other standard setters have done. Pursuing the two concepts of legal enforceability (or legal basis) and conditions or eligibility requirements should not preclude the identification of other useful concepts for determining obligating events in a federal environment.

Recommendation 2

For some nonexchange transactions, there may be no obligating event until settlement is due. However, staff does not believe that is an intrinsic characteristic of all nonexchange transactions. Further, staff believes that the mere fact that an exchange does or does not exist is not an essential characteristic that should affect how a federal liability is defined, any more than it affects how other authorities have defined a liability.

Staff recommends, therefore, that the Board continue to work towards a single definition of liability, regardless of whether a transaction is exchange or nonexchange. This will entail acknowledging that obligating events may occur prior to the date that settlement is due for nonexchange as well as exchange transactions.

Recommendation 3

Staff recommends that the Board continue to consider including constructive as well as legal obligations in the definition of a liability. Both terms need to be defined more precisely. If the Board agrees, staff will prepare a paper that proposes a definition of each term.

Following that, staff proposes to examine whether federal nonexchange transactions can usefully be grouped into classes so that obligating events can be proposed for each class. GASB Statement 33 and the IFAC-PSC's ITC on Social Policy Obligations are two examples of classification, but further consideration may suggest other possibilities.