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FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

FASAB NEWS

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COST OF CAPITAL PROJECT

The cost of capital task force delivered a draft discussion memorandum to the Board for the August meeting. Mr. Donald Chapin, General Accounting Office's Chief Accountant and chair of the task force, briefed the Board on the contents and the objectives of the DM. Ms. Justine Rodriguez, a task force member from OMB, also participated in the presentation and discussion.

Chapin noted that the task force did an excellent on the draft DM. While not all members of the task force agreed on all issues raised, they did agree that cost of capital was a cost incurred when entities use capital. Given that premise, the draft DM explores issues of entity level accounting for this cost through imputing interest expense on entity assets.

Mr. Chapin noted that this practice is used by private sector corporations with multiple operating units through internal managerial accounting. Operating units are often charged with interest expense on the capital employed in their operations. Because the charge is based on each unit's capital, it includes the unit's share of both equity and debt financing. These charges are eliminated for external consolidated financial reports.

Mr. Chapin believes that this concept could apply to Federal entities--that the interest charges could appear on entity operating statements and be eliminated for consolidated financial statement. Although the efits derived by the private sector relate to the profit objective, they remain relevant to government managers. The private sector benefits are two-fold. First, unit level managers are encouraged to manage their capital more effectively in order to optimize profits. Second, evaluations and comparisons between units and products is enhanced because unit operating results give weight to the relative capital employed in each.

In response to the draft DM and Mr. Chapin's comments, the Board generally supported the notion that cost of capital is an opportunity cost. In addition, several Board members believe that increasing awareness of this cost at an entity level could be beneficial. For example, one Board member suggested that revolving funds could be encouraged to manage inventories more efficiently if the interest cost were explicit. They also suggested that if a method is developed to impute interest expense it should not be too complex--otherwise it would not be practical to implement.

However, with regard to the task force's draft DM Board members believed that it was not sufficiently neutral on the issues to be considered a DM. They noted that DMs typically present both viewpoints on an issue and solicit comments. Mr. Chapin agreed that, due to his own and other task force members' strong views on the issue, the draft DM favored imputing interest expense atthe entity level. The consensus of the Board was to solicit comments on the issues since these comments would be of use to the property, plant and equipment project. They asked that the document be revised to present a balanced view of the issues as well as ensuring that the document did not imply that the Board favored the methods described therein.

Further, the Board members asked that this document be titled "An Invitation for Views" rather than a discussion memorandum. Mr. Chapin agreed that these changes would be made and the document returned to the Board for approval in September.

CAPITAL EXPENDITURE PROJECT

PROPERTY, PLANT AND EQUIPMENT: CLEANUP COST

At its August meeting, the Board discussed issues associated with cleanup costs for the property, plant and equipment (PP&E) exposure draft (ED). These issues were identified at the July meeting and include (1) the appropriate term and definition for cleanup costs, (2) recognition of changes in estimated total cleanup costs, and (3) reporting on cleanup costs associated with stewardship assets.

The Board concluded that the term "cleanup cost" was the most communicative of the alternatives presented. In addition, the members reviewed and approved a definition and scope statement for the proposed standard.

For changes in total estimated cleanup costs, the Board concluded that, if material in amount, separate line items should show (1) the current period allocation of total estimated cleanup costs based on the new estimate and (2) the adjustment to the liability balance for changes associated with prior periods.

The Board discussed treatment of cleanup costs associated with stewardship assets, such as nuclear submarines, extensively. Stewardship assets would not be reported on the balance sheet and depreciation expense would not be reported on these assets--the acquisition cost would be reported as an expense when the assets were acquired. Hence, some Board members questioned whether it would be consistent to (1) report an associated liability on the balance sheet when the asset would be on a separate report, and (2) allocate cleanup costs on a period-by-period basis absent similar treatment of the acquisition cost of the asset through depreciation--which is the treatment agreed on for cleanup costs associated with balance sheet assets. They argued that if one is not interested in the periodic capital cost of stewardship assets then one would not be interested in period-by-period allocations of cleanup cost.

The Board discussed the following options for stewardship assets:

-recognizing the cleanup cost and recording a liability at the time the asset is placed in service,

-not recognizing cleanup cost and the liability until the cleanup begins, and

-reporting the cleanup cost liability on the stewardship statement with the asset when the asset is placed in service.

The Board consensus was that the liability should be on the balance sheet and that, since the cost of the stewardship asset would be recognized when acquired, the total cleanup cost should be recognized when the asset is placed in service. However, given the diversity of opinion on this issue, the Board asked that specific questions be raised in the ED regarding other options.

REVENUE DISCUSSION

Donald Chapin, chairman of the FASAB's task force on revenue and other financing sources, led the Board's discussion of this project at the August meeting. The Board last discussed issues regarding revenue and other financing Sources in April. It decided then, in general terms, how to accrue tax revenue. Since then the Task Force has worked on implementing that decision and on related matters.

For example, the Task Force has worked with Tom Luter of the Treasury Department on how to implement the reporting ideas implied by the basic principles implicit in the Board's decisions. These principles include the distinction between exchange (earned) revenue and nonexchange (demanded) revenue and the focus on the net cost of operations. One of the group's goals has been to avoid major disruption to the Standard General Ledger. The exchange revenue section of the working draft Exposure Draft (ED) is largely complete and will be presented to the Board in September. In October more material on the implied framework for reporting will be presented. In November the Board is expected to review a draft of the entire Exposure Draft for issuance.

At the August meeting the Board addressed three major issues related to nonexchange revenues and other financing sources (all decisions are tentative, pending final approval of an Exposure Draft):

1. **Accrual of tax revenue and other nonexchange revenue:** The Board affirmed the basic provisions of the working draft, which were based on the Board's April decisions. These call for recognizing cash received in payment of taxes as revenue, plus (or minus) an accrual adjustment to reflect the change in accounts receivable. In the case of taxes, this effectively means assessments receivable. "Assessments" in this context include assessments by the taxpayer (e.g., filing a tax return) and assessments made by the government as a result of a formal determination of amounts due (e.g., an audit and subsequent demandfor payment). Some Board Members regard this as a full accrual, others regard it as a limited accrual that needs to be enhanced in the future. Accordingly, the ED will refer to the standard as an accrual standard, yet recognize that further accrual might be an option in the future.

2. **Disclosures and RSI for collecting entities:** The working draft included an extensive list of proposed disclosures to be made by agencies like IRS and Customs that are responsible for collecting nonexchange revenue. Some Board Members said that the list was too detailed and prescriptive. It will be revised accordingly.

3. **Supplemental information about unrecognized financing flows and potential financing flows of resources:**

3a. The **tax gap** is the estimated amount of revenue lost because taxpayers don't voluntarily pay amounts due under law. The working draft presented for the Board's consideration would have required supplemental information on estimates of tax revenue lost on illegal as well as legal income. Based on considerations of feasibility and benefit, the Board decided that the ED should not require reporting estimates of taxes lost on illegal income. It will, however, call for disclosure of IRS's best estimate of the tax gap on legal income.

3b. **Tax expenditures** are estimates of the revenue foregone because of preferential exemptions to the baseline provisions of the tax structure. The working draft presented for the Board's consideration would have required supplemental information about tax expenditures associated with specific federal programs. The draft noted that tax expenditures generally are intended to achieve public policy objectives and often are an alternative to direct expenditures to accomplish those objectives. It was from this perspective, for example, that the Washington Post observed in a recent editorial (9/6/94) that the exclusion of employer-paid health insurance premiums from taxable income "is viewed by many as the 'third largest federal health care program' (after Medicare and Medicaid) on the ground that the Treasury could take in more than $56 billion a year from taxing these benefits."

The Board decided not to require RSI on tax expenditures because the association with programs is not sufficiently clear in some cases, and because the information is available elsewhere now, e.g., in the Budget of the United States Government. Accordingly, disclosure of these estimates in general purpose federal financial reports would be voluntary both at the component entity and at the government-wide level. Mr. Chapin noted that the National Performance Review called for reporting such information:

"By 1997, we will require the Department of the Treasury to provide an audited consolidated annual report on federal finances--including tax expenditures, hidden subsidies, and hidden contingent liabilities such as trust funds and government-sponsored enterprises." -- NPR Summary Report, page 83.

3c. **Directed flows of resources** are flows of resources between nonfederal entities that are directed by federal regulations. In these cases the federal government imposes costs on nonfederal entities to accomplish missions defined by the federal government. As with tax expenditures, these can be an alternative to direct federal taxes and expenditures to accomplish a given objective. Thus, they can be regarded as a way of financing federal programs.

The working draft had proposed requiring supplemental information on the cost of economically significant regulations because their effects are similar to the effects of direct federal expenditures and revenue. An Executive Order currently requires federal agencies to estimate the cost of new regulations that have an expected cost over $100 million. The Board decided not to require RSI on directed flows at this time because some of this information is not available now and would not be available to preparers of financial reports without added expense. What is more, the estimates in some cases would be very imprecise, as is evidenced by the experience of the Congressional Budget Office, which is often called upon to make such estimates. Also, it was noted that the working draft proposal did not call for estimates of the benefits of regulations.

The working draft proposed requiring supplemental information on the cost of regulations: it did not address funding. The FASAB lacks authority to recommend budgetary and regulatory policy. However, the debate on financial reporting about the cost of federal regulations takes place in the context of an on-going debate about who should pay these costs. Officials of states and local governments often refer to federal regulations that impose costs on such entities as "unfunded mandates." A survey conducted last year for the National Association of Counties by Price Waterhouse & Co. found that counties reported that 12 unfunded mandates consumed an average of 12.3% of their locally-raised revenues. Some counties reported much higher percentages. A county representative has written:

With unfunded mandates, the federal government doesn't have to set priorities. It simply shifts the tax burden to other levels of government and allows the federal government to escape without accountability or responsibility....County officials are not opposed to many of the goals of mandated programs. We simply want the federal government to make the fiscal commitment and to be accountable and responsible if these goals are worth achieving. (Larry E. Naake, Executive Director, National Association of Counties, in a letter to the editor of The Washington Post, May 13, 1994.)

Some groups have expressed concern about other proposals, including some bills introduced in Congress, that would actually have the Federal Government pay the cost of mandates. For example, some are concerned that such a requirement has the potential:

...for undermining the laws designed to protect the health, safety, and rights of all Americans [and to] derail vital initiatives such as health care reform and reauthorization of crucial environmentaland safety laws. ("Interest Groups Hit Bills Asking Funding For U.S. Mandates," Greg Pierce, Washington Times, April 29, 1994.)

TENTATIVE DECISIONS OF BOARD

It should be noted that all Board decisions referred to in this and all other issues of the Newsletter are tentative unless otherwise clearly stated. They are subject to final Board action.

AGENDA FOR SEPTEMBER MEETING

The agenda for the September 19 Board meeting includes discussions on (1) Stewardship Reporting issues, (2) Revenue Recognition issues, and (3) final approval of a Cost of Capital Invitation for Views. The meeting will be held in room 7C13 of the General

Accounting Office, 441 G St., N.W., Washington, DC. Further information on the agenda may be obtained by calling 202-512-7350.

PUBLIC HEARINGS TO BE RESCHEDULED

The public hearings originally scheduled to be held on October 26 and 27 are being rescheduled. The change in schedule is to allow sufficient time for commentators to review the exposure drafts soon to be issued. These are (1) Accounting for Federal Liabilities and (2) Managerial Cost Accounting Standards. Also, the Board anticipates issuing an "Invitation to Comment" on the Applicability of a Capital Charge, and will attempt to have that issue as a subject at the public hearing. The new hearing dates are expected to be in late November but have not yet be set.