FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD
May 23-24, 2007
Rooms 1N37 & 5N30
441 G Street NW
Washington, DC 20548

Wednesday, May 23, 2007

- ### Attendance

The following members were present throughout the public hearing and meeting except as noted: Chairman Allen, Messrs., Dacey, Farrell, Jackson, Patton, Reid, Schumacher and Werfel (Ms. Hug represented Mr. Werfel from 9 to 10 AM on Thursday), and Ms. Cohen. The CBO member, Donald Marron, did not participate. Mr. Orszag, CBO Director, and Mr. Murphy, CBO General Counsel, participated alternately throughout the meeting. The executive director, Ms. Comes, and general counsel, Mr. Jacobson, were also present throughout the meeting.

- ### Public Hearing

Chairman Allen began by noting that a public hearing is the most important part of due process because it provides an opportunity to explore the “why” behind the responses. He requested that each participant begin with five to ten minutes of opening remarks to be followed by discussion with members.

Robert Bixby – Concord Coalition (letter 66)

Mr. Bixby noted that he was a user/consumer of federal financial reports and a veteran of entitlement reform "wars" over the years. In his capacity as Executive Director of the Concord Coalition (a non-partisan organization), he consulted with several coalition officers regarding his letter. His views were endorsed by Warren Rudman, Bob Kerry, Peter Peterson, and Charles Bowsher.

He believes that the Board's work will have a great impact on public perception and may influence reform.

Mr. Bixby noted that his organization had lamented the absence of information about the long-term obligations of programs such as Social Security and Medicare. He is now able to access this information on a regular basis and attributes much of the improvement to the Board's work.

His concerns regarding liability recognition arise from the following:

1. The nature of the commitments are different than pensions in the public sector.
2. There is great potential for misunderstanding either way you approach it.
3. If the primary view prevails,
    a. because Congress can change these programs they are not strictly speaking liabilities.
    b. coming up with numbers different than the trustees report has the potential to confuse people who are users of the financial reports with respect to what the government is "on the hook" for, which will complicate reform efforts.
    c. if you have a liability, then you don't want the government repudiating liabilities; therefore, you would have to raise taxes to meet the liabilities.

This is a difficult thing to account for. The question is whether or not the government itself – under current fiscal policies – is able to sustain itself. He supports the alternative view because the fiscal sustainability statement is a step forward through a government-wide view.

Such projections are do-able, but he does not believe that the sustainability report can be basic information. He believes it could be enhanced by showing scenarios such as cuts in health care costs or changes in tax policy.

Jim Patton noted that Mr. Bixby's view seems to call for only legal liabilities to be recognized on the balance sheet. He noted that the Board has indicated the need to look at the economic substance of the transactions. Mr. Bixby said that he thought "due and payable" should be the liability, but that that does leave something out. That's where the SOSI comes in.

Mr. Patton asked if there were other kinds of obligations that were not strictly legal obligations for which recognition would not be appropriate. Mr. Bixby noted that there may be others of which he is not aware and could not respond.

Mr. Jackson asked if Social Security could be viewed as being different than other entitlements such as food stamps. Mr. Bixby said there were varying levels of commitments. There is a different perception, due to earmarked revenues, but technically the ability to change both exists. He believes earmarked revenues create a distinction about the ability to change, but he doesn't know if it's a relevant distinction for accounting.

Mr. Reid noted that a liability is a snapshot of where the program is and asked if Mr. Bixby would be interested in knowing what that number is even if it is not a liability. Mr. Bixby indicated that it would be an interesting number. It's different than the closed group number and the open group number – both of which measure different things. This new number would measure a different status of the program. He doesn't object to the number, but having it as a liability would confuse people.

Mr. Schumacher asked whether earmarked revenue is an indication of an exchange transaction. Mr. Bixby said the public probably perceives it as such. This is one of the problems you face in reform; people say they've been paying their money and are due benefits. He said, in reality, the benefits are not directly tied to payments into the system. He would look at the legality of the program; not how the public perceives it.

Mr. Allen asked about what Mr. Bixby called a huge unfunded obligation. He asked Mr. Bixby whether, when looking at the financial statement of the federal government and that obligation increased or decreased during the year, one wouldn't expect to see something about the change in the obligation reflected in the balance sheet and operating statement. Considering that the statements wouldn't reflect those changes, he asked whether it wouldn't be better to not even have them since having them would muddy the picture you are trying to portray? Mr. Bixby noted that the alternative view includes a statement of changes in the statement of social insurance, which he supports as a more comprehensive approach.

Mr. Allen mentioned the issue of financial statement integration. Mr. Bixby noted that some of problem relates to the program's pay-as-you-go nature. If you were trying to fund it as you do in the private sector, he would be more comfortable with the primary view. People are cynical about the deficit and would be more so if you add in the deficit from accruing benefits; what are you going to do about it? You cannot advance-fund such a large number. He said the way it is done now is fair and rational. All the information is there and it avoids the argument of whether there is a liability or not.

Ms. Cohen stated that the public must be pretty conversant with the large numbers by now. She noted that the "fiscal wake up tour" has been spreading word about the large unfunded amounts. She thinks that pointing out what has been accumulated to date is useful. She asked Mr. Bixby whether it is just the balance sheet amount that is a problem. Mr. Bixby noted that it was in relation to the perception that raising the retirement age is a repudiation of a liability.

Ms. Cohen noted that state governments issued debt that they were not responsible for and credit rating agencies delivered the message that, if it looks like a debt, it is a debt. It served a valuable purpose to call it what it really was.

Mr. Bixby noted that words matter. Recognizing a liability on the balance sheet has consequences. Once you call it a liability people will not understand that it can be changed.

Mr. Dacey asked if it would be helpful if there was something on the balance sheet that directed readers to the Statement of Social Insurance. Mr. Bixby believed it would.

Mr. Jackson noted the preoccupation with the balance sheet. He indicated that his interest was in the operating statement. The operating statement measures the cost of services rendered during the year. He said he struggles with the notion that the people will understand the relationship between the benefits earned by people not working for the government (as opposed to benefits promised to employees of the government). In his view such non-government employees have not produced a service for the government. He questioned whether it would be a fair representation to include the cost of these other workers in the operating statement. Mr. Bixby responded that the alternative view would not include such costs. He does not believe that they should be in the operating statement.

Sheila Weinberg – Institute for Truth in Accounting (letter 30)

Ms. Weinberg's prepared summary is presented as Attachment 1. In addition to her prepared summary, Ms. Weinberg noted the importance of independent standard setting. She noted that her apprehension about the Board's independence has been heightened by the recent appointment of a former federal official (a former Board member) to the Board.

Mr. Werfel asked about the notion of a social contract and how it would apply to programs such as Food Stamps that are also entitlements. Ms. Weinberg responded that it is really what the public thinks based on what politicians say – they refer to these social insurance programs as social contracts.

Mr. Werfel asked if politicians spoke of Food Stamps in the same terms as they speak of Social Security would you view them as liabilities. Ms. Weinberger said she would.

Mr. Werfel asked whether, from Ms. Weinburg's perspective, the presence of earmarked payroll taxes gives more of an indicator of a social contract. He noted that it really resides in how the programs were portrayed by the government. Ms. Weinberg noted that the earmarking is part of the whole scheme that confuses the public and causes them to believe these are liabilities.

Mr. Jackson asked if a non-traditional financial statement would be a better way to communicate to the public on the status of social insurance programs – financial condition (not financial position) – than traditional financial statements. He expressed concern that a $14 trillion dollar number is a scary thing. He asked what more meaningful information might presented about financial condition, information that reflects the long-term health of the program.

Ms. Weinberg commented that Robert Anthony said that if the financial statements are not used by decision makers then the Board should go home. She believes the accrual figures should be provided by Treasury on a monthly basis. The public needs to know on a regular basis how the financial status of programs has changed. The argument that large numbers will scare the public dumbfounds her. Mr. Jackson explained that his point really was whether we were using the right scary numbers. We should select the numbers that portray the story appropriately.

Ms. Weinberg noted that the Board may decide to call the balance sheet number something other than liability but the number should be there, and the change in the number should be reported as a cost.

Mr. Dacey asked whether, if the same information were available in the SOSI but not in the balance sheet and in the operating statement, would that meet user needs. Ms. Weinberg responded that the bottom line of the statement of net cost equates to the budget deficit and that is the number that should be focused on.

Mr. Dacey asked about reporting on fiscal sustainability and whether she supports that. Ms. Weinberg noted that one does need to look at the government overall.

Mr. Patton noted that letters suggested that reforming Social Security would be more difficult if a liability was recognized. He asked whether she agrees and why there is a difference of view. Ms. Weinberg noted that she does not believe that is true. She gave the example that if a liability were recognized and then politicians did reform the programs, you would have a measure of the change and a way to show that you are fixing the program.

Mr. Werfel asked about social contracts. He asked that if the primary view were adopted and the rhetoric did change and politicians did start saying we are not going to honor the scheduled benefits because the benefits are unsustainable, whether in that case the sense of a social contract would shift and the Board would come back and change the standards to remove the liability.

Ms. Weinberg responded that this is why the IFTA says that, if you don’t record the liability, then you must reform the political debate through the list of changes.

Mr. Dacey noted that decisions to raise taxes would not be captured in the primary view’s liability amount. He said this was one reason that he supported the alternative view. Ms. Weinberg noted that the reality is that payroll taxes are used for more than just Social Security. She believes it is appropriate to exclude payroll taxes from the liability number.

John Rother – AARP (letter 37)

Mr. Rother noted the AARP's support for the alternative view. The key difference between private sector and government is that the government has the ability to raise taxes and to change the benefits. The alternative view is a more accurate representation of this.

Mr. Jackson asked whether the AARP members would view social insurance as a liability of the federal government to them. Mr. Rother explained that AARP members understand that there is no liability. They understand the shortfall as portrayed in the Trustees' report and they have been through a lot of change in these programs. They understand that this is not a program "locked in concrete." Mr. Jackson asked then why do the politicians struggle so much with change; this struggle leads one to believe the benefits are irrevocable. Mr. Rother responded that the elected officials recognize the need for change; at issue is balanced change.

Mr. Patton asked about the measurement problems noted by AARP (that social insurance is dynamic and hard to predict) and that such concerns might lead one to not recognize an amount. On the other hand, various agencies are making projections based on actuarial estimates that drive policy. He wondered about the difference.

Mr. Rother supports the activities of the Social Security actuaries and Trustees. His concerns go toward the non-traditional idea of recording liabilities based on these projections. Due and payable is the correct liability approach.

Mr. Allen asked if there is a point in time when there is reasonable certainty that no changes would be made. Mr. Rother believes Congress will always be reluctant to change benefits for current retirees. He thinks that for those near retirement the problem grows and you need time to plan for changes. As a general matter; those retired or near retirement have a greater need for certainty and should be able to count on benefits as scheduled.

Mr. Orszag asked whether AARP fully supports presenting accrual information, albeit not in the primary documents. Mr. Rother notes that they support greater transparency.

Mr. Orszag explained that CBO calculations show that the 50-year present value (an accrual type projection) of Part D last year was $3 trillion greater than this year. He asked if Mr. Rother thought that was a good guide for policy makers in evaluating the fiscal condition of the government. Mr. Rother believes that would be profoundly misleading.

Mr. Orzsag asked, if AARP had promised some benefit to AARP members in the future and had the right to collect a fee from them in the future, would AARP accrue that future fee as an asset and the future payment as a liability? Mr. Rother said AARP would look at both sides simultaneously.

Mr. Allen asked if the calculation of the amount would change Mr. Rother's views. For example, he noted that some respondents suggested including the future revenue in the calculated net present value. Mr. Rother said "probably not." One advantage of the alternative view is the ability to recognize the growing uncertainty of benefits to younger people.

Mr. Orzsag asked if Mr. Rother had ever encountered a system that did not have symmetry between revenue and expenditure aspects of social insurance programs. Mr. Rother said he had not, but he also had not found many countries going beyond 25 year projections. He acknowledged how accounting can impact decision making. By putting out smaller numbers and smaller increments, some countries are able to make gradual changes to benefits. In the US, we tend to have once-in-a-generation changes.

Mr. Patton asked about the relevance of the criterion that some respondents have mentioned, i.e., the belief that the primary view proposal would make it harder to change the programs. He noted that standard-setting bodies are normally considered neutral.

Mr. Rother responded that accounting ought to be judged by how useful it is for decision making. If it is not useful, then it should not be done. He finds the alternative view a much more useful basis for making decisions about social insurance.

Thomas Prince, Northwestern University (letter 51)

Mr. Prince's summary statement is attached.

Mr. Jackson asked if Mr. Prince would call Social Security benefits a liability on the balance sheet. Mr. Prince would prefer a supplementary table showing information by cohort so that individuals could calculate their own benefit. Mr. Prince also argued that once a beneficiary had attained retirement age there was a liability for Social Security and Medicare.

Mr. Dacey asked if Mr. Prince envisioned supplementary reporting as a part of the financial report. Mr. Prince indicated that he would. A regular standard schedule would be best.

Mr. Allen asked about Mr. Prince's concerns that business leaders could not understand social insurance information and wondered how average citizens could. He wondered how such concerns might be overcome. Mr. Prince said that more disclosure of information would help. He noted the need for a framework against which to assess projections.

Jagadeesh Gokhale – CATO Institute (letter 35)

Mr. Gokhale's prepared summary is presented as Attachment 1.

Mr. Jackson asked when we should start recognizing a commitment for future benefits. Mr. Gokhale responded that the commitment exists as long as the policy is in place. As long as the policy is in force, there is a liability.

Mr. Jackson asked when the financial effects should be recognized. For example, should the benefits attributable work by a 21-year old be recognized. Mr. Gokhale said the short answer is yes. You should recognize the benefit not just for very young beneficiaries but for all beneficiaries. He prefers a comprehensive measure based on both past and future events; which eligibility criteria are met should not be a sticking point.

Mr. Gokhale said his focus is on measuring the implications of current policy, including the future implications. He is indifferent to what you call it but his interest is in all the future flows arising from the policy.

Mr. Orzsag asked:

(1) Regarding the scope of the measurement of fiscal balance, whether in Mr. Gokhale's opinion, the exclusion of Medicaid make sense. (He referenced the shift of costs between Medicare Part B to Medicaid.)

Mr. Gokhale answered that he preferred to start measuring fiscal condition from a government-wide perspective. The commitment for Medicaid net spending should be added to a government-wide commitment.

(2) Mr. Greenspan is quoted in favor of an accrual system. He asked whether Mr. Gokhale had ever seen in his work an accrual based system that excludes the revenue side.

Mr. Gokhale answered that he has not examined other countries that closely but has not seen academics take such an approach.

Mr. Werfel asked about the continuum of government commitments from public debt to less firm commitments such as future social insurance benefits and ultimately to annual spending on research and development. He asked whether it is important to make sure that how you characterize future spending is consistent with this continuum – that some future expenditures are more fixed than others. He asked how to ensure transparency about the continuum.

Mr. Gokhlae said he would begin with a complete picture of the projections overall; then describe the components that explains the continuum.

Mr. Werfel asked whether it would be a problem if some of the items in the middle of the continuum are placed on the balance sheet – which is viewed as holding things on the fixed end of the continuum.

Mr. Gokhlae said you will have problems in understanding once you move down the continuum.

Mr. Patton asked about how this testimony helps resolve the primary view issues. Both sides support sustainability reporting. The primary view is more forward looking in some respects than the alternative view because it includes some future flows that the alternative view would not.

Mr. Gokhale said that the issue is capturing the full effect of policy changes. Suppose the government creates a future benefit funded completely by a future tax, the primary view approach would exclude the future revenues and would show deterioration in the financial position of the government. He is after transparency and the government-wide view of future flows is superior in that respect.

Mr. Allen asked about Mr. Gokhale's proposal to include information in an executive summary. Mr. Gokhale clarified that he would integrate the information in the current executive summary.

Mr. Jackson asked about the operating statement. He asked Mr. Gokhale whether the benefits accruing to workers over time under these programs should be recognized in the operating statement (which is a backward-looking statement). Mr. Jackson said the presumption is that a social insurance program does not lead to services rendered to the government; people affected by the entitlement have not rendered service to the government.

Mr. Gokhale said that if the government enacted a policy that everyone gets $50 then the cost of the policy is that amount.

Mr. Dacey asked whether Mr. Gokhale thought the primary view could mislead people. Mr. Gokhale answered affirmatively.

Mr. Patton said he would still characterize this as an economist's view of financial reporting. He believes there are other constraints that an accountant would impose. He supports the sustainability reporting ideas but does not view these as complete. Mr. Gokhale questioned whether he was transferring constraints that work well in the private sector but not in the public; for example, use of shut-down measures when the program will not be shut down.

Martha Zeigler, Metropolitan Sewage District of Buncombe County, North Carolina (letter 50)

Mr. Orzsag asked about the difference between future defense spending and social insurance spending; he wondered if she viewed the spending any differently from the “ain’t going to happen” perspective she noted earlier. Ms. Zeigler responded that the programs were different.

Mr. Allen related the concerns from other respondents that liability recognition would preclude reform. Ms. Zeigler responded that she thought it would be more likely to stimulate reform.

Mr. Schumacher asked about the perception that there was a legal liability if a liability were recognized. Mr. Zeigler responded that liability recognition does not alter legal standing.

Mr. Farrell asked why her Board did not act before the accounting standards required liability recognition to reform post-employment benefits since they had the information. She believes the delay was related to a notion of “why ask for trouble” when there are no consequences.

Mr. Dacey asked about the cliff analogy she made. He asked if she supported the statement of fiscal sustainability. She did. He asked whether, if a sustainability statement were available, balance sheet recognition matters. She believes it does. The balance sheet is a snapshot in time and the statement on sustainability helps evaluate that point-in-time picture.

Mr. Jackson noted that the costs of future benefits promised to employees may be viewed as different from the benefits promised to workers in the general population. He said there is no deferred compensation for the latter. He wondered about putting the liability center stage and showing cost on the operating statement when the government has received no services. Ms. Zeigler compared it to an insurance contract – if she pays in premiums and is expects a benefit, then both should be recognized by the company.

Steven Schaeffer – Social Security Administration, Office of the Inspector General (letters 22, 24 and 49)

Mr. Schaeffer supports the alternative view. He said due and payable recognition is appropriate and consistent with the liability definition in the exposure draft; the cost proposed to be recognized by the primary view would dwarf other costs recognized; and the amount of benefit payments is uncertain; estimates are unreliable.

Mr. Reid asked if the disclosure of the primary view information would be useful to individuals. In other words, the information would be available but not recognized. Mr. Schaeffer indicated that it would and that was current practice – the information is available. In addition, sensitivity analysis is displayed. He has no problem disclosing the information.

Mr. Orzsag noted that multiple scenarios are presented as is a sensitivity analysis. He asked about the focus on a single number implied by the primary view. Mr. Schaeffer said that would be a problem. There are now discussions about what the proper assumptions are – you would end up with more discussion of that.

Mr. Orzsag noted that in the 1980's intermediate assumptions were politicized and actuaries were split. This led to presentation of A and B intermediate projections. Mr. Schaeffer could not speculate as to the causes.

Mr. Allen asked about Mr. Schaeffer's views on the payroll taxes as "just another tax" and about his opposition to showing a liability for deferred revenue. Mr. Allen noted that there was not a direct tie between tax payments but that there was a relationship. Higher income individuals receive higher benefits. He believes that is inconsistent with a social program. Mr. Schaeffer commented that it is true that a higher income beneficiary gets more money; but the formula is weighted to give a higher benefit relative to your income to lower income individuals. The program has raised individuals out of poverty. It is an intergenerational transfer.

Mr. Schumacher asked Mr. Schaeffer to comment on whether the amount is a liability. Mr. Schaeffer does not believe it meets the definition of a liability. He does not believe it differs from the funding of defense. He mentioned that how we manage spending is similar to how an individual manages the family finances – they do not prefund the cost of raising a child when the child is born.

Mr. Allen noted Mr. Schaeffer's did not support the primary view because, among other things, it does not consider future income. He asked whether, if future income were considered, Mr. Schaeffer would change his views. Mr. Schaeffer said if you were going to do it then you would need to consider all the flows.

Mr. Orzsag asked if some social insurance programs were by design intended to be financed by general revenues, what would be the right treatment of the general revenue financing. Mr. Schaeffer said he would disclose that future general revenue would be impacted by this amount.

Mr. Orzsag asked whether, if future benefits were included on the liability side and future payroll tax on the asset side, you would also show general revenue. Mr. Schaeffer said he would not go there but that if you did then yes.

Mr. Allen asked about Mr. Schaeffer's concerns regarding changes in assumptions. He said that the whole concept of accrual accounting is based on making estimates and includes ways to deal with changes in assumptions. He asked Mr. Schaeffer whether he believes less accrual accounting ought to be done in other areas to address uncertainty. Mr. Schaeffer said that we have to deal with the specific circumstances. We know with certainty that we can not pay this level of benefits.

Mr. Allen asked about groups under a closer horizon such as those over 65. Mr. Schaeffer said a reasonable time frame could be looked at.

Mr. Patton asked if this was a question of measurement and not definitional. Mr. Schaeffer reiterated that he does not believe this is a liability.

Mr. Werfel asked about the current framework where non-exchange transactions are recognized when they become due and payable. The primary view would move this set of programs off that framework. He asked whether there something about this set of programs that is different than other entitlement programs, whether a line has been drawn in a logical place when we set these aside for different treatment. Mr. Schaeffer said they should not be distinguished from other entitlement programs. These programs have been changed many times.

Mr. Patton noted that he is confused about the fact that the focus of the primary view is on things that have happened to date – the benefits attributable to work before the balance sheet date – and the suggestion that future revenues are relevant to measuring that balance. He asked about Mr. Schaeffer's concerns regarding the lack of consideration of future revenues relative to an assessment of the situation at the balance sheet date versus what needs to be raised in the future to address the liability. Mr. Schaeffer argued that if you are going to address a liability for the program you need to consider that the program provides funding for today's benefits through future payroll taxes. Benefits will be paid by people working in the future.

Bob Childree, Association of Government Accountants Financial Management Standards Board (letter 55)

Mr. Childree acknowledged that the issue at hand has been controversial for many decades. He hopes that there is a way to make the information readily understandable to the average reader. He wonders how this can be done and suggests that there is a great deal of work to be done.

Mr. Childree believes that the proposal will create serious issues unless the fiscal sustainability report is developed and used to communicate the totality of the issue. The liability standard could follow that effort. His group would look forward to working on that issue when the time comes.

Mr. Allen noted that the committee must have deliberated extensively on the letter. Mr. Childree explained that the process for the committee is rigorous. There were a lot of differences of opinion. The national debt is trillions, yet how many people consider the national debt in their thought process? The problem with standards is that they must be generally accepted. Putting a large number on the balance sheet should be accompanied by the ability to educate and provide knowledge beyond what the financial report says.

The split among the committee members was not just the primary versus the alternative view. The split was also on when you begin recognition. The committed decided that the sustainability report may have a bigger role than the balance sheet in making the issue understandable.

Mr. Jackson asked if the AGA group would feel that traditional financial statements must be supplemented. He asked if the committee was suggesting that another form of financial reporting would be more appropriate.

Mr. Childree noted that the whole issue revolves around whether this is a liability or not. The federal government has the ability to change things – what if the Congress changes this tomorrow and the liability goes away? The ability to drive policy is important.

Mr. Patton noted that in working on a conceptual model for several years we have a framework that includes a balance sheet and operating statement. The sustainability would be an extension from that framework. Given the existence of the statements, he asked whether it would be possible to resolve the liability question within that framework and then deal with sustainability.

Mr. Childree noted that he had looked at the performance reports and wondered what they mean. The committee wanted to understand that before addressing the liability question. Something is needed that helps us understand what this really means in the grand scheme of things. We need to know what we are currently tackling. The sustainability report may help us understand and justify a $44 trillion dollar number on the balance sheet. It may give us a better way to view the liability.

Mr. Allen noted that the committee did recommend splitting the social insurance programs between pension-like and insurance-like programs. Mr. Childree noted that there seemed to be two separate issues. The Social Security program appears to be a pension while Medicare appears to be an insurance plan. Accounting for these programs as such would help people understand.

Mr. Allen asked what the committee envisioned for the sustainability report. Mr. Childree indicated that the discussion on sustainability was very high-level. There may be some benefit from isolating programs in a high-level report. The issues may differ between Social Security and Medicare.

Mr. Patton asked about the implications of putting social insurance on the back burner. If we did that, then it would call into question the conceptual framework project. If it is not helping to solve problems, we should not do it. It seems we would have a moratorium on progress for some time.

Mr. Childree noted it is clear that social insurance should be addressed. Doing sustainability first will inform decisions about whether the right number is $44 trillion or $50 trillion. Many issues are discussed that lead people to ask what will will be generally accepted. He questioned the value of a standard that is not generally accepted. He opined that, for most citizens, if you threw a number out they would not say it made any difference. The point is that you need a report that is relevant/has meaning and that people read and understand. We need people to understand what the standard is and what it will provide. The sustainability report will help people understand why we have a liability and why it is the size that it is. If we don't do that well, then you could pick either view because no one would care.

Mr. Allen asked about the problem of getting the attention of those who don't normally pay attention to financial statements. Does it get more attention when pension accounting moves from disclosure to recognition?

Mr. Childree said OPEB was a good example. As comptroller, he has been exposed to OPEB and has brought it to the attention of leaders. Nothing occurred until the bond rating agencies said what are you doing about OPEB in Alabama; people then started asking him what to do about it. The interest of the rating agencies caused the leaders to ask about it and ask what the accounting standards were.

Mr. Childree feels it is a poor reason to issue a standard to provoke political action on a problem. A good reason is if it is really an obligation.

Mr. Farrell noted that few are lining up to read the financial reports. He thinks that when an accountant wants to read the financial reports they would approach it with an expectation and understanding of what should be there. They would expect to see all liabilities represented. As a Board, we have not discussed what the President, Congress or citizens might do. We've approached it from the perspective of complete financial statements.

Mr. Childree did not mean to imply that the Board should be governed by what people think. An accountant may have some expectation that this financial statement contains all assets and liabilities that are proper. The question is what is proper. The sustainability report may help us understand what is proper. There are strong views. The AGA/FMSB wants the Board to take a serious look at the sustainability report, the factors affecting sustainability, and when the liability really attaches. Is it when they receive a check, at 65, at 40 quarters or when they begin work? The sustainability report will help us do that.

David Walker – Government Accountability Office (letter 61)

Mr. Walker noted that he is speaking on behalf of the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Director of the Office of Personnel Management (the principals of the Joint Financial Management Improvement Program). He affirmed the principals' support for continued improvement in financial reporting for social insurance and transparency. He also explained that the outcome of the Board's work – while important – is not expected to lead to the resolution of issues regarding the sustainability of the programs. He noted the absence of readers of the financial reports and the push for a summary report.

The alternative view provides full accountability for social insurance programs. He noted that it is clear that the social insurance programs will not survive in the form they are today. He asserted that you must look broadly at sustainability and include all programs and sources of revenue.

Mr. Walker noted that the alternative view is consistent with current law, the federal government's other communications (benefit statements), current and likely international accounting and reporting standards. The principals do not believe that the primary view meets any of these three criteria. Further, it may lead to confusion. The primary view could narrow options for reform. However, the Board must make its decision based on the intellectual merits of the issue.

The primary view treats the social insurance programs like private sector retirement benefits and this is inappropriate. The primary view does not take into account the differences among these programs.

Mr. Walker noted that he had personally attended town hall meetings in 20 states and met with his colleagues from other countries. There is broad agreement on the need for more transparency on sustainability. There is also broad agreement that liability treatment such as that proposed by the primary view is not appropriate.

Mr. Walker discussed the trust funds of these programs. He noted that these funds do not equate to real investments. He asked whether there should be a liability recognized for the balances in the trust funds. They represent an irrevocable commitment of the United States. Supreme Court cases have supported the notion that these amounts must be paid out. They have legal, political, economic and moral significance. We are treating these as if the left hand owes the right hand. This is inconsistent with how they are being held out to the public. We should reconcile this inconsistency.

The principals believe the alternative view is more consistent with current law, communications and the direction of current international accounting. There is great interest in fiscal sustainability and intergenerational equity. It is not just what you do but how you do it. It will either be a net plus or a net minus in improving public understanding, and the possible narrowing of options for reform.

Mr. Allen affirmed that the Board does view its role as driving public policy.

Mr. Jackson asked whether, if you recognized the trust fund balances as a liability (deferred revenue), that suggests a liability greater than due and payable. Mr. Walker agreed and explained that the trust fund balances exist – the transactions have occurred – and the international community has not addressed this because other countries do not have this arrangement.

Mr. Jackson noted that the revenues go to reduce the deficit as they are received. If you treat this as deferred revenue, would this deferred revenue account go toward balancing the short fall? Mr. Walker noted that this deferral would have the effect of increasing the reported deficit which is currently being masked. He said that in 2009 the surplus will start to go down – the country will start going through withdrawal pains. The surplus will be gone in 2017, and in 2041 the trust funds will be empty. Medicare had a negative cash flow this year. He said that the answer should not result in a change in the accounting based on the funding mechanism. He characterized the primary view as resulting in a liability of about $40 trillion being on the balance sheet. Recognition of a liability at 40 quarters results in recognizing something for those as young as 27-years old. He finds the idea that today's 27-year olds will get scheduled benefits at retirement to be unrealistic.

Mr. Reid noted that there are a lot of respondents who find the liability measure to have value. He asked Mr. Walker if he would support disclosing the liability number – that is, disclosure but not recognition. Mr. Walker stated that disclosure is something to consider as long as its understandable and in the right context. In discussions with colleagues around the world, he finds there is a notion that we really need to think about whether a traditional balance sheet is meaningful for a national government. He listed examples of important items not on the balance sheet. The balance sheet is now deeply in the red but has not motivated anyone to do anything. That's why he believes fiscal sustainability is important. He suggests that we need to think outside the box – find a statement that combines traditional balance sheet obligations with items from the fiscal sustainability information. This might be a lot more meaningful and useful than what we have right now. He believes this is relevant to the discussion today.

Mr. Werfel acknowledged the concern regarding the traditional balance sheet and suggested that the Board ought to discuss it. One theme from prior witnesses is that the Board is not a policy Board – they report on the problems but don't necessarily fix the problems. He asked where the line is between social insurance programs and other programs. If SI programs are liabilities but other programs are not, then there is movement into the policy arena; these programs are given status that other programs do not have.

Mr. Walker noted that these programs are more defined than other programs. We have a current standard now. He asked what evidence exists that says it is inadequate. He noted that we are part of a global community. More consistency is needed in standards. He asked what the clear and compelling reason is for us to do something different than the international community. He opined that the primary view is not consistent with the international community, and noted that fiscal sustainability is of interest to the international community.

Mr. Patton noted that the funding status of a program seems to influence Mr. Walker's notion of whether something is a liability. Mr. Patton asked whether the excess contributions are able to be diverted from social insurance. Mr. Walker's understanding of the law is that these are irrevocable commitments that can only be used to pay benefits. He said whether something is funded or not is not the issue. The fact that these obligations exist and have been placed in an entity and the law says these funds must be used for the specified purpose is unique. The assets of the trust fund can only be used to meet obligations of the programs.

Mr. Allen noted that he attended the IPSASB meeting and observed two interesting votes. One was that the IPSASB voted that there was an obligation – a liability – once participants have attained age (e.g., 65). The second was that the international community was not ready for this level of accrual and therefore the scope of the project would be changed to address disclosure. Mr. Allen agreed that we should be consistent but when we are the leaders we should proceed. We are far ahead in the area of social insurance reporting. We are not totally inconsistent but we are leading.

Mr. Walker explained that he is relying upon Bob Dacey – who attends the meetings – but his views are supplemented by meetings with colleagues around the world. They discussed this issue during a recent meeting. He agreed that it is fair to say that the US is ahead of the rest of the world; that is all right; we want to be there. But he said there is a fundamental difference between disclosure and the primary view's notion of liability recognition on the balance sheet. The significance is that much greater.

Mr. Allen observed that he watched the 60 Minutes session and applauded. A question at the end was "how do we really know this is real." His thought at the time was that he hoped they don't look at the balance sheet. He said it seems like that we ought not to have a traditional balance sheet if we aren't going to give people all the obligations that they expect to see there. Mr. Walker noted that he can count on his right hand how many questions he's gotten in eight years on the financial statements. He thinks there is important information to be conveyed – perhaps in a more consolidated and concise form. That may be a more innovative approach than a balance sheet. In his speeches, he combines information from balance sheets and other sources. He converts the data to percent of GDP and per capita numbers. This approach resonates with people.

Mr. Orszag expressed the view that we are not leading the world on sustainability reporting. He referenced the UK's reports which are more inclusive. There are academics producing more informative measures of the fiscal future of the government. Mr. Walker said the point is well taken. But, we are ahead on social insurance reporting but not on fiscal sustainability.

Steve Robinson for Senator Grassley (letter 52)

Mr. Robinson summarized as follows:
1. The unique characteristics of the two largest programs - Social Security and Medicare – make the primary view inappropriate.
a. current law expressly reserves the right to change or repeal these programs
b. the legal authority to pay benefits is limited by the Trust Fund balances
2. Current standards requiring due and payable liability recognition is consistent with the current laws.

3. FASAB should not expand the definition of liability to include social insurance programs; FASAB should focus its efforts on improving the statement of social insurance

a. Summary measures are not adequate; thus the projected costs should be shown as a percentage of taxable payroll

b. Sustainability reporting should be improved.

Mr. Robinson suggested that changes to social insurance accounting should await the results of the fiscal sustainability reporting task force.

Mr. Allen explained his view that the existing liability definition would also embrace the primary view. He asked what led Mr. Robinson to conclude that the proposed liability definition was an expansion. Mr. Robinson explained that his reading of the history of the elements project and the suggested wording changes – particularly regarding the ability of the entity to change the terms of the obligations – suggest an intent to expand. His view is that In order to make the current program fit as a legal liability then you must change the liability definition. He perceives that as what the Board is trying to do.

Mr. Robinson suggested that there are other tools to allow readers to gain the information. He believes people can flip the page and find the information.

Mr. Allen noted that several standard setters are looking at liability definitions. He said Liability definitions include more than a legal definition. Companies and state and local governments currently recognize promises and obligations as liabilities even though they have the option to change them in the future. FASB and GASB adopted a view of financial reporting that is distinct from legal form. He said the goal is to capture the economic understanding between two parties at a point in time and to capture changes in a period. Financial reporting was never intended to be a legal form.

Mr. Robinson asked what are we trying to convey here. He referenced the policy changes that Congress has made – Medicare Part D and veterans benefits. There is value to convey the implications – in terms of cash flow – to the public. But the balance sheet has a current presentation that does not include these types of things and he believes there are other ways to communicate this information. He believes the Board is trying to obfuscate the difference between liabilities, obligations and promises.

Mr. Robinson noted that the notion of accruing liabilities is so that you might set aside resources to pre-fund that liability. The reason we want to accrue a liability for a business is that we don't want employees left high and dry if the business goes out of business. For government, we won't go out of business. He finds it odd as an on-going entity with an ongoing program to accrue some subset of the liability. The full liability should include all future benefits and then you have such a huge number that you certainly couldn't fund it. You would have to set aside 5% of GDP each and every year to pre-fund the full obligations. You exceed 200% of GDP very quickly. The implication that you are going to pre-fund Medicare and Social Security is not appropriate since the fund needed would exceed the entire value of stocks and bonds.

Mr. Allen said the notion of pre-funding is not relevant. The purpose of accrual accounting is intergenerational equity – to show that which relates to the past but has not been funded.

Mr. Dacey noted that the alternative view holders believe exchange and non-exchange transactions should be viewed differently. He asked whether Mr. Robinson perceived a substantive difference between exchange and non-exchange transactions.

Mr. Robinson said the political reality is that just as large an uproar would arise if you tried to do away with a program such as Food Stamps. He said that if the message to the public is what is the level of future resources that have been pre-committed by the government, then there is no reason to distinguish between exchange and non-exchange. He does not think the notion that we are only going to recognize exchange and not non-exchange is useful. The payroll tax has little significance other than political. The parts of Medicare are funded differently but have the same substance.

Stephen Goss, Social Security Administration (letter 27)

Mr. Goss presented his summary remarks (see text in Attachment 1).

Mr. Schumacher noted the comments made during the hearing and in respondents' letters regarding the ability of the government to change the law. He explained that OPEB offered by employers are not enforceable but a liability has been recognized. His experience is a change in his promised retiree health benefits yearly; it goes down each year. He does not see a difference between the ability of the government to change law and the ability of business to change benefits.

Mr. Goss responded that perhaps two wrongs don't make a right. He suggested that different approaches might be considered regarding reporting. Some line must be drawn between what you call liability and what you do not. Thinking about obligations to employees and whether they should be recorded as explicit liabilities, he would not find it appropriate to do that. If we got to a point where private employers were over promising to the extent that the government is, the Board may want to consider how that impacts the accounting. He said he would feel badly about representing these benefits as promises because of the misunderstanding that it can create. If promises are changed, that makes the individuals who change them promise breakers. We should not make it sound as if these benefits are locked in because they are decreased from time to time.

Mr. Reid asked for Mr. Goss' thoughts on deferring revenue recognition until benefits are paid. Mr. Goss indicated that there is no question that trust fund assets are as rock solid as any financial commitment can be. These assets create as absolute a draw on the US government as there could be. If we deem those amounts to be assets for the Trust Funds then there may be a liability associated with that. This seems to be an on-and off-budget question. It could be meaningful to recognize the liability in that context. In a unified budget context, perhaps not.

Mr. Werfel asked if there is a risk that, if the Board finalizes its elements project first (before social insurance), it will foreclose options for addressing this issue. He wondered if it was important to answer these questions on elements and social insurance concurrently. Mr. Goss noted that ideally one would do this all at once. However, that's impossible. There must be linearity to the discussions. He characterized the elements project as a good faith effort, and said that many of these issues are open enough to judgment that the concepts do not foreclose options. There will be debate on the issue.

Mr. Allen agreed and noted that many people believed that.

Mr. Jackson asked if one concluded that social security was a liability but also that the program could not be sustained past a certain point, would an actuary "cap it." Mr. Goss said that the concept of sustainability is not well defined. We believe Social Security is not sustainable at the level of scheduled benefits beyond a certain point. But what you can not say is that the system as it is structured – a pay-go system of payroll taxes – is unsustainable. He noted several proposals that would bring the system into balance (e.g., changes in tax rates and/or benefits). We would not refer to the system as unsustainable. Mr. Jackson noted that since current law requires you to contract benefits to the available funds the system is per se sustainable.

Mr. Goss agreed and noted that speaking literally the unfunded liability is zero because of the cap on benefits. He also noted that it is difficult to say what percent of GDP would be unsustainable.

Mr. Orszag noted the support of many respondents for fiscal gap measures and asked about future revenues. He asked whether it is the same for the sustainability of the program if future benefits are reduced by a dollar; or, taxation of benefits increased by a dollar and dedicate the dollar to future benefits. Mr. Goss – yes, they are the same. For the individual – Mr. Goss said the political decision-making would be different; it is a choice between changing taxes or reducing benefits.

Mr. Goss said that it makes the most sense to project all revenues and expenses. Lay it on the table and see what it looks like.

Howell Jackson – Harvard Law School

(See attachment 1 for prepared remarks.)

Mr. Jackson commented on the potential for changes to law and how that influences liability recognition. He said it is important to emphasize the capacity of the government to change laws that impact liabilities. If Congress wanted to change the trust fund arrangement, for example, zero out the program and eliminate the bonds in the Trust

Fund, they could do so. Congress could change a great many things including repudiating debt. He suggested that this is not very helpful in deciding whether something is recognized.

Mr. Jackson explained that there are many factors (trust fund, payroll tax, accrual of benefits from being in the work force) that distinguish these social insurance programs from others. The open-ended appropriations are significant with respect to these programs and distinguish them from others. Other programs tend to fluctuate relative to their share of GDP over time as opposed to these programs which are rising over time.

Factors Mr. Jackson considered in deciding whether recognition proposal would be appropriate:

1. does the proposal convey the magnitude of the commitment
2. does it convey the change in fiscal burdens
3. based in law in some way

He endorsed the primary view (but would quibble in some ways). He suggested that the closed group obligation may be a useful compromise. It gets to the generational imbalance. It increases over time due to implicit interest, picks up statutory changes, picks up future taxes and new enrollees. Economists and actuaries are familiar with the closed group approach. It would be useful to use a measure that is familiar. The closed group liability does a better job of adjusting for general revenue draws that some programs such as Medicare have.

He suggested that the closed group vested measure was similar to how swaps are accounted for and could be useful.

Mr. Jackson felt that integrating the amounts with current statements is very important. The fact that the amounts are large should not deter us. One aspect of the private account proposals was that the cut in benefits was not picked up – just the cut in taxes. With respect to integration, he referred to the two models of linking amounts illustrated in his paper beginning at page 3 – one being consolidation and the other being a summary table that combines appropriate measures with the information from the financial statements. This approach is in the current financial statements. (Page 6 of the CFR.) Summary formats may be useful. The summary approach can be very flexible and could include projections.

Mr. Jackson noted that the increased visibility of these numbers may bring political pressure on the actuaries. He believes that looking at the measures in five year increments is helpful.

Mr. Allen asked Mr. Jackson to address the deferred revenue issue. He responded that the bonds are not special. The deferred revenue approach asks the wrong question. The question is what is the obligation for future benefits. It is not the amount owed. In addition, the outcome would be perverse. We have been disguising the deficit by folding in surpluses. The surpluses are almost over – so by the time you institute a standard, we would have a restatement and then you would get to enjoy the revenues again as they were used to offset benefits paid from the trust fund balances.

Mr. Allen noted that Mr. Jackson had focused on communication and that the Board was focused on how to better communicate information. He asked whether Mr. Jackson had a preference between the two approaches he laid out and which would communicate better. Mr, Jackson said the effort to stay within the metaphors and structures of existing financial statements is helpful. For example, the notion of implicit interest on obligations is understandable. The traditional label for changes in Social Security valuation is “change in year.” This is not understandable. You have done a great many new things but the structure of traditional financial statements is helpful. For experts, the Trustees report is helpful; for non-experts, they need a bottom-line. He opined that the closed group number is the right number. He said there are advantages to the summary approach he proposed as alternative two. One task is simplifying around a number – but it must be a single number.

Mr. Patton noted that one member has asked about a continuum – some things are scheduled benefits and others are planned programs. We are looking for the line to draw on the continuum. Mr. Jackson responded that the grey area is the entitlement programs. These programs with mandatory spending fall on the liability side. Some programs have statutory provisions or formulas but Congress appropriates differently each year. It is easier to block changes than to put through changes. Thus, permanent appropriations are hard to change and are somehow locked in. That said, He did not care much where the line was drawn. He noted that he supports the sustainability idea but it addresses a different question.

Mr. Patton noted that it seems that the funding mechanism drives whether there is a liability. Mr. Jackson responded that, to the extent that permanent appropriations are funding, then yes. His view is based on the economic reality that these programs are very hard to change. Regarding the issue of whether a recognized liability would make it harder to change the program, he is in the camp that believes the primary view would make it more likely to change. The act of sending benefit statements sent to individuals has not seemed to lock in the program. He does not think it is plausible that reporting a gross number will accomplish that.

Mr. Allen asked about the likelihood of change varying by age group. Mr. Jackson suggested that the obligation be broken down by age group (15 – 24, 25 – 34, etc…). This is helpful because it helps people understand where changes have to occur. For example, that you can not simply cut benefits to young people by 10%.

Mr. Werfel asked about the notion that we look at programs that historically Congress has not changed a lot. If we say to Congress that we will treat programs that you do not change often differently, will we presuppose an outcome. How do you draw the line at the right place? For example, if Medicare has not been adjusted in many years how would we decided how many years it would have to be. Once Congress starts acting on Social Security changes, do we have to act to remove the liability?

Mr. Jackson noted that this is what makes the issue challenging. He referenced the number of things about the program listed by the primary view as reasons. These are valid but he would add to that list the notion that the program is on auto-pilot with a continuous stream of funding. This is not to say there won't be hard cases. This is not to say that if Congress drastically changed the program you would not have to revisit it. But that is true of everything on the balance sheet.

Mike Shannon (letter 62)

(See prepared remarks at attachment 1.)

Mr. Shannon provided his summary remarks for the Board. Mr. Allen asked him about the communication aspects of the proposal. Mr. Shannon said credibility is gained from being objective. He tells students to go home and ask their parents for a check for $175,000 per child. He believes the per-person present value of these amounts communicates best.

Mr. Werfel asked about effective communication. One message would be that here are the benefits that have been promised to you. The other would be that we will need to alter the scheduled benefits. Does the liability message say that there is a promise there and you need to fight for that promise? Is this the right message?

Mr. Shannon believes it is. Calling the amounts a liability will lead to change. The size of the amounts is not relevant.

Mr. Jackson asked how a liability can be recognized for that which can not possibly come to pass. Mr. Shannon referred back to what is successful in negotiation: don't declare a position, work toward your interests. Whether the declared position is liability recognition or to informing the public changes the discussion. If there is a way to educate the public, then he is open to that.

Terry Menzel – KPMG (letter 53)

Mr. Menzel noted that KPMG comments are based on the model as it exists today. If something different is developed, then comments may change. The firm supports the primary view but believes the beginning-work-in-covered-employment is the point at which measurement should commence. There is an implied exchange transaction when payroll taxes are paid. An individual pays taxes and believes he/she is earning a benefit.

With respect to measurability, the firm does not believe there are issues. With respect to changes in law, accounting measures liabilities based on the circumstances at the balance sheet date. This notion is embedded in the literature.

Mr. Patton asked if the federal government can unilaterally decide not to pay benefits how can that be a liability. Mr. Menzel said that until the expectation is withdrawn then you make your measurements accordingly.

Mr. Patton asked if beginning work in covered employment is an eligibility criterion.. Mr. Menzel said you can start accruing a benefit before you vest and you would have to estimate whether they will become vested. It does complicate the measurement but it can be done. The exchange is the payment of taxes in return for the benefit.

Mr. Reid asked for his views on deferred revenues. Mr. Menzel said – fundamentally – they have a hard time seeing the logic of that proposal. All the steps that the government needs to do to earn the revenue have been done. You may restrict its use but that doesn't mean it isn't earned.

Mr. Jackson asked about the Nuclear Waste Disposal Fund. The government collects money from energy companies and sets the money aside to use for future services (storage of spent fuel). The money set aside is invested in the same way that the Social Security Trust Funds are. A liability is recognized for the future services. He asked Mr. Menzel whether he thought there is a similarity between this and the exchange of payroll taxes for future benefits. Mr. Menzel noted that Energy is a client and he should not comment.

Mr. Dacey noted that we have the Statement of Social Insurance and will have a statement of changes in Social Insurance. He asked for Mr. Menzel's thoughts regarding how this would meet users needs. Mr. Menzel responded that these address two different questions. The balance sheet question is: what are the liabilities. The statement of net cost question is: what are the costs. Over the years, he did not believe it mattered whether you placed the information in notes or recognized them. He has since come to realize that it does make a difference whether you recognize amounts in the balance sheet.

Mr. Allen noted the understanding that if you have a statement of changes in financial position it should include all changes. Having the information somewhere is not sufficient. Mr. Menzel added that if you have a statement of financial position and it does not include all aspects of position then you are misleading people.

Mr. Allen asked if it mattered whether the liability definition changed. Mr. Menzel said his view would hold under the existing and the proposed liability definition. He acknowledged that the federal government is unique and that perhaps the traditional balance sheet is not helpful – it is something to think about.

Rep. Jim Cooper (letter 65)

See attachment 1 for Congressman Cooper's summary remarks.

Mr. Allen asked if Congressman Cooper believes that the primary view's proposal – if implemented – would lock in the scheduled benefits.

Congressman Cooper noted that the financial statements are not for the high priesthood – they are for citizens. Citizens comprehend that a benefit is being accrued as they work. From a technical legal point it would not lock us in. Recording a liability does not require that we fund it. To be conservative, we first have to look at the liabilities. We have a tax gap in this country – we don't know what will come in but we know we will pay benefits.

Congressman Cooper suggested that the Board needs to go beyond the term of one person and consider the long-term good. Democracies have a tendency to over promise.

Mr. Werfel explained that the alternative view is that liability recognition under the primary view raises many questions – why stop at with Social Insurance, why not other programs. One thing the alternative view points out is that the first page of the financial report shows the open group shortfall. He asked whether we can effectively use this number to tell Americans that they have been counted since they are in this number? Is it a viable alternative to use other methods to carry this message or is the balance sheet the only way?

Congressman Cooper responded that the balance sheet is the only way. The people view the balance sheet as the real financials. The Rotarians can be reached with the balance sheet. We fail to account for many obligations. How do we differentiate between these obligations? Social insurance is not a welfare program; the programs give the appearance that participants are paying for benefits. Accounting must mesh with people's understanding of the programs. If it's not on the balance sheet it's probably not real. Making the number some unidentified flying object out there will not work.

Mr. Jackson asked whether Social Security was passed with the understanding that this was like a pension plan; that you would get something back for the taxes you paid. Congressman Cooper noted that he was more familiar with the short life expectancy back then. He believes that without the kind of numbers you are proposing it is likely we will pass another program like Medicare Part D. He asked for the chance for congressmen to see real numbers.

Congressman Cooper related that many countries have moved to accrual budgeting but we are stuck with cash budget. Many Congressmen do not understand accrual and believe estimates are not trustworthy. Accrual accounting does a better job of mirroring reality. Most of the Congresspersons are living a lie – we say that benefits are promised. Decisions we make today have an impact tomorrow. He implored the Board to give the Congress a chance to learn.

Alison Fraser – Heritage Foundation (letter 63)

Ms. Fraser noted that the Heritage Foundation is a non-partisan research firm and does not receive any government funds. Views expressed are her own.

Ms. Fraser noted that she is a member of the “fiscal wake-up tour.” Her experience leads her to believe we do need better information available more widely. There should be a broad public understanding of information. She asked what the policy message would be that was taken away from changes in accounting. She is sympathetic to the primary view – there are many similarities between pensions and social security.

A liability is something that must be paid yet we know social security benefits can be changed at any time. Under this definition, classifying social security benefits as liabilities under this definition would be misleading. In the public square, language is very important. The liability label would make the benefits intractable. This would be a harmful step backwards. The primary view also would not offset the future benefits with future payroll taxes. This is misleading. This would be dramatically different than current discussions of social insurance.

The current statement of social insurance is helpful but could be improved. A bottom-line would be helpful and could be tied to other reports and schedules in the executive summary. Table 1 in the executive summary is excellent. It combines the balance sheet amounts with the social insurance long term projections. She suggested coming up with another name for the long-term benefits.

Mr. Werfel noted that several witnesses talked about the fact that no one is reading the financial statements. The next extreme is that if we don’t do this on the balance sheet then it is not “real.” He asked rhetorically how these views can be reconciled. He asked Ms. Fraser whether in her travels she can help reconcile this. Will the balance sheet resonate with the public?

Ms. Fraser noted that people don’t read financial statements. It’s up to people like the people on the fiscal wake up tour to bring the message. Your job is to develop the tools that we can use to deliver the information. Such as Table 1. She likes the statement of fiscal sustainability. She might do some things differently but these kinds of things help people understand.

Mr. Allen noted that he believes Table 1 is a balance sheet. It has some segregations that we would not have. He concludes that her biggest problem is not the presentation; it is the title “liability.” He asked her if that was true. Ms. Fraser agreed that her problem is the word “liability.” She believes SI commitments are different than liabilities.

Mr. Allen asked about the operating statement. One of the things that is getting traction is people talking beyond the cash deficit. They are saying the cash deficit is $XXX trillion but the GAAP number is $XXX trillion and people – such as the Rotarians – understand the GAAP number. But, now it leaves out the changes in Social Security; that is troubling to him. It ought to reflect the true change in the position of the government. You should not have to explain that the GAAP number leaves out the change in these programs. He asked Ms. Fraser what she would have them contrast with the deficit.

Ms. Fraser noted that David Walker covers the whole spectrum of the cash deficit and the GAAP deficit. GAAP is a strong message with business people. But, what do we want people to take out of this? If we want to say the “beyond-GAAP” number then what is the policy prescription that we want to take from this. With liability recognition, the immediate reaction is a tax increase because the benefits are liabilities.

Mr. Farrell noted that he has been hearing that we are in an unsustainable position and we’re all in favor of more disclosure and more information. But the one thing we don’t want to do is change the financial statements. In addition, we have people saying that no one reads the financial statements. We have our accountant respondents saying that if we retain the current model then we should recognize all the liabilities.

Ms. Fraser said she does not believe these are liabilities. Changes could be made in the statement of social insurance – add a statement of changes – add a Table 1 format. Other changes could be made. It gets around the issue of people like her who are concerned about calling these liabilities. Also, the problem of recognizing the liability but not the revenue stream is a challenge. Not recognizing the revenues is completely different than other treatments.

Ms. Cohen explained that the primary view is to recognize what has occurred to date. The revenues that have been collected to date are the ones that relate to the benefits accrued to date. Beyond that, the concern with calling it a liability may be connected to the desire to dismantle the program. Ms. Fraser said it had to do with facing the choices we have on the table. Her concern is that calling these a liability takes one option off the table.

Mr. Allen asked if you were to go to the primary view approach, is there a better way to calculate the amount. He asked whether an approach that counted future revenues would resolve some of her concern. Ms. Fraser said it would mitigate it but she wonders what a liability really means. Changing the calculation by adding the revenue stream would help. The 75-year window is an issue as well. Some solutions work for 75 years but not 80 years. She believes the measure must acknowledge that.

Mr. Dacey asked about the fiscal sustainability reporting project. He wondered about the value of information that helps people understand the interaction of programs such as Medicare that use general revenue and other programs. Ms. Fraser noted that the challenge is in giving any sort of trajectory of discretionary programs. She believes it is helpful.

Adjournment

The hearing concluded at 5:30 PM.

Thursday, May 24, 2007

Administrative Matters

- **Approval of Minutes**

The minutes were approved electronically before the meeting.

- **Social Insurance Hearing and IPSASB**

Mr. Allen began the meeting by thanking staff for the effort devoted to the excellent public hearing the previous day. He felt there was generally enough time for each person. If members have follow up questions for speakers, they should send them to Ms. Comes. Staff would then seek responses from speakers. Mr. Allen encouraged members to offer ideas for improving future public hearings.

Mr. Allen noted that the Board would start redeliberations in July. He believes we ought to break the analysis down to eight to ten major issues. He believes members could find support for their position within the comments but that will not help us move forward. He believes we are headed down a path of compromise. He encouraged members to communicate with staff if they have ideas about what to explore and in what sequence.

Mr. Patton asked about the International Public Sector Accounting Standards Board (IPSASB). He noted his impression that their policy preferences were not entirely stable. Mr. Dacey attended the meeting in March and updated the Board. He explained that certain events influenced where they were headed – the OECD meeting in Paris in early March. At the OECD meeting, there was a groundswell towards fiscal sustainability and little support for liability recognition beyond due and payable.

Mr. Reid commented that there are some very well done sustainability reports. There seemed also to be a great deal of support for reporting in the preparer community. The attraction seems to be that there is no requirement for accrual accounting. If you project cash long enough, you don't need accrual accounting. All countries are capable – in the long run – of doing the cash projections. There was a belief that such projections may influence decision makers.

Mr. Dacey noted that there was active discussion of how to report. The IPSASB meeting, that followed the OECD meeting later in March, led to decisions to place a high priority – the highest priority – on sustainability reporting. They decided to start the project this year. In addition, on social insurance, they decided to go ahead with disclosure of the amounts expected to be paid to those currently receiving benefits until payments are interrupted. For example, for unemployment the projection would be for current enrollees until they return to work. No explicit standards regarding the liability recognition would be provided. Some concern relates to the ability to communicate the information.

Mr. Dacey noted that one concern is the ability of the international audit community to deal with the projections related to fiscal sustainability.

Mr. Reid stated that the Statement of Social Insurance is the only audited statement he is aware of regarding sustainability. Other sustainability reports are not audited.

Mr. Allen noted that we had some encouragement from Mr. Walker (at the public hearing) to work with the international community. He asked Mr. Reid about ways to work with the IPSASB.

Mr. Reid acknowledged the notion that working together would be viewed positively. Mr. Allen related his experiences with collaborative projects between GASB and IPSASB. At that time, GASB provided most of the staff support for the project and the GASB had to adjust its timelines a bit to accommodate the collaboration. There was tremendous effort to work together and the project resulted in slightly different standards.

Mr. Allen noted that the normal course is to be educated by what other standard setters do but that you don't adjust your schedules to collaborate. Mr. Dacey noted that we have a great opportunity to learn from what other countries have done on sustainability reporting. He would view the objectives of the two groups as consistent. He felt we ought to work through the projects together recognizing that we may end up at different points.

Mr. Reid said there is a natural impetus to converge in the private sector due to the global economy. He believes there would likely be resistance. The tendency is to focus on our laws and our conventions. Nations may have reasons not to come together on standards. In IPSASB standards there are many cases where options are offered because nations can not agree on one approach. He views this as a barrier to consolidation.

Mr. Allen noted that the IASB/FASB partnership is driven by the goal to select the most robust standard. The goal is to protect investors. He does not believe this common goal would emerge in government standard setting.

Mr. Reid noted that he is also mindful of the fact that few countries are reporting audited financial statements in a timely manner.

Mr. Patton asked if we have the resources to participate at this level.

Mr. Reid noted that the IPSASB has gained a great deal of support – most recently from Canada. Their staff is now centralized in Canada. Several countries are providing staff on assignment. This makes the collaboration more equitable since they have staff to devote as well.

Mr. Dacey noted that the sustainability projects ought to be easier to coordinate because of the timing. In addition, GASB has some interest in the project.

Ms. Comes suggested that staff return in July with two project plans for sustainability – one proceeding alone and one in collaboration with IPSASB. She noted that an update on the project was handed out Wednesday.

Mr. Reid explained that the JFMIP Principals had discussed convergence at a recent meeting. They agreed that convergence was generally a good thing. There was no specific direction regarding next steps.

Mr. Dacey noted there are many models for convergence as well. There are pros and cons of different approaches. We could learn a great deal from assessing how others have approached convergence.

Agenda Topics

- **Reporting Gains/Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates**

Based on the March discussion and the subsequent communication with Board members, staff presented a number of questions and tentative conclusions about the proposed exposure draft (ED). The Board generally agreed with the staff's conclusions.

The Board discussed whether the proposed standard would preclude display of more than one line item on the statement of net cost (SNC). Paragraph 19 in the ED implied one line item. The Board decided that the proposal should provide for more than one line item if needed for a fair presentation. This issue might arise, for example, if changes occur in opposite directions in more than one assumption. The relevant paragraphs and pro forma SNC illustration will be changed accordingly.

Mr. Patton stated that the phrase "financial reporting transparency perspective" in the boldface type for "question for respondents" #3 was too narrow. He suggested deleting the sentence in which this phrase appears because the respondent should reference a broader framework of objectives in answering the question. The Board decided to revise question #3 accordingly.

Mr. Farrell requested a change with respect to the discussion of cost and benefits. The May ED contained a new general statement in the introduction to the questions for respondents regarding cost-benefit, as well as revisions to Question for Respondents #1. The Board decided to change the ED so that cost-benefit is discussed only in the introductory paragraphs.

The Board discussed two issues regarding the discount rate provisions. A member mentioned that preparers might interpret the word "historical" differently. The Board decided to add a Question for Respondents asking the respondents how they would interpret “historical” in the phrase “historical average discount rates.” Also, the Board decided to add paragraphs to the basis for conclusions explaining the CBO position regarding market rates.

The Board considered and approved the staff proposal to replace “best estimate” with “reasonable estimate.” In addition, Mr. Dacey was concerned that the phrase “most likely” in the paragraph discussing “reasonable estimate” was inconsistent with the concept of “reasonable estimate.” The Board decided to eliminate that phrase. The Board also decided to require that the preparer merely explain why it did not use assumptions in use generally in the federal government.

Conclusion

The staff will make the changes describe above and any other editorial changes the members submit, circulate a pre-ballot draft for member comments, and present a ballot draft in July.

- **Appropriate Source for GAAP**

Staff opened the session by providing a summary of the two main components of the May briefing paper. The first component is an analysis of various characteristics on ten selected entities[1] in the areas of (A) General Profile of the Entities; (B) Size of the Entity; (C) Likely Users of the Financial Statements; (D) Title of General Purpose Federal Financial Report; (E) Financial Statements Presented; (F) Main Line Items; (G) Compliance with FASAB Standards and USSGL Requirements; and, (H) Primary Differences between FASAB Standards and FASB Standards. From the population of characteristics contained in the areas listed above, staff selected 16 characteristics that it deemed most relevant to the determination of the appropriate source of generally accepted accounting principles (GAAP).[2] Using those 16 characteristics, staff provided a draft framework for determining which source of GAAP would be more appropriate for a given entity utilizing a non-weighted scoring mechanism.

The second component of the May briefing paper is feedback from the user community in the form of a brief survey that was circulated to the ten selected entities to provide

[1] The ten selected entities are Community Development Financial Institution, Corporation for National and Community Service, Federal Deposit Insurance Corporation, Federal Prison Industries, Government National Mortgage Association, Millennium Challenge Corporation, Office of Thrift Supervision, Pension Benefit Guaranty Corporation, Tennessee Valley Authority, and U.S. Mint (Mint switched to FASAB beginning with fiscal year 2005).

[2] The 16 characteristics selected by staff as most germane to the distinction between FASAB GAAP and FASB GAAP are (a) Included in the federal budget; (b) Bureau and/or consolidated with a parent agency; (c) Reports utilized by taxpayers; (d) Appropriated funding; (e) Included in the CFR; (f) Individually significant/material to the CFR; (g) Government corporation; (h) Reports utilized by management; (i) Reports utilized by beneficiaries of services; (j) User fee funded (not necessarily self-sustaining); (k) Required by law to follow a different set of accounting rules; (l) SEC filer; (m) Reports utilized by investors; (n) Predominately of a business nature; (o) Potentially self-sustaining through the production of revenue; and (p) Has a large number of business-type transactions with the public.

information on the expected benefits and perceived costs and burdens associated with various approaches to resolving any concerns regarding the source of GAAP. Staff summarized the sense of the comments received from the respondents, which were generally not in favor of converting from FASB GAAP to FASAB GAAP. Staff also opined that the members may want to consider the nature of AICPA's Rule 203 designation "as the body to establish accounting principles for federal government entities" as well as the AICPA recommendation that FASAB determine which entities should be required to follow FASAB GAAP. Staff then asked the members if they would like staff to develop guidance on this issue.

Mr. Schumacher asked how many other entities besides the ten analyzed there are? . Mr. Reid said he believes the ten selected include the most material entities, but there are a couple hundred entities currently following FASB that, when added together, do not have a material impact on any one line item of the consolidated financial statements. Mr. Reid pointed out that a conversion to FASAB standards, however, could be material within any given agency's financial statements.

Mr. Werfel asked if all the entities that Treasury needs to consolidate the financial statements effectively under the proposed framework would be required to use federal GAAP. Mr. Reid responded that the Board has made provisions so that everyone that currently responds is under federal GAAP. However, Mr. Reid noted that because there are different bases of accounting being reported, Treasury is consolidating apples and oranges and questioned whether there should be standardization to address that.

Mr. Allen said it is still accrual accounting and he thought the issue was whether or not there are components of the information that Treasury is not receiving from those entities that report under FASB standards.

Ms. Comes said the question that originated is really much broader than that – is it a fair presentation for standalone federal component entities' financial statements to rely on FASB GAAP and present that as GAAP for a federal entity?

Ms. Comes said the answer is currently that the presentation is considered GAAP because the practice has been grandfathered. However, two important questions arise: Is continuing that practice appropriate and do we support the consolidation appropriately?

Mr. Werfel asked if there are agencies today that are relying on FASB standards, in whole or in part, and are material to the consolidated financial statements where there would be value added from a consolidation standpoint by requiring them to move to FASAB?

Mr. Reid responded that the answer to the first part of Mr. Werfel's question is definitely yes; the second part is unknown. Mr. Reid said that Treasury currently has a material weakness related to the financial statement preparation effort and one of the things that makes it difficult to overcome is the lack of budgetary resource statements for entities following FASB. Another issue is how numbers might materially change if entities were required to comply with FASAB. Mr. Reid noted that one example is the issue of valuation of retired assets within the Tennessee Valley Authority (TVA) – these retired assets would be written off under FASAB standards but retain their value under FASB standards to allow TVA to recover the costs through rate-setting. That amounts to about $10 billion at TVA for just that one issue so it is not immaterial. Mr. Reid questioned whether one could allow one practice for rate-setting and another for consolidation, stating that it is not an easy answer, which is true for most of the issues.

Mr. Allen said that there is nothing that precludes us from asking for the information that is needed (e.g., budgetary reporting). FASAB could still grant an exception and state "except that we want X information."

Mr. Jackson questioned what relevance there was to requiring a Statement of Budgetary Resources (SBR) for agencies that do not have to go through the hoops that are required in order to prepare an SF-133.

Mr. Reid said he would ask the question differently – if you are a federal entity, and Treasury is consolidating your results, then Treasury needs all of the information that is required to do that. He went on to say that, currently, Treasury is not able to collect audited information that is outside of what is required to be audited under existing GAAP.

Mr. Werfel said that even if an entity is not currently preparing an SF-133, and some of them are not, he does not think that renders an SBR unnecessary.

Mr. Jackson said that he does not think that many of these entities that are not preparing SF-133s would have many of the elements that appear on the SBR.

Mr. Werfel said the larger question is a question of making sure that OMB guidance and FASAB guidance dovetail in a way that makes sense. Mr. Werfel said OMB is thinking of requiring all government corporations to follow FASAB GAAP through Circular A-136. In addition, OMB would reissue the 1995 OMB Memorandum from Alice Rivlin (M-96-05) discussed in the last meeting that requires government corporations to follow FASAB GAAP.[3]

Mr. Werfel went on to state that OMB would provide an opportunity, as it often does, for agencies to justify, through costs or other factors, as to why they might want an exemption to the requirement. Then OMB would coordinate with Treasury as to whether an exemption should be granted or not.

[3] [Staff note: OMB Memorandum 96-05 has been posted to the OMB website subsequent to the board meeting at http://www.whitehouse.gov/omb/memoranda/m96-05.pdf. In addition, a draft of OMB Circular A-136 that went out for comment on May 22, 2007, included the statement that "Effective for FY 2008, all sections of the PAR apply to Government Corporations."]

Mr. Werfel said that setting the policy and the direction but allowing the flexibility to make sure they are meeting the needs and not violating cost/benefit and other things seems to be the right approach. The question is what language needs to be in FASAB literature to help facilitate that.

Mr. Farrell provided an example in international operations where international subsidiaries send consolidation packages to the parent companies based on what is demanded by the parent company. The parent company does not require the subsidiaries to maintain their books in any specific fashion other than what makes their business work, but they have to be able to provide the information to the parent company that is necessary for purposes of consolidation. If we could get a consolidation package from each of the entities that we are concerned about, which may or may not include budgetary reporting, we would not be requiring them to change all of their financial systems, hire new accountants, etc.

Mr. Reid says that his main concern is that Treasury needs an audit opinion on whatever information is provided that says it has been audited in accordance with GAAP.

Mr. Dacey said there are two different issues – the first is what does FASAB want the individual entities to report in their statements so the reader is adequately informed as to which GAAP is being followed and the second is that the entities do currently submit reporting packages and they should be crosswalking their statements to FASAB GAAP but that is not always happening.

Mr. Dacey went on to state that FASAB could have a situation potentially where the individual agency statements are published and issued on one basis of GAAP and the auditors are opining in the consolidated financial statements on another basis of GAAP. He commented that FASAB would have to construct its requirements so they would both be GAAP but he is not sure how that would be accomplished.

Mr. Reid said he is not wedded to any solution; he needs an audit opinion that is GAAP and regardless of how that is accomplished – whether it is a footnote, crosswalk, etc. – some level of improved standardization is needed.

Staff commented that there may be ways to make changes less burdensome and costly to agencies, such as waiting until XBRL (eXtensible Business Reporting Language), which is already being used to a limited extent by a few federal agencies, is extended to the A-136 in a few years to allow for reporting on both FASAB and FASB basis with less effort or having a rolling implementation whereby agencies would be required to comply with FASAB when acquiring a new financial system or making major enhancements to existing systems.

[Lunch Break]

Upon returning from the break, Mr. Allen noted that the three sponsors (GAO, OMB, and Treasury) are most concerned regarding the resolution of the issue and suggested that they let the rest of the Board know exactly what they need.

Mr. Reid said that statutorily, Treasury is authorized to obtain whatever information it needs for consolidation. There is a question about how enforceable that law may be and how far OMB's authority reaches with respect to government corporations.

Mr. Allen inquired if GAO's audit responsibility extended to all of these entities and Mr. Dacey confirmed that it does.

Mr. Dacey said he believes that they can deal with these issues administratively with OMB's assistance and get the information needed. However, he questioned whether there is some benefit to including some of the information in the entity's individual statements that would assist in providing necessary audit coverage. Mr. Dacey noted that there are a number of ways – a reporting package, agreed-upon procedures, etc – to validate the adjustments to go from FASB GAAP to FASAB GAAP. He said the sponsors would probably need to discuss the different options – one of which would be putting some of the information in the individual statements – and get back to the Board.

Mr. Allen said he would like to have more input from the sponsors because he does not know all of the forces that are in play and all of the issues involved.

Mr. Werfel said he thinks the best outcome is if OMB can craft a governmentwide policy through a circular and have FASAB evaluate what kind of changes are necessary to FASAB guidance, assuming the Board agrees with that policy, to ensure that the policy is even stronger. Mr. Werfel said that when OMB issues guidance, it gets general compliance with it, but it is even better when the FASAB literature aligns with it.

Mr. Allen said the sponsors should come back with the policy and direction that is most useful.

Mr. Reid noted that the real lever would be if an agency could not get a clean opinion unless it complies; the question is – What short of that will work? He said that he is skeptical that simply changing a circular will have that impact.

Mr. Jackson said the Board needs to take some formal action at some point because the way it is currently dealt with is through a newsletter and the Board really needs something more formalized. He said the Board needs criteria that will guide OMB's decision-making process and OMB, GAO, and Treasury can help develop the criteria. The criteria could indicate which agencies have to follow FASAB GAAP but he feels the Board definitely needs to have something formal.

Mr. Jackson went on to say that he believes that there are definitely some federal entities that have legitimate reasons for following external reporting practices and should not be subjected to marching over to OMB and asking for a exception. He said that should be built into the criteria and some characteristics should be considered conclusive; there may be some that, if met, would be a definitive indicator of whether an entity should follow one source of GAAP or another.

A brief discussion was held on relevancy of other possible criteria such as whether an agency is subject to the Antideficiency Act, part of the budget, or backed by the full faith and credit of the United States.

Mr. Dacey said he would like to remind the others when they discuss this issue that there are legislative agencies that are in this category as well. Mr. Jacobson said that is a tougher nut to crack because no FASAB sponsor has authority over the legislative or judicial branches.

Mr. Farrell asked about whether the FFRDCs (federally funded research development centers) are included. Staff responded that the federal entity project would address whether or not FFRDCs should be treated as federal entities and if so, they would probably need to follow the same criteria that will be developed in this project.

Mr. Allen asked if there were any objections to staff meeting with the sponsors to discuss the requirements and work out the criteria to present to the Board at a future meeting. There were no objections.

> **CONCLUSIONS:** FASAB staff will coordinate with GAO, OMB, and Treasury on potential solutions to the issue and, if possible, come back to the Board with a draft framework that could be used to determine the appropriate source of GAAP for federal entities.

- **Administrative Discussion – Cost-Benefit Considerations and Alternative Views**

The Board discussed briefly the policies and procedures for (1) soliciting input on cost-benefit considerations and (2) alternative views.

Mr. Farrell noted that he had raised concerns regarding how we solicit feedback from respondents on benefit versus cost considerations. He believes the we need some consistency as we move forward. With respect to the draft exposure draft on changes in assumptions, he pointed out that we have text in the preamble to the specific questions. He believes that is appropriate to broadly seek input. It may be useful to ask a standard question that seeks any cost-benefit input on (a) the entire document, (b) any specific aspect of the document, (c) any questions that are asked or (d) any of the views expressed in the basis for conclusions or alternative views.

Mr. Farrell pointed out that in the draft ED on assumptions at par. A10, page 17, we specifically mention that we did not propose a certain requirement. He prefers that we deal with cost-benefit in one place rather than piece meal and perhaps inconsistently throughout the document. We should mention it in the preamble to the questions and perhaps have a specific question.

Mr. Werfel noted that we may have delved into cost-benefit on a specific consideration and we end up highlighting it for the community. We may have thought about cost-benefit generally for the whole proposal but dealt with it more explicitly in specific instances. The goal is good responses from the community on cost-benefit.

Mr. Schumacher supported the notion that we talk about cost-benefit once. The general statement covers it. A piecemeal approach suggests we don't consider it in cases where we are silent.

Mr. Allen supported having the preamble because it sets up the questions. Mr. Dacey noted that some of these issues are preparer issues. We sometimes want preparers to focus on issues. One way to deal with this is to have a standard question on cost; to seek input potential barriers to implementation. His concern is that having the preamble without the question may not focus respondents on the issue.

Mr. Allen suggested having a standard cost question as the last question. Mr. Jackson said the question should not be worded "do you believe this proposal is cost-beneficial." Instead, it should call on them to identify any concerns they have with respect to complying with the standard. You don't ask a question; you open an avenue for their feedback so that you are inviting but not leading them.

Mr. Werfel suggested that you have the global question but where you have a specific concern you may still have a focused question that hones in on the issue. Mr. Allen agreed but noted that ideally specific concerns are addressed by the Board before a proposal is made. Mr. Jackson agreed but Mr. Farrell noted that we do that. He reminded the Board that the SSA, DOI and DOD staff met with us extensively on practical implications of standards that they would have to implement.

There was no objection to having the final question focus generally on cost issues.

Ms. Comes noted that the rules of procedure for alternative views were developed in light of the need for federal members to have time for consultation within their agencies before they provide their alternative views. Ideally, the document would contain a balanced presentation of the majority view and the alternative view with respect to the concern raised. This is often challenging since the majority view must be prepared without full knowledge of the alternative view (which is sometimes added after balloting occurs).

Mr. Patton indicated that while waiting for alternative views, and thinking about the fact that this is the last thing added, he worries about the balance in the document. He believes there should be some discussion of the alternative view in the basis for conclusions. The primary view may look awkward if the final alternative view is not as expected. This may lead to an additional alternative view to adequately explain the majority view.

Mr. Allen agreed that until you know what the alternative view is you can not adequately explain in the basis for conclusions what the majority view is. Mr. Patton asked how he can vote on a document that is not finished until the alternative view is included.

Mr. Jackson said the deliberative process should reveal the views. While the alternative view is not written; it certainly should be raised during discussions. The federal members have plenty of time to deal with alternative views in advance. The Board needs to be able to move forward with or without the written expression of the alternative view. He believes there needs to be a point in time when you move forward; there should be a drop dead date. There should be some independence in the process through limits on the amount of time allowed for preparing alternative views.

Mr. Patton clarified that his concern is not the length of time; it is the sequence. He has already voted and subsequently sees the written alternative view and may wish to respond with an explanation of why he does not agree with it.

Mr. Allen suggested that we not change any formal procedures but that we work through good faith to attempt to get alternative views – in body and substance – to the Board earlier than the vote. Ms. Comes noted that the statement of members responsibilities encourages that practice.

Ms. Comes explained that staff typically provides the alternative view to the members who have voted and asks whether it would cause a member to retract his or her ballot. She also acknowledged that members would at that point have a chance to offer an alternative view and the clock would start again.

Mr. Allen concluded by saying that there did not appear to be alternatives. We must to rely on members to convey the substance of their views during deliberations and provide timely alternative views when the formal process begins.

- **Elements**

The Board received a revised draft final Concepts Statement on Elements, showing changes made since the March draft, and a cover memo explaining the changes. Ms. Wardlow reviewed for the Board the goals of the Elements project, the approach taken on the principal issues, and the decisions made since the project began in the fall of 2003. She said that the modifications to the Elements ED proposed in the March and May draft final statements were not intended to change the substance of the proposed Statement as presented in the ED. Staff had reworded some material and added clarifications designed to resolve concerns raised by some Board members, including concerns about potential misunderstandings by constituents. Ms. Wardlow said the goal of the meeting was to reach agreement on the proposed changes and address any additional concerns, so that the staff could prepare a preballot draft.

The Board first discussed the additional wording in the May draft that was designed to clarify the role of concepts statements and their position in the GAAP hierarchy compared with statements of standards. Wording had been added or modified in the discussion of "Statements of Federal Financial Accounting Concepts" in the preamble, the Executive Summary, the Introduction, and the Basis for Conclusions (BFC). Staff also had added a new Appendix C, which reproduces the AICPA's AU Section 411 discussion of the GAAP hierarchy. The additions were intended to reduce the possibility of confusion among preparers, auditors, and others concerning the applicability of the definitions in the new concepts statement versus the definitions in existing standards.

Mr. Dacey said that perhaps the issue was addressed in too many places in the draft. He mentioned the Board's decision to add paragraph A33 to the BFC in the Oil and Gas standard to address the applicability of definitions and he thought something similar could be placed in the Elements document and other material could be reduced, although he thought the additional discussion in the preamble was helpful. He was not sure the document should address potential conflicts between concepts and standards or should simply discuss the place of concepts in the GAAP hierarchy and how concepts should be used. He agreed with the addition of Appendix C. Ms. Comes said she had introduced the lengthy material to clarify the issue. She could reduce the material to one paragraph if that was sufficient clarification. Mr. Farrell reminded the Board that over the four years of the project these issues had been discussed multiple times, and often when the Board has taken something out or tried to clarify something to meet a member's concern, another member has then disagreed with the change. If the Board reduces the new material to something similar to paragraph A33 of the Oil and Gas document, which he would not object to, would someone raise the issue again at the next meeting and request additional material? Mr. Dacey said he thought that one could reduce the number of additions on this issue. Mr. Farrell responded that the additions were made to answer questions from the last meeting which indicated that there was insufficient discussion of the issue. Now members are saying we have too much. Mr. Allen said the main point is whether the Board has adequately addressed the issue and he does not hear anyone answering "no" to that, so the second question is whether, as Mr. Dacey is saying, one could address the issue more succinctly.

Ms. Comes asked first whether the Board members read anything in the additional material that they did not agree with. Secondly, would the Board members be comfortable if staff continues working with the members who raised the specific concerns—for example, the questions inserted in the BFC: "How Does This Concepts Statement Affect Existing Definitions?" "What Impact Should This Concepts Statement Have on Practice?" and "How Will the Board Reconcile the Differences Between the Concepts Statement and Standards?" The relevant text on those questions runs for about two pages and there are summarized versions in different places in the Statement. Board members generally agreed to both questions. Mr. Dacey said he thought the additional material in the BFC was useful; he was referring more to the additions in several places in the Statement and the fact that they sometimes were expressed differently. Ms. Wardlow said some of the differences were due to different contexts. Mr. Patton said he was disappointed to read in the BFC that "the elimination of inconsistencies between concepts statements and standards . . . will require many years . . ." He was hoping for quicker action. Ms. Wardlow added that, from her experience with GASB, when a Board reopens a standard to amend one part of it, often the Board finds other things it wishes to change and the process takes much longer than originally anticipated. Also, in terms of the new definitions of elements, more than one standard may be affected because the standard was written with a different definition in mind.

The Board then discussed the second question in the staff memo: "Does the Board agree that the definitions in this Statement are needed to resolve issues or problems raised with existing definitions in FASAB standards and with definitions in the Glossary that have not been adopted in a statement approved by the Board?" Some members had questioned why the Board does not simply extend the use of current FASAB definition of elements or adopt the definitions of other standard setters, instead of developing new definitions. To address this issue, staff had added paragraphs 7 and 8 to the BFC. Paragraph 7 lists the current FASAB definitions of asset, liability, and revenue in FASAB standards and the alternative definition of asset and a definition of expense that are included in the Consolidated Glossary but have not been adopted in any final statement approved by the Board. Paragraph 8 lists the principal issues or problems that have been raised with existing FASAB definitions. Mr. Dacey said he liked paragraph 7. He agreed with the points made in paragraph 8, but suggested stating them more positively to remove the negative tone.

In response to Ms. Wardlow's and Mr. Farrell's earlier comments about the length of time the concepts statement had been in development, Mr. Werfel said that most of that time was prior to the ED. Now that comments had been received on the ED, he thinks the various issues should be reexamined, particularly in light of some of the comments. For example, a number of responding agencies asked the Board not to change the current definitions of elements. This prompts the question why the Board is changing the definition of a liability, which the respondents seem to think the Board is doing. But the Board is not doing that. The current definition of a liability [in SFFAS 5] will remain intact, and the definition in the concepts statement is a different definition that serves a different purpose. Because of this, he thinks the clarification in the document is helpful. However, he still is concerned that in the FASAB literature there will be two definitions of certain elements and even with the added clarification in the document, there is a risk of confusion in the preparer and auditor community. Mr. Jackson said that he had shared that concern, but it had been alleviated at a previous meeting when he realized that this situation is not uncommon. There is precedent in the FASB and GASB arena, where things were defined in the early days and then later concepts statements evolved in which the definitions might not be consistent with a preexisting standard, but that did not change the standard. But this is dealt with in a professional environment. It is only when there is no guidance or definition in a standard that one turns to the concepts statement—that is, one starts to go down the GAAP hierarchy and may find oneself looking to the concepts statement for guidance. Most professionals, preparers and auditors, know that and have encountered that situation before. Mr. Dacey said the auditors are well versed because the hierarchy is in the auditing literature. But it is not in the accounting literature, so the preparer community is less well versed. Currently the FASB is in the process of incorporating some of the auditing literature into their own literature. Mr. Jackson said that FASAB staff has done the same by adding Appendix C, which cites the GAAP hierarchy. Mr. Allen said that GASB also added some standards to its Statement No. 34 that previously had existed only in the auditing standards.

Mr. Werfel commented that when he looked at the differences between the definitions in the FASAB Elements statement and the definitions of other standard setters and the problems cited by FASAB staff with those definitions, he asked Ms. Comes whether FASAB definitions are different because there are problems with applying those other definitions in a federal context. Ms. Comes had responded that the perceived problems are general ones and not specific to use of those definitions in the United States. The definitions are different because there are different beliefs about how to express a definition of an asset or a liability. So, there appears to be a divergence rather than a convergence going on at the present time with other standard setters. When one adds that to the current situation where the Board's new definitions are diverging from the current definitions, there seems to be more confusion.

Mr. Allen said the information staff provided in a summary table on problems with other definitions was educational only, and what one person might see as a problem another might not. In some cases, he thought different standard setters had used different words, but he was unsure that there was any substantive difference between their definitions. As staff has pointed out, the FASAB wanted to have an integrated set of definitions. Other standard setters might see it differently. He does not believe there is as wide a variation in definitions as might at first appear. He was unsure how the standards would be different if they were based on different definitions. He thinks there would not be significantly different opinions if one applied the SFFAS 5 definition of a liability versus the definition in the concepts statement.

In response to Mr. Werfel's comments, Ms. Wardlow said that the summary table did not include the definitions of Australia and New Zealand. However, with the exception of the United Kingdom, practically all of the industrialized countries have adopted the FASB's definitions. They made some wording changes, sometimes due to environmental differences, but none of them had done a conceptual framework before and their definitions are basically the FASB's definitions. She added that the FASAB's new asset and liability definitions are where the FASB is going in its joint project with the IASB. The principal changes they are making relate to the problems they have had with probability, which they are putting in measurement, and the focus of the definitions. That is, the FASB's current definitions state that an asset is a future flow and a liability is a future sacrifice. The FASB's and IASB's proposed new definitions state, as do the FASAB's definitions, that assets and liabilities are, respectively, the resources and obligations that exist at the reporting date. The expectation of future inflows or outflows is addressed through measurement. So, in her view, the FASAB is at the cutting edge in terms of the direction being taken by the FASB and the IASB.

Mr. Werfel said he did not mean to imply that FASAB is going in a different direction. His concern is that there are many things that cannot be done in government today because there are many different definitions of terms such as child, loan, and default. With that experience, he wonders whether the different definitions of elements by different standard setters will be a constraint or complication if the Board wants to look across governments. He would like to leave on the table the idea that it is not good to have two definitions of the same term in the literature, but it may be necessary. A more difficult question is how different these definitions are. He understands that difficulties or ambiguities may have occurred with the SFFAS 5 definition, but the question being asked at his agency is whether there is a substantive difference between that definition and the one in the concepts statement. Are there things that would be changed in past standards if the new definition had been in place or are there things today that would not be captured if one referred to the SFFAS 5 definition but would be captured with the new definition? He and his agency would like to know in what direction the new definitions would take federal reporting. Would more things or more types of things or fewer things be recognized?

Ms. Wardlow responded that it is difficult to tell. Likely there would be some differences but for many things there would be no difference. She had not yet looked at how past FASAB standards might have been affected. However, she had done a similar exercise for the GASB several years ago to see whether things included in prior standards would not be included under the proposed new definitions of asset and liability. She found it was almost impossible to answer that question because there was a lack of consistency between the standards, so that items considered liabilities under one standard might not be considered liabilities under another standard. That highlights one of the FASAB's goals in developing the Elements concepts statement—to have some commonality in the definitions, some common understanding of what an asset is and what a liability is for the Board to work with in the future as well as for preparers, auditors, and users to share that common understanding. There would then be greater consistency from one standard to another and in the thinking of one Board to another. That is the aim of all conceptual frameworks. She thought FASAB certainly could look at past standards but there might not be an easy answer except that probably not a lot would change.

Mr. Allen agreed with Ms. Wardlow's comments. He recalled that GASB had talked about this and was concerned about inconsistencies in its standards, and from talking with Ms. Comes and others he understands that there are inconsistencies in FASAB's standards. GASB was concerned that members not come to conclusions based on what they had for breakfast that morning. That phrase was often used. The GASB found as Board members came and went that everyone has his or her own definitions. With deliberations and going through due process the Board would come to reasonable conclusions, but as the years pass, one realizes that there are inconsistencies. That does not mean that any of the standards are wrong. Many of them could be better. A concepts statement is more important for the Board than for anyone else. After going through due process, the Board should be comfortable with it. New Board members are not asked to swear allegiance to it, but it helps guide them and they realize that the concepts statement went through due process and the Board felt comfortable with it. The Board may for various reasons issue a standard that differs from it, but at least the concepts statement was a starting point for a discussion of the issues. All one can ask as members is do we feel comfortable with the definitions based on the discussions and the due process that the Board had over the last three or four years? At that point, we issue the concepts statement and move on.

Mr. Jackson asked why the GASB took so long to address other postemployment benefits (OPEB) when people in a number of states knew it was a liability. Mr. Allen responded that all standards take a long time. Pensions took many years. The GASB required OPEB disclosures until the Board had time to address the issues. When the Board finished pensions and looked at OPEB, there was very poor compliance with the disclosure requirements. The Board took generally the same approach as with pensions, but there was a new Board, some questions had arisen with pensions having been in effect for several years, and in a couple of areas the Board reached a different conclusion. Now the GASB is making some modifications to the pension standards so that there will be consistency between pensions and OPEB, and he had just described a 20-year process. Mr. Jackson asked whether there was a liability definition in place. Mr. Allen said no, but it would not have changed anything in that 20-year process. It is just the time it takes to gather information, educate people, and obtain support. Ms. Wardlow added that it did not change the FASB's pension and OPEB standards either. They looked at how they thought pensions and OPEB should be accounted for. Neither Board has put the entire liability on the balance sheet. The definition of a liability only takes one so far. The FASB had certain things that it thought were important to report, but it was not simply a matter of applying the definition of a liability. Concerning the GASB projects, Mr. Allen said he believed strongly that pension and OPEB promises were liabilities. But he reached a comfort level with the decision to go prospective. The Board did not make a big argument over whether the promises are or are not a liability. The Board adopted a "funding" approach and, moving forward, the government will either fund that year or recognize the liability for that period. The approach did not mean there was not a liability for the promises. It was a practical approach to getting the liability recognized. The FASB did something similar by giving a 10-year phase-in for the OPEB standard. The Board has to deal with realities. Ms. Comes said there is a social aspect to accounting. It is not like an engineer discovering a new way to construct a bridge and then all bridges are built the new way. Accounting is about information and a community of people who use information and they accept change only gradually, so you have to bring the community along with you. There is an incremental nature to accounting because we are serving people, not building bridges.

Mr. Dacey asked whether any member thinks that after the concepts statement passes he or she might want to take the Board in a different direction and would be inhibited by the concepts statement. Mr. Farrell said that four years previously he did not favor taking on the Elements project. He thought that accountants know what assets and liabilities are and the Board has important things to address and should focus on solving accounting problems for the preparers and auditors. Mr. Patton persuaded him that the Board could not develop standards when it did not understand the context, because the

Board did not have good definitions of assets, liabilities, revenues or expenses. The project has been a useful process for the Board. We still know what assets and liabilities are. We will discuss things and arrive at what we think is right in the circumstances, but we will always have something to fall back on. He does not believe there are any preconceived notions.

Mr. Werfel said he was not advocating a perfect knowledge of the future. We need not tell people exactly what will be recognized as a result of this change in the concepts. But, he does believe an understanding of what direction the new concept is taking us in is helpful. Is it more clarity and better information – we have a baseline that we have been relying on for years. In order to be transparent, we should signal in the concept statement what direction we are going in. When he briefs OMB, he would like to be able to say the definitions are not substantively different and that the Board believes the trajectory should stay stable. Or, the Board believes this represents a change in trajectory. He is currently not sure. The only item up for consideration is social insurance. It seems to be a different trajectory and would extend to other entitlement programs. It is a major trajectory since it is trillions of dollars. He referenced the government's ability to change law as a central point. This seems to be a change to him. His question is whether the concept is part of a larger strategic direction we are taking.

Mr. Allen indicated that he does not believe the Board could define the current trajectory. But, he wanted to go around the room and ask whether their conclusion on social insurance would be any different if they had never seen the elements document. Mr. Reid indicated that the elements definitions do not change his mind in any way. But, the document does help him know if he left anything out; we had not missed anything. He has had at least three colleagues tell him that absent SFFAS 17 – some elements of social insurance would have been deemed liabilities. If that had happened, some agencies would have had liabilities and some would not under similar circumstances. The social insurance standards being developed will govern the outcome – not the elements definitions in concepts statements.

Ms. Cohen, Messrs. Farrell, Schumacher, Dacey, and Allen indicated that they would not have come to a different conclusion on social insurance with the old definitions. Mr. Dacey believes that he can equate the old and the new definitions.

Mr. Patton indicated that he voted for SFFAS 17 – which did not treat social insurance as a liability – and the context was that liability treatment would trigger a veto. He believed that the potential veto influenced some members' votes. His personal view was that the conceptual framework was underdeveloped at the time. The frustration of trying to apply the concepts that existed was insurmountable. He believed that the change to liability recognition would have been too large a change in the absence of a framework. He could not operationalize the objectives.

Mr. Patton believes the new definition will lead you to ask different questions but that is not a strategic move to obtain a different outcome. The concepts structure debate.

Ms. Wardlow noted that FASB periodically has educational sessions. Standards don't flow from definitions; definitions are not engraved in stone. The value on concepts is in putting people on the same basis, it gives you a common way to think about things, you may still say I won't do precisely what this concept suggests I should do, the discipline is that you must explain yourself in the context of the concepts.

Moving to question 2, Mr. Allen asked do you agree that definitions are needed to resolve issues. Messrs. Jackson, Farrell, Schumacher and Patton and Ms. Cohen believed they did. Mr. Reid was inclined to say no; it is a concept statement and not a standard. Mr. Werfel – No. Mr. Dacey deferred responding. Mr. Allen said that the thrust of the question is whether you need concepts statements.

Ms. Wardlow explained that question 3 seeks input on the Board's preferences with respect to the wording of the asset definition. The options are (a) an asset is a resource that embodies economic benefits or services that the federal government controls and (b) as asset is a resource that embodies benefits or services to which the federal government controls access.

Mr. Patton par. 28 – The second essential characteristic is the ability of the government to control. He asked if is "able to control" might be considered. Ms. Cohen suggested that each phrasing had the same meaning and she believes the Board might benefit from simply picking one and sticking with it.

Mr. Jackson believes that the ability of the government to control things is quite broad and could sweep in a great deal. With the exception of Mr. Patton, the members preferred option a – an asset is a resource that embodies economic benefits or services that the federal government controls.

Ms. Wardlow explained that question 4 – Does the Board agree with the addition of a reference to statutory settlement in pars. 40 and 45? – arose from a request from Mr. Jackson. The addition would explain that the meeting of the minds between parties regarding settlement can arise from statutory language. Members other than Mr. Werfel and Mr. Reid agreed.

Ms. Wardlow explained that question 5 addresses the changes to the definitions of revenue and expense. Examples of revenues and expenses have been removed.

> Proposed: A revenue is an increase in assets, a decrease in liabilities, or a combination of both that results in an increase in the government's net position during the reporting period. [Existing in ED: A revenue is an increase in assets, a decrease in liabilities, or a combination of both <u>from providing goods or services, levying taxes or other impositions, receiving donations, or any other activity (excluding borrowing) performed</u> during the reporting period. – delete underlined text]

> Proposed: An expense is a decrease in assets, an increase in liabilities, or a combination of both that results in a decrease in the government's net position during the reporting period. [Existing in ED: An expense is a decrease in assets, an increase in liabilities, or a combination of both <u>from providing cash or cash equivalents, goods or services, or any other activity (excluding repayments of borrowing) performed</u> during the reporting period. Delete underlined text]

In addition the following language has been added to par. 54 to explain the nature of items such as tax refunds – "Common sources of revenues are charges and fees to other entities for goods or services; tax levies and other impositions; and donations. Expenses generally result from the provision of cash, cash equivalents, goods, and services to other entities. Reversals of transactions involve the same element as the original transaction. For example, a tax refund is considered a revenue reduction and not an expense."

Mr. Dacey noted his concerns regarding the word "reversal." Ms. Wardlow agreed to suggest alternative wording since members agreed with the concept.

Ms. Cohen objected to the added language at par. 54. She did not believe that it added anything. No other members objected but some did wish to see the modified language.

Ms. Wardlow explained that her changes to the "effects of uncertainty" section related to wording selection, redundancy and particularly par. 57.

Mr. Dacey suggested that the prior version of par. 59 – the last two sentences – conveyed the notion that an item might not meet the basic recognition criteria because of uncertainty. Mr. Jackson indicated that it seems to go without saying. Mr. Allen asked if anyone objected to including the concept of stating it both positively and negatively.

Ms. Wardlow suggested adding the statement "items that because of uncertainty do not meet the basic recognition criteria may be candidates for disclosure." There were no objections.

Mr. Allen polled the members on question 6 which asked if the members agreed with the revised section on the "Effects of Uncertainty." All members agreed. Mr. Dacey asked if the language might trigger restatements due to errors versus treating items as changes in estimates. He suggested that a footnote would help. Members did not object.

With respect to question 7, Ms. Wardlow explained that Mr. Dacey had previously asked if we had clearly addressed intra-governmental activity. She believed we had and attempted to make the language clearer. She sought concurrence on the new language at par. 14 and in footnote 7 of par. 43.

While items that meet the definition of an element from the perspective of the federal government are assigned to component entities, some items recognized in the accrual-basis financial statements of component entities are not recognized in the consolidated financial statements of the federal government because they do not meet definitions of elements from the perspective of the federal government. Instead, they are items that would meet element definitions from the component entity perspective and are treated as such by the component entity. For example, component entities may exchange services for a fee and recognize the resulting intra-governmental assets, liabilities, and related elements in their financial statements. However, intra-governmental items offset each other when the government is viewed as a whole and are eliminated in preparing the government's consolidated financial statements.

Mr. Dacey does not believe that capital donations and imputed costs are adequately dealt with. He would not change the meaning but would add detail.

Ms. Wardlow noted that the issue seems to be that the definition is written from the perspective of the government as a whole. She does not believe that the issue is a problem. Mr. Dacey indicated that capital contributions are not revenue or expense and they do not exist at the government wide level. Thus, the edits are helpful but don't address the entire issue. Perhaps some examples would help.

Mr. Allen found the text broad enough to deal with it. Mr. Jackson indicated that the examples listed near the end of the paragraph could include Mr. Dacey's examples. He agrees that this would help. No one objected to this solution.

Ms. Wardlow noted that she had not attempted to revise the appropriations language and she wanted to confirm the Board's support for the existing language in light of earlier concerns expressed by Mr. Dacey. No objections were raised.

Ms. Wardlow noted that the basis for conclusions had not been discussed extensively. She requested that comments on the basis be sent to her after the meeting.

Mr. Werfel requested consideration of paragraph 44.

44. 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.

Mr. Werfel noted that the public hearing and the comments on social insurance brought to light (a) a central question in social insurance is the question that par. 44 addresses – the government's ability to change law - and (b) that there is the a continuum of the government's commitments from extremely firm to those that will be changed with great frequency. His questions are:

1. If we are to include par. 44, should we debate and discuss what we learned from the feedback on the social insurance project?
2. Should we talk about the concept of little or no discretion? We seem to be diverging from FASB and GASB here. Both have this concept but we don't.
3. Should we eliminate this language completely? Do we really need this language or can we survive without it.

Mr. Allen suggested that we discuss question 3 first. Mr. Allen asked why the par. 44 language was included in the elements ED. Ms. Wardlow indicated that it was added in response to members and others who said that if something is going to or may happen in the future you should consider it. Accounting is based on what has occurred up to the date of the balance sheet. You may have doubts about future changes but the likelihood of change can be considered in measurement. In response to the ED, we had 19 that supported the language in par. 44 and seven who agreed with the alternative view to remove par. 44. The responses were solidly in favor. Further, Congresses ability to change things is pervasive and you would end up not recognizing anything.

Mr. Werfel acknowledged this and explained that the notion of a continuum and little or no discretion addresses that. You would not be saying that there is an absolute. There could be differences along the continuum. Ms. Wardlow said these things are part of the assessment of whether you are obligated. This has been discussed extensively – including the notion of little or no discretion.

Mr. Jackson indicated that he was unsure that we really needed par. 44. He indicated that he'd think about par. 44 in the context of specific standards. Mr. Patton believes it's broader than a standard would be. Mr. Jackson indicated that the wording was very explicit. Ms. Wardlow said that it was intentionally so and that GASB also had similar language.

Mr. Allen related that FASB confronted this issue when it addressed OPEB. Companies objected to recognizing a liability for commitments that could be changed unilaterally. FASB decided that accounting is not legally based – it is about capturing the understanding at the time. You can take into account the likelihood that you may not meet the obligations so that you adjust the measure of the obligation. GASB also relied on this concept.

Ms. Comes explained that comparisons between single words or phrases were incomplete. She explained that the GASB document uses "little or no discretion" in the context that ability to change laws does not preclude liability recognition or liabilities arising from constructive obligations. In addition, the Board chose to remove the phrase “little or no discretion” but explains the requirement to settle in other terms. So that the notion is not absent – it is explained in different terms that are – perhaps – clearer.

Mr. Allen asked the members to vote on whether we leave par. 44 in the document. He also asked whether we should discuss the continuum of discretion. He noted that Ms. Wardlow’s view is that discretion belongs in the measurement phase.

Mr. Werfel expressed concern that he expected to devote considerable time to considering the comments from yesterday’s hearing and the letters. That information would be analyzed and explored for alternatives that could be considered. He wonders whether a central theme is the government’s ability to change the law, the impact that has on the liability definition, and the notion that there is really a continuum. If we have that discussion for social insurance then we should have it for the concept statement. He views the ideas as relevant to the elements definitions. He wonders if we need to consider the input in the elements discussion. The question is whether we wish to take time to consider the discussion of social insurance with respect to elements.

Mr. Dacey supported such a discussion. Messrs. Schumacher, Patton, Jackson, Murphy and Reid voted to have a discussion but limited it to one meeting (July). Mr. Farrell indicated no because we are operating under a defined model based on past transactions. He believes such a discussion – changing the entire reporting model – would be a major undertaking. The concept of this model would not be changed. Ms. Cohen voted no. Mr. Werfel expressed his appreciation of the time allowed for consideration.

Mr. Reid agreed to discuss with Ms. Wardlow his concern regarding losses due to litigation and whether there is an agreement as to when settlement would occur.

> **CONCLUSIONS:** Members are asked to convey any proposed edits to the basis for conclusions to Ms. Wardlow. Ms. Wardlow will work with Mr. Dacey regarding his concerns (the language regarding GAAP status and intra-governmental amounts). With the exception of the Board’s discussion on the ability to change laws, the document is expected to be in near final form for the July meeting. A pre-ballot draft will follow shortly after the meeting.

- **Steering Committee Meeting**

The Steering Committee received the budget for FY 2008 and 2009. Members agreed to seek input from their agencies and provide feedback as soon as possible.

Adjournment

The meeting adjourned at 4:30 PM.

Summary of Testimony – Sheila Weinberg
Response to Preliminary Views issued October 23, 2006
Accounting for Social Insurance, Revised

A fisherman can distinctly see any fish that are near the surface. The deeper in the water the fish, the less clearly one can see them. If the fish are deep enough, even if one knows they are there, the fish can become invisible.

Today there is a great emphasis on transparency in financial reporting. IFTA finds the Primary View presentation of Social Insurance costs and liabilities to be the more transparent of the two views presented in the October 23, 2006 Preliminary Views document. While additional Social Insurance information would be provided in the Alternative View, its proposed government-wide financial statement presentation resides deeper in the federal government's financial report and is, at best, translucent.

IFTA agrees with the Primary View's recognition of benefit costs being accrued over the period of covered employment starting from the point of full insurance benefit qualification. This is the proper recognition, because it is the covered work period that determines the qualification for and amount of benefits. Fundamentally, the Social Security and Medicare programs remain premised on the promise that an individual's "contribution" to the program is held by the Government in trust and then paid out in retirement. These programs to date are not billed to be forms of taxation separated from and independent of the benefits to which one is entitled upon retirement or disability. Starting the recognition of benefit costs from the point of full insurance benefit qualification also recognizes that those who have not achieved full qualification do not receive tax refunds if they ultimately fail to qualify. Also benefits bases do not increase after the covered work period has ended. We reject, therefore, the Alternative View that benefits paid are non-exchange transactions.

IFTA would, however, use the Primary View's pro forma financial statements as the basis for a statement of sustainability rather than as a financial statement. We are particularly impressed with the transparency of the interperiod inequities (for example comparing line "c" to line "k" on page 102 of the PV) as it relates to sustaining social insurance.

The financial reporting liability should be the accrued liability for current participants (for example, for Social Security line "g" on page 102 of the PV). The cost reported on the face of the financial statements for any fiscal year should include actuarial current costs. To facilitate the public's ability to evaluate elected officials' decisions, any actuarial cost of benefit level adjustments enacted during that fiscal year should also be included. Since any social insurance "trust fund" investments are in U.S. obligations and such investments are eliminated in the government-wide consolidation, market value fluctuations are not a cost factor.

IFTA does not agree that the "present value of future payroll taxes and income taxes to be paid" should be included in the calculations of the accrued liability and related current year cost. These "earmarked" taxes are commonly used to pay for non-social insurance benefits and services. The "present value of future benefits attributable to current and future participants' future work in covered employment…" should also not be included. While inclusion of these two items is useful as part of a statement of sustainability, a balance sheet liability is a condition at one point in time.

IFTA agrees with the Alternative View that recognition of future social insurance benefits, which have vested due to a covered work period, on the financial statements would diminish significantly the relative size and importance of other expenses and liabilities shown on the financial statements. This should not be considered negatively. This is a reality citizens need to know. Omitting what currently are monstrous costs and liabilities from the face of the government-wide financial statements grossly distorts the presentation of the Government's true financial position from the perspective of the constituency from who these reports are most directly useful—the American citizens. This inappropriately shifts the focus away from the most financially significant programs managed by Federal agencies.

IFTA would consider, but likely still disagree, with the Alternative View about the timing of the recognition of the liability and cost if the following steps were taken by the Government:

1) The 7.65% in specific social insurance payroll taxes and related employer payroll taxes were canceled;
2) The discontinuation of the use of the term "trust fund" by Government employees and officials, including members of Congress and the Administration, to describe funds that the Government has custody and control of and does not take on a fiduciary responsibility to hold in trust for beneficiaries;
3) A massive, straight-forward education program to help the American public and their elected officials to understand that:
    a) social insurance benefits are not guaranteed and can be canceled or reduced at any time and,
    b) payroll taxes taken out of private companies' employees' paychecks are forms of taxation, not "contributions" maintained in separate "trust fund" accounts;
4) The cessation of issuing personalized annual Social Security Statements of estimated benefits and;
5) The enactment of a law that would consider it felony fraud for any Government employee or officials, including members of Congress and the Administration, to imply the continuation of social insurance programs and the solvency of "trust funds."

It is well established that the promise of social insurance benefits is a legitimate "social contract." Translucency at best was not the goal the Board set for itself in 2003, when it first committed to improving how these social insurance liabilities are reported. Social insurance benefits are set automatically through continuing appropriations. Congressional action is required to increase or decrease these benefits. Reporting the social insurance liability on the face of the balance sheet and related cost on the statement of net cost would allow the public and their elected officials to straightforwardly identify increases or decreases in promised benefits. Then the public could easily evaluate their elected officials' decisions to adjust benefits.

For more than 20 years the Financial Accounting Standards Board (FASB), recognizing the onset of challenges in private sector pension and other post employment benefits plans, has been working to improve financial reporting of benefits earned during a covered work period but paid after the close of that covered work period. More and more of these costs and liabilities swim closer to the surface of private company financial reports. This transparency has led to more informed decision-making in the private sector. Such transparency should be the goal of the Government and would strengthen our democracy by providing citizens essential financial information. This knowledge would facilitate greater citizen participation in the decision-making processes that are critical to the posterity of our country. Citizens need to be able to clearly see all of the relevant facts about our country’s financial position on a timely basis and in an understandable format. Just like a fisherman who can’t see a shark deep in the water, what we can’t see can hurt us.

ATTACHMENT 1 – SPEAKERS' SUMMARIES OF TESTIMONY

Summary of Testimony At FASAB Open Hearing, May 23, 2007 – Jagadeesh Gokhale

The government is in principle an everlasting entity. Describing the government's financial condition and managing fiscal affairs to maintain continuity of government operations – both of which are among the FASAB's chief objectives – requires forward-looking financial measures. Traditional fiscal measures such as outstanding debt, annual deficits, and net operating costs, however, are backward looking because they result from past transactions and economic outcomes. Traditional budget accounting measures have other shortcomings as well.

From the perspective of fiscal management, measuring the government's financial condition without reference to its impact on private sector budgets and economic opportunities is inadequate. Viewed in these terms, however, traditional budget measures are not sufficient to fully and correctly describe real underlying fiscal policies: For example, a given deficit level (or time series) could correspond to many different real underlying fiscal policies and is, therefore, inadequate for assessing the government's financial condition from a forward-looking perspective. Moreover, a given real underlying fiscal policy (and, hence, the government's financial condition) could correspond to different deficit levels (or time series) depending on underlying accounting conventions.

Given these shortcomings, a meta-objective should be to supplement traditional budget measures with ones that capture the government's financial condition fully and consistently – recognizing that the future implications of current fiscal policies are an integral part of defining that financial condition.

Adopting the Primary View proposal would not introduce any new budget accounting measures, but it would alter the content and sizes of traditional measures – national debt, annual budget deficits, and net operating costs. However, I do not think that adopting the Primary View proposal would enhance the quality and informational content of those measures.

The Primary View proposal does not eliminate the above-mentioned shortcomings of traditional fiscal measures. Indeed, that proposal is likely to introduce a large element of uncertainty and measurement error in the government's "recognized" liabilities. That's because the achievement of "fully insured" status under Social Security does not eliminate all contingencies in determining whether and when future benefits would be paid. For example, the acquisition by a worker of fully insured status under Social Security may trigger auxiliary benefit accruals for related individuals, or may extinguish such auxiliary benefits accrued earlier depending on future events.

Recognizing social insurance liabilities based on current but not prospective acquisition of "fully insured" status under Social Security appears to be arbitrary given (1) that continuity of government is assured and (2) that the likelihood of prospective accruals under current policies is very high. Restricting the liability definition to current accruals is inappropriate for a government entity because it removes important forward-looking commitments from consideration.

The Primary View proposal would impose an arbitrarily strict definition between "recognized" liabilities and other obligations when in reality the degrees of commitment associated with different prospective government functions constitute a continuum. In addition, recognizing social insurance obligations as "liabilities" on par with explicit government debt may place unnecessary and undesirable impediments against future reforms of those programs.

One benefit of adopting the Primary View proposal would be to provide a natural experiment for assessing financial market reactions to announcing a firmer government commitment to (a subset of) its future social insurance payments under current policies.

Overall, we should utilize alternative methods for assessing the sustainability and stewardship implications of social insurance policies – including net liability accruals from past, current, and future transactions. The current emphasis on the distinction between contractual liabilities and non-contractual obligations is excessive. That distinction should be de-emphasized by providing an integrated picture of the results of past transactions and the financial implications of future ones under current government policies.

Comments on "Accounting for Social Insurance, Revised Statement of Federal Financial Accounting Standards Preliminary Views"
Presented by Steve Goss, Chief Actuary, Social Security Administration
May 23, 2007

The Office of the Chief Actuary at the Social Security Administration has worked with the FASAB closely for many years through the development of the Required Supplementary Stewardship Information and its evolution into the Statement of Social Insurance. I'd like to thank the Board for the opportunity to comment on the preliminary views document.

LIABILITY---The Alternative View supports the long standing view of FASAB that a Social Insurance liability can only be recognized when a benefit becomes due and payable.. The Primary View makes no compelling case for changing that approach.

The Primary View would recognize a liability when a worker first attains "fully insured status" under the program. While insured status is one necessary condition for benefit receipt, it is in no way sufficient to qualify as an obligating event for liability recognition.

An overriding uncertainty exists under the Social Security (and all Federal Social Insurance) programs. This is the Government's right and ability to alter potential future benefits. Until benefits become due and payable, there is no binding commitment over which a worker has control and so no liability can be recognized.

In the recent concepts paper on elements of accrual accounting, the FASAB well established that an asset cannot exist without the holder of the asset having exclusive control. Similarly, for there to be a liability the entity with the liability cannot have the ability to single handedly alter the liability. Because the Federal Government retains the right to alter benefits up to the time they are due, there can be no liability until benefits become both due and payable.

Deeming potential future benefits as liabilities would fail to be consistent with the actual funding mechanism of the Social Insurance programs. Future benefits can be paid on a current cost (pay as you go) basis only if future tax collections are made at the same time. Thus, such future taxes would have to be deemed as current assets if future benefits were to be deemed as current liabilities. Both possibilities make no real practical sense and neither qualifies for the designation. Thus, this information should not be added to SOSI or the balance sheet.

Other concepts required for liability recognition, such as the need for an exchange transaction to create an obligating event, simply do not exist based on the crediting of earnings or payment of taxes while working. Benefits are not directly related to or committed upon the receipt of earnings or the payment of taxes. Again, as FASAB ruled appropriately in SFFAS 17 and has upheld since, a liability can only be recognized when a benefit is due and payable.

STATEMENT OF CHANGES---We agree with the Alternative View that inclusion of a Statement of Changes in Social Insurance as supplementary information would be desirable, but only in the case of Social Security if it is consistent with the statement in the Trustees Report. But we also recommend including the amount of trust fund reserves available at the valuation date in the Statement of Social Insurance for agency and government-wide statements. While Trust Fund assets do net out on the unified budget, they are very important in the narrower context of Social Security solvency. Here the fund assets have real value and will allow benefits to be paid well after exhaustion of the TF. Reflecting the starting Trust Fund assets for OASDI would help clarify the true actuarial status of the program.

SUSTAINABILITY---We agree with the alternative view that a **Statement of Fiscal Sustainability** would be a useful and informative addition to the consolidated Financial Report for the entire Federal Government. But such a statement should be developed only if it can fairly and appropriately represent the prospects for all Federal programs.

Some attempts to develop this kind of analysis are based on the assumption that discretionary (non-entitlement) Federal spending will automatically and certainly be balanced against revenue, and thus will not provide any potential for long term shortfalls or surpluses. This is inappropriate. If this statement is to be created and is not to be misleading, it must reflect a reasonable extrapolation of actual current action. For the discretionary portion of the budget, current tax rates and policy should be the basis for reasonable extrapolations of current policy, spending levels, and trends.

For sustainability, the elements of ***timing and trend*** are critical. The clearly appropriate measure that would allow comparison across all Federal programs is the ratio of projected annual program cost to annual gross domestic product (GDP). Expressed in these terms, the various program costs could be compared or combined in a form that readily relates to the fundamental potential tax base for all Federal programs, the GDP. The level and trend of such annual ratios would provide a clear picture of the expected draw on the economy to fulfill the intended spending. Expressing the future revenue levels and trends in a similar manner would complete the sustainability picture.

Aggregated present-value numbers for long periods of time, like 75 years, or even longer, are not appropriate for assessing sustainability. In any context, such summarized numbers should not be expressed as ratios to the numbers of just current workers or current households. The financial shortfall over the next 75 years cannot possibly be borne by only today's workers or households. Eliminating these shortfalls will require changes in scheduled benefits and taxes that will affect most if not all current and future workers and beneficiaries throughout the next 75 years. Thus, such ratios should be presented for long periods only relative to the total number of workers, households, earnings, or GDP that are expected during the period as a whole.

Aggregated shortfalls over many years can only be meaningfully compared to aggregated resources over the same period.

Howell E. Jackson – written statement
FASAB Public Hearing on Social Insurance

I am delighted to appear before the Federal Accounting Standards Advisory Board (FASAB) this afternoon and to discuss with Board members its October 23, 2006, Preliminary Views on revising federal accounting standards for social insurance. I begin my remarks with several general comments about the issues before the Board today and then turn to the specific questions on which the Board has requested comment.

General Comments

1. The Goal of Accounting Standards for the Federal Government: Federal accounting standards should be measured by the extent to which they communicate to the general public and our political leadership a) an accurate picture of the state of the nation's fiscal affairs and b) the manner in which that state is changing over time. In the context of today's hearing, the question is whether the Financial Report of the United States Government, as currently structured, satisfies these two criteria for our principal social insurance programs, most notably Social Security and Medicare. A key weakness of existing reporting standards is that they do not recognize the substantial retirement benefits that current law promises both retirees and the aging baby boomer generation. Nor do these standards capture the rate at which these promises are accumulating each year or the dramatic increase in social insurance commitments of the sort occasioned by the adoption of a Medicare prescription drug benefit in 2003. The fiscal burden that the growth of our social insurance programs imposes on future generations is many times greater than the growth of our public debt or net operating costs as currently reported in the Financial Report of the U.S. Government.1[1] Accordingly, one can only applaud all of FASAB members and the Board's staff for working so hard to come up with ways to improve the federal government's financial reporting standards in this area.

2. The Special Nature of the Government and its Capacity to Change Legal Requirements. One of the complexities of establishing accounting standards for the federal government is the unique capacity of the sovereign state to change legal requirements. With respect to social insurance programs, there is no doubt that the federal government has reserved the right to alter benefit payments for

---

[1] For a detailed review of this issue for the first five years of this decade, see Howell E. Jackson, "Counting the Ways: The Structure of Federal Spending," in FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POLICY (Elizabeth Garrett, Elizabeth Graddy, & Howell E. Jackson, eds.) (forthcoming Cambridge University Press 2007) (avail. as John M. Olin Center Working Paper No. 583 at http://www.law.harvard.edu/programs/olin_center/papers/583.php).

all participants and beneficiaries, even the elderly or those close to retirement who have made payroll tax contributions over their entire working lives. But the federal government's power to rescind legal obligations is much broader than that. Under the doctrine of sovereign immunity, the federal government could theoretically repudiate other obligations, including the public debt. Or Congress could simply repeal all appropriations for funding contract disputes or tort claims against the federal government or eliminate the obligations of federal instrumentalities to comply with environmental laws. In a host of ways, the federal government could take actions that could alter the nature of financial obligations currently reflected in the Financial Statements of the U.S. Government. For this reason, the legal capacity of the federal government to amend current law does not provide a particularly useful test for distinguishing bona fide liabilities of the federal government from lesser forms of financial commitment. Rather one must rely on a combination of pragmatic considerations, including the requirements of current law as well as an assessment of economic and political realities to define appropriate accounting standards for the federal government.

3. The Relevance of Open-Ended Appropriations. One legal consideration that might be useful for the Board to consider in its review of its social insurance proposal is the relevance of open-ended appropriations for funding certain of our social insurance programs.[2]2 One of the distinguishing features of Social Security, for example, is that Congress has adopted a permanent appropriation for the program that appropriates a combination of payroll taxes, certain income taxes, and interest on trust fund investments for the payment of Social Security benefits. Based on current projections, these revenue streams will be sufficient to support all Social Security benefits through 2041 but thereafter a substantial fraction of scheduled benefits. The existence of open-ended appropriations of this sort is, in my view, of critical importance to the Board's analysis, because it puts certain social insurance programs on automatic pilot. If Congress does nothing until 2040, all Social Security benefits will be paid as currently scheduled. While some other federal spending programs (like interest on the public debt) have similarly permanent appropriations, the vast majority of other kinds of federal programs do not. It is the combination of scheduled benefits based on past employment coupled with open-ended appropriations sufficient to fund full benefits for many decades to come that distinguishes Social Security and other social insurance programs from defense and other forms of discretionary spending.

1. *The Importance of Consolidated Articulation:* At the heart of the disagreement between the Primary and Alternative Views is, I think, the question of whether

---

[2] For an overview of this issue, see William Fay & Michelle Rodgers," Appropriations for Mandatory Expenditures" (May 11, 2006) (Briefing Paper No. 17) (avail. at http://www.law.harvard.edu/faculty/hjackson/MandatoryExpenditures_17.pdf).

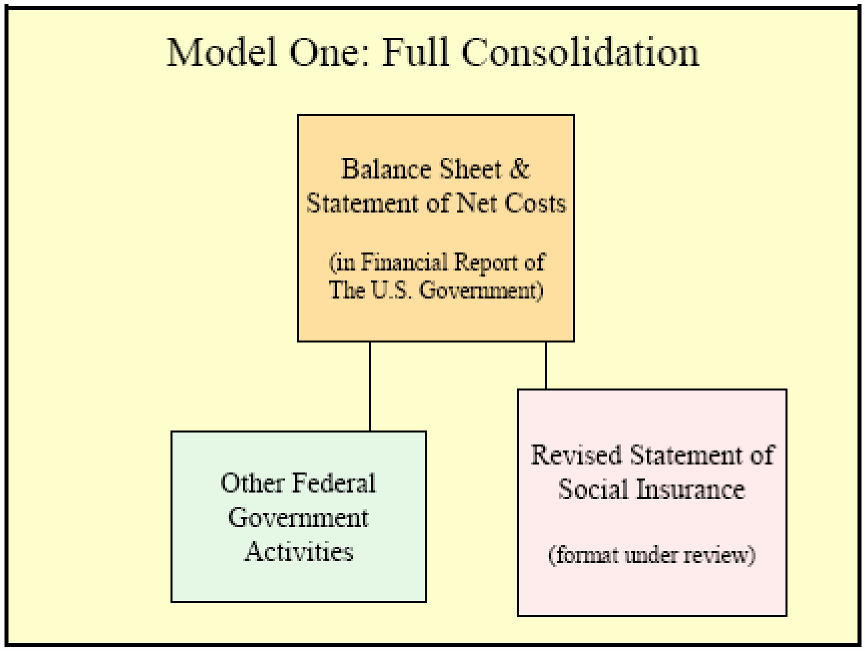
some measure of implicit obligations associated with social insurance programs should be combined with the principal accounting statements of the Financial Report of the U.S. Government.3[3] Putting aside technicalities of how social insurance obligations should be measured, I believe that it is imperative for the federal government to provide some sort of consolidated financial statement encompassing one of several plausible ways of estimating accrued social insurance obligations.[4]4 In brief, the advantages of a consolidated approach are:

- Consolidation facilitates comparisons of the country's explicit debts and its implicit social insurance obligations.
- Consolidation encourages politicians to undertake entitlement reform promptly, both by emphasizing the speed with which social security obligations are now growing (a stick) and providing rewards for reducing consolidated fiscal burdens or at least the growth of consolidate fiscal burdens within two and four year election cycles (a carrot).
- Consolidation offers a more accurate view of entitlement reforms (like individual accounts of some forms of medical savings accounts) that incur current costs in exchange for a reduction in future scheduled benefits.

5. Two Models of Consolidation. Having stressed my view of the importance of consolidated articulation, let me now suggest that there is more than one way to achieve this goal. As illustrated in the attached figure, one approach would be full

[3] The Preliminary View terms this issue "linkage" or "articulation."

[4] For an overview of my thoughts on the subject, I am attaching as Appendix A to my Statement a copy of a presentation I made to a CBO Conference on Accrual Accounting last December. For a more complete presentation of my views (and related commentary), see Howell E. Jackson, *Accounting for Social Security and Its Reform*, 41 HARV. J. LEGIS 59 (Winter 2004).

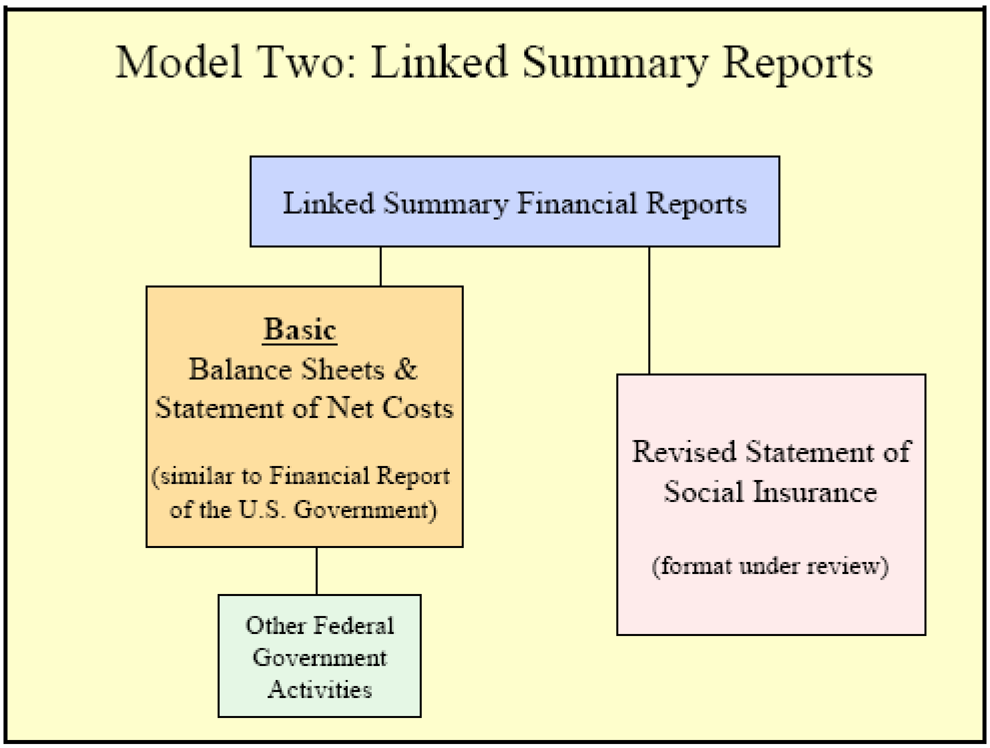


consolidation, in which the operations of social insurance programs (measured under some system of accrual accounting) would be combined with all other federal government activities. This is the approach adopted in both the Primary and the Alternative Views. An alternative approach – labeled linked summary reports in the second figure – would largely retain the current structure of the Financial Statements of the U.S. Government as a "basic" statement and provide a separate statement of social insurance, appropriately revised. What would then be added would be a relatively small number of linked summary reports into which the two basic statements would be combined. This second model represents something of a compromise position between the two positions articulated in the Board's Preliminary Views. First, it retains a greater degree of separation between the implicit liabilities of social insurance and the other obligations of the federal government, while at the same time it provides through the summary financial reports the principal advantages of consolidated articulation outlined in the previous paragraph. To the extent that members of the Board are concerned about retaining financial statements that are roughly comparable to those of other jurisdictions, the preservation of Basic Balance Sheets and Statements of Net Costs would accomplish that goal.[5]5 In addition, this approach would presumably pull out of the Basic Balance Sheet & Statement of Net Costs treasury debt held by social insurance programs, thereby

---

[5] While I have reviewed several of the comments from multilateral organizations, I personally would not be troubled if the FASAB were to chart a new course for social insurance programs. For one thing, the Board has given the issue considerably more attention and thought than comparable bodies in other jurisdictions. Moreover, I think that it is quite likely that the legal structure of entitlement spending in the United States – particularly their connection to wage history and the presence of open-ended appropriations – distinguishes our approach to social insurance programs from that of other countries.

recognizing these obligations as liabilities of the federal government on the Basic Balance Sheets and Statement of Net Costs. (Strikingly, the FY2006 version of the Financial Report of the U.S. Government made an initial step towards a model of linked summary reports when it aggregated in table four on page 6, the net position of the U.S. government with estimates of the closed group liability of Social Security and Medicare.) Within the confines of this testimony, I will not explore exactly how such a system of linked summary reports might be framed, but, if the Board is interested in pursuing this possibility, I would be happy to discuss the matter with the staff or interested members of the Board.[6]



5. The Irrelevance of Unsustainability. Some critics of new accounting treatments for social insurance programs argue that these measures are inappropriate because many of our social insurance programs are manifestly unsustainable at current benefit and funding levels. Thisargument is, in my view, profoundly misguided. For many years now, social insurance experts have understood the problems facing Social Security and Medicare. These experts and the reports they have produced have thus far failed to convey the seriousness of this problem to the general public or most politicians. The Board's efforts to reform federal accounting for social insurance program are important precisely because

[6] Among other things, the Board would need to consider the extent to which the administrative agencies overseeing social insurance programs should be included in the Basic Balance Sheets and Statement of Net Costs, as opposed to the insurance functions of these programs.

the reforms offer hope that the unsustainability of Social Security and Medicare might be more effectively conveyed to the general public and politicians. As is often the case, the purpose of recognizing a new form of liability is to highlight its significance and allow leaders to manage its growth. In short, the unsustainability of our social insurance programs is actually an argument in favor of moving towards an accounting standard that conveys both the magnitude and rate of increase in our social insurance obligations in order to help the country enact the legislative changes necessary to move these programs to a more sustainable path.[7]

Specific Responses to Questions from FASAB Preliminary Views

Question 1: Which obligating event do you believe creates a liability and expense that should be recognized? Please provide the rationale for your answer.

In my view, the Board should evaluate recognition rules against three criteria. First, the rule should produce a liability estimate of sufficient magnitude to communicate unambiguously the significance of the social insurance obligations that current law provides as compared with the federal government's other liabilities. Second, when applied over time, the rule should convey the significant rate at which our social insurance obligations are growing through the accrual of new benefits, the accretion of implicit interest on existing obligations, and the adoption of new statutory commitments. Third, the rule should be based on objective principles that are comprehensible to an

---

[7] Critics also sometimes suggest that the recognition of substantial social insurance obligations will somewhat make it more difficult to enact reforms. I also find this claim implausible. All reports on the financial condition of Social Security and Medicare are based on scheduled benefits and scheduled revenues. Estimating current liabilities based on scheduled benefits is no different. In terms of engendering strong reliance interests on the part of the general public, the Social Security Statements sent each year to most American workers and including projected individual benefit levels are much more likely to cause misunderstanding. In that context, disclaimers that the program benefits might change are generally thought to be adequate to prevent confusion on the part of the general public. See Howell E. Jackson, "Accounting for Social Security Benefits," in BEHAVIORAL PUBLIC FINANCE (2006) (Edward J. McCaffery & Joel Slemrod, eds) (previously released as John M. Olin Center Working Paper No. 520)(available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=839246). *A fortiori,* similar disclaimers for the total liabilities of social insurance programs included in the Financial Report of the U.S. Government should be sufficient to prevent unjustified reliance on schedule benefits.

informed member of the general public and that are based on the current statutory basis of our social insurance programs and consistent with economic reality.

Arguably, a number of recognition rules could satisfy these three criteria and invariably experts will differ in their preferences among the various possibilities. As explained below, I believe that the approach proposed in the Primary View satisfies these standards. I also believe that one variant on the Primary View's approach might provide a modest improvement at least in my view. In addition, a recognition principle based on closed group measures would also satisfy my three criteria and might provide a plausible compromise position attractive to all members of the Board. An inferior, but not wholly implausible approach would be based on recognition when participants reach retirement age. In short, there are several different but reasonable solutions to this problem. What's important is that the Board adopt one, and then the general public and our political leadership will be able to use the rule to evaluate the scope and growth of our social insurance obligations and consider the impact of proposal for entitlement reform.

1. The Primary View Proposal: Recognition Based on a 40-Quarter Vesting Rule and Accrual of Benefits Under Statutory Formulae. The Primary View's approach clearly satisfies my three criteria. It would generate a social insurance liability number of significant magnitude and that liability number would grow over time to reflect implicit interest charges and the enactment of new statutes. Being so closely tied to statutory requirements, it also satisfies the requirement that it conform to an objective principle that can be explained to the general public. In my view, the only defect of the Primary View's approach is the accrual of full Medicare benefits at the end of the 40-quarter vesting period. While this recognition rule follows statutory provisions, one could quibble that as a matter of economic reality workers earn their Medicare benefits over their full working careers and not upon the completion of 40 quarters of covered employment. I do not regard this issue as disqualifying, and the effect of discounting does mitigate the problem somewhat by reducing the reported size of Medicare obligations to younger workers. But I do regard this aspect of the Primary View as a modest negative.

2. A Variant of the Primary View Based on 40-Quarter Vesting and Normal Cost Allocation over Projected Working Life. A variant of the Primary View would be to use a normal cost technique to spread the accrual of Medicare benefits over the working life of workers. From the Preliminary Views document, I gather the Board and its staff considered this alternative, but I do think further thought on this option might be useful. Especially as actuarial adjustments and programmatic changes in the Medicare Program are likely to occur with some frequency, a normalized cost approach will be a bit less volatile than full vesting after 40-quarters. This normal cost variant would satisfy my criteria of producing substantial liabilities and producing increased liabilities over time. It does, however, probably fare a bit less well than the Primary View's approach in being less tied to statutory standards (as it takes a cost approach rather than benefit approach) and in being more difficult to describe to the public. Moreover, the variant would pose a question of whether Social Security benefit should also be accrued on a normal cost approach, to provide consistency across programs.[8] Were the Board to go down this path, my personal preference would be to impose a normal cost standard on both programs, but I think it is a close question.

3. Recognition at the Attainment of Retirement Age. Another alternative mentioned in the Board's Preliminary Views document would be to make the attainment of retirement age – that is 62 or 65 – as the obliging event. This approach is plausible, but it has some substantial drawbacks. On the plus side, the present value of accrued social insurance commitments to retirees is substantial (though only a fraction of the key programs' total liabilities). Reporting liabilities based on this recognition would be sufficient to demonstrate the rough magnitude of our social insurance obligations and would generate substantial annual increases, many hundreds of billions of dollars. The problem with this approach is that it is not well grounded on an objective statutory criteria nor does the approach match any sense of economic reality. Our politicians routinely promise not to make any adjustments in retirement benefits for those in the 50's or even younger, and a recognition principle that fully ignored these participants would be deficient. Moreover, to the extent that a new accounting approach might offer politicians some sort of political carrot for taking bold action to reform our entitlement programs and thereby reduce the fiscal burden on future generations, a recognition principle based on retirement age would wholly miss the impact of reforms affecting younger workers.

4. Recognition Based on a Due and Payable Rule (the Alternative View). This approach fails on all three of my criteria. It will not recognize a substantial liability for our social insurance programs; it will not generate any significant annual increases in reported liabilities from year to year; it will not pick up implicit interest costs, the accrual of benefits under statutory formulae, or the effect of legislative changes; and it is wholly inconsistent with current statutory requirements and the economic reality of our country' social insurance commitments.[9]

5. An Alternative Approach Based on 40-Quarter Vesting and Closed Group Obligations. Having reviewed the Board's Preliminary Views and a number of the public comments, I would like to suggest for the Board's consideration an alternative approach to recognition that would retain the 40-quarter vesting requirement but then recognize liabilities based on the closed group obligation of all vested participants and retirees. This approach is also based on current statutory requirements, but it views the social insurance commitments as a life-long contract on which vested participants are required to make additional contributions in exchange for the statutory entitlement to certain benefits. Thus, the measure reflects the economic realities of the government's net

---

[8] The progressive nature of the Social Security benefit formula will cost benefits to accrue quickly for younger workers and thus will generate an accrual formula that is front loaded. This effect may be somewhat undesirable on the economic reality dimension because it is more likely that a younger worker will experience changes in their benefits.

[9] By way of comparison, it would be implausible to delay recognition of liabilities on zero coupon bonds until payment became due and payable, which is exactly the treatment the Alternative View proposes for social insurance.

commitments to vested participants and retirees. This approach satisfies my requirements of recognizing substantial liabilities (albeit somewhat smaller liabilities than under the Primary View) and would also generate significant annual increases in reported liabilities, both from implicit interest and legislative changes and also from the addition of new cohorts of vested workers each year. The approach also reflects a wholly defensible view of the economic reality of social insurance obligations and is analogous to the accounting treatment of certain financial instruments under GAAP. The approach is also consistent with the level of Social Security benefits reported in individual Social Security Statements, albeit reduced by the amount of future participant tax payments. In addition, this approach offers certain advantages over the alternatives discussed above:

A. Several commentators have expressed that social insurance obligations should be offset, to some degree, by future taxes. The closed group measure addresses this concern by factoring in the project future taxes of current participants (or at least of vested participants). The resulting net obligations is thus arguably a more accurate measure of the fiscal burden being passed on to future generations than alternative measures of accrued liabilities.

B. By reflecting future tax obligations of vested participants under current law, this approach would also do a better job of reflecting legislative changes that adjust future tax rates. Under other approaches described above, payroll tax changes would not reduce recognized liabilities even though such changes arguably effect the economic reality of our social insurance program commitments.

C. Another potential advantage of using a recognition principle based on the closed group measure is that it links back to concepts commonly used by both the actuarial profession and the economics community. Thus this recognition principle would connect to the two other disciplines that have been most influential in studying social insurance. For example, leading economists like Gokhale and Smetters commonly distinguish Generational Imbalance (GI), which is a closed group measure, from total Fiscal Imbalance, which combines closed group and open group infinite horizon measures. The Social Security and Medicare Trustees Reports also routinely reports closed group measures (albeit typically truncated to 75 years and including unvested participants). While I would not consider this consideration dispositive, I do think that there are some advantages of utilizing common measures.[10]

D. Another advantage of the closed group measure is that it is well-suited for decomposing closed group obligations into generational cohorts – that is, the closed group obligations of participants aged 15 to 24, those aged 25 to 34, etc. Particularly to the extent that the Board's accounting principles are used to

[10] If the Board were to adopt this approach, I do think that it would be useful to require disclosure of the kinds of information about accrued statutory benefits presented in Appendix B to the Preliminary Views. I would simply recommend that the linkage into the Financial Statements be based on the closed group measure. For considerations similar to the ones outlined above, this is the approach I utilized in my article on Accounting for Social Security. *See* Jackson, *supra* note 4.

structure pro forma analyses of entitlement reform proposals, distinguishing generational cohort may help illustrate the impact of alternative reforms.[11] In addition, readers of the Financial Statements of the U.S. Government may have different interpretations of the social insurance obligations and would find it useful if the obligations owing various cohorts were reported separately.

E. Finally, as I discussed in a recent article, relying on a closed group measure for Medicare may allow for more accurate accounting for the fact that a portion of Medicare funding has traditionally come from general revenues and not dedicated payroll taxes orpremiums.[12]

Question 2: Do you believe that the Social Security and Medicare obligations are measurable for purposes of recording a liability after 40 quarters or equivalent of work in covered employment as proposed in the Primary Views? Please provide the rational for your answer?

Yes. One of the most attractive features of the Primary View proposal is that it relies on many fewer assumptions about future demographic changes and economic projections than do the 75 year projections typically included in other financial reports on social insurance. The liabilities are limited to accrued benefits on past work under current statutory formula. The alternative closed group measure suggested above requires more assumptions as to future work patterns for vested participants, but is still substantially easier to estimate than open group measures that include future generations.

Question 3.1 Do you believe that the Primary View proposal to add line items to the SOSI that tie the revised expense and liability amounts reported on the statement of net costs and the balance sheet, respectively, should be adopt?

Yes. As mentioned above, I think this is the most important aspect of the Primary View's proposal. I do, however, think that much of the benefit could be accomplished through linked summary reports, while retaining a distinct Basic Balance Sheet and Statement of Net Costs.

Question 3.2 Do you believe that the reasons for changes in SOI amounts during the reporting period should be reported and, if so, do you favor the reporting (1) as proposed by the Primary View, (2) as reported by the Alternative View, or (3) some other approach? Please provide the rationale for your answers.

[11] I am currently working on an illustration of such a pro forma approach to Social Security reform and would be happy to share the results of my work on this project with FASAB staff.

[12] *See* Jackson, *supra* note 1 (discussing adjusted closed group obligation for Medicare and adapting methodology proposed by Auerbach, Gale & Orszag).

I do think that it is critical that the SOSI include a statement of changes as one of the principle functions of financial statements for social insurance should be to communicate to the general public and politicians how our social insurance obligations are increasing over time. I believe the approach suggested by the Primary View much better accomplishes this goal, as it conforms to more generally accepted and understood models of financial reporting and produces a bottom line that can quite easily be linked to components of the Financial Report of the U.S. Government. The approach suggested in the Alternative View strikes me as much less useful. To begin with, it does not follow the familiar structure of financial statements – for example, lacking an measure of implicit interest or newly accrued benefits. In addition, as best I can understand, theAlternative View proposes to use the 75-year open group liability measure as its bottom line. This measure is a highly idiosyncratic estimate, which is less easy to measure and incommensurate with other liabilities measures typically included in financial statements. Finally, the alternative view approach is largely (if not entirely) redundant with information already included in existing financial reports. These reporting conventions have already proved themselves incapable of stimulating public support for entitlement reform.

Question 4. Do you believe the [Alternative View] proposal [on fiscal sustainability] should be adopted? Please provide the rationale for your answer.

I have not formed views on this question, but I do think the issue of fiscal sustainability is broader than the question of social insurance and requires consideration of a full range of government programs. As such, I think the matter should be considered in a separate project.

Question 5. Do you believe the Board should consider recognizing deferred revenue for earmarked renveues in excess of related program costs? Please provide the rationale for your answer.

While this is an interesting suggestion, I would not favor it for two reasons. First, in principle, this proposal is a poor solution for the problem the Preliminary Views document is intended to address. The goal here is to devise an appropriate measure of the obligation's associated with our social insurance programs. As explained above, there are a number of plausible ways to resolve this issue, but all are based on some estimate of the obligations due to beneficiaries. The deferred revenue approach is a measure of excess taxes over benefit payments – basically the accumulated balances in social insurance trust funds. This figure is no ways corresponds to the obligations owing under social insurance programs. After all, if the trust fund balances equaled total obligations our social insurance programs would be fully funded. A second, more pragmatic problem with the deferred revenue approach is the perverse effects that would result were we to switch to this accounting systems just as the trust funds were about to draw down their reserves. Since 1983, trust fund surpluses have been used to offset deficits in other government accounts. Were the deferred revenue approach were adopted, a restatement would (I assume) create a large deferred revenue liability to reflect past excess taxes. Then, as benefits exceed taxes and the trusts funds are drawn down, the deferred revenue would be shifted into income. At least in terms of reports of annual net costs for the U.S. Government, the same revenue would then have been recognized twice – once before the restatement occurred and once afterwards. In my view, that can't be a sensible result.

Question 6. Please offer any comments that you wish to make on the Primary View provisions or the Alternative View provisions.

A final key advantage of the Primary View is that it offers a single, sensible bottom line for social insurance obligations and suggests a way in which that measure can be tied into the activities of the rest of the operations of the federal government to provide a unified an comprehensible view of our country's fiscal affairs. While I have offered a few suggestions about how this measure might be adjusted and how the linkage might be structured, my principal recommendation is that the Board not stray from these central virtues. The chief problem with the Alternative View is that it does not offer this single sensible measure that provides linkage to the rest of government's financial affairs. Instead, by combining multiple open group and close group measures, the Alternative View risks confusing the general public and reducing the likelihood that politicians will be able to address the difficult challenge of entitlement reform before the inevitable adjustments become so painful and disruptive as to cause genuine hardship and social upheaval.

Appendix A
How Accrual Accounting Could Facilitate Entitlement Reform
Howell E. Jackson[*]*
December 4, 2006

As a prelude to our discussions at the CBO Director's Conference this Friday, I have taken my hand at summarizing what I see are the major advantages of accrual accounting for entitlement reform. I also address several potential distractions and make one modest proposal. The figures cited in this memorandum are my own estimates of recent growth in the unfunded obligations of Social Security and Medicare. My methodology is less sophisticated than the one recently proposed by the Federal Accounting Standards Advisory Board (FASAB), but produces roughly similar results.

---

[*] James S. Reid, Jr., Professor of Law, Harvard Law School. A number of the points made here are

developed in the attached chapter from "Counting the Ways: The Structure of Federal Spending," in Fiscal Challenges: An Interdisciplinary Approach to Budget Policy (Elizabeth Garrett, Elizabeth Graddy, & Howell E. Jackson, eds.) (forthcoming Cambridge University Press 2007). See also Howell E. Jackson, *Big Liability: SocialSecurity, Medicare, and Accounting*, THE NEW REPUBLIC ONLINE (July 12, 2006) (avail. at http://www.tnr.com/docprint.mhtml?i=w060710&s=jackson071206), and Howell E. Jackson, *Accounting for SocialSecurity and Its Reform*, 41 HARV. J. LEGIS 59 (Winter 2004) (avail. at

http://www.law.harvard.edu/students/orgs/jol/vol41_1/).

ATTACHMENT 1 – SPEAKERS' SUMMARIES OF TESTIMONY

Five Important Advantages

1. A Scorecard for Annual Performance. Accrual accounting highlights the annual impact of new scial insurance commitments on the fiscal burdens of future generations. Cash flow accounting ignores these mounting obligations. So, for example, in 2005, when the Social Security trust funds reported a cash surplus of hundreds of billions of dollars, the program incurred an accrual accounting loss of $1.5 trillion dollars, once one takes into account new statutory obligations incurred over the course of the year. Medicare in the same year incurred another $1.0 trillion in estimated losses. These annual shortfalls represent the amount by which the implicit debt of these programs for future generations increased in 2005 alone, and are massively more significant than the federal deficit in FY05 ($315 billion). See Table One.

2. A Measure of Implicit Debt of Social Insurance Programs. Accrual accounting also provides a common metric for assessing the accumulated implicit debt of social insurance programs and reveals how that implicit debt has been increasing over time. For example, between 2001 and 2005, the implicit debts of Social Security and Medicare grew by nearly fifty percent, from $17.5 trillion to $26.1 trillion. This growth in fiscal burden is much greater than the increase in public debt during the same period and represents the nation's most significant fiscal challenge. See Table One.

3. Identify Long-Term Fiscal Implications of Pending Legislation. Another important advantage of accrual accounting is that it can identify the long-term fiscal implications of proposed legislation.

Table One (Table Nine in Counting the Ways)

Alternative Presentations of Overall Fiscal Policies

(billions of dollars; Calendar Years for Social Security and Medicare)

	2001	2002	2003	2004	2005
Annual Impact of Fiscal Policies					
Total Budget Deficit or (Surplus) as Reported	-$128	$158	$378	$413	$318
Change in Other Net U.S. Operating Cost	$643	$207	$287	$203	$442
Change in Social Security Closed Group Liability	$675	$526	$810	$1,031	$1,517
Change in Medicare Adjusted Closed Group Liability	$544	$908	$2,225	$572	$1,027
Total Annual Impact	$1,734	$1,799	$3,700	$2,218	$3,304
Total Annual Impact as % of GDP	17.2%	17.3%	34.1%	19.2%	26.9%
Accumulated Burdens from Past Fiscal Policies					
Public Debt Outstanding	$3,320	$3,540	$3,913	$4,296	$4,592
Net U.S. Position Minus Public Debt Outstanding	$3,139	$3,280	$3,191	$3,414	$3,867
Closed Group Liability of Social Security	$11,216	$11,742	$12,552	$13,583	$15,100
Adjusted Closed Group Liability of Medicar	$6,298	$7,206	$9,431	$10,003	$11,030
Total Accumulated Burden	$23,973	$25,768	$29,088	$31,295	$34,589
Total Accumulated Burden as % of GDP	238.3%	248.0%	268.3%	270.9%	281.4%

In 2003, for example, accrual accounting would have clearly revealed that the enactment of a new prescription drug program would increase the unfunded obligations of Medicare by trillions of dollars. Accrual accounting, moreover, would have located the costs of the program in 2003 when Congress was reviewing the legislation and could have considered different kinds of benefits and alternative funding mechanisms. Current budget accounting rules focus only on short-term fiscal impacts.

4. Set Reform Targets within Politically Relevant Time Frames. Accrual accounting could also be used to set reform targets over the next few years. For example, one could easily extrapolate the growth in the government's fiscal burdens shown in Table One through the end of this decade and also project the ratio of fiscal burden to GDP in 2010, most likely well in excess of 300 percent. Experts could be invited to propose entitlement reform proposals that would reduce the projected level of fiscal burdens to some lower target, say 200 or 225 percent of GDP in 2010. The country could then debate the relative merits of various plans to achieve this goal, and politicians could then be held responsible for adopting and implementing reforms that would achieve the targeted levels within the next four years. Whereas recent debates over entitlement reform have focused on trust fund depletion dates in 2040 and beyond, accrual accounting would locate the problems of our entitlement programs in promises being made today and would point to reforms that could be implemented within one or two congressional election cycles.

5. Enhance Range and Presentation of Reform Proposals. Accrual accounting could also facilitate entitlement reform. For example, by clarifying that reforms will not reduce current obligations to vulnerable beneficiaries such as the elderly or low-income beneficiaries, accrual accounting might help assuage some groups that have traditionally resisted entitlement reform. In addition, by distinguishing between benefits that have accrued under current statutory formulae and those that have not, accrual accounting may make it easier to adjust certain benefits. Finally, accrual accounting concepts could be employed to change the structure of appropriations for social insurance programs.

Four Potential Distractions

6. The Special Status of the Federal Government. Some critics of accrual accounting suggest that the federal government does not need to recognize its long-term obligations because the government, unlike private corporations, has the power to raise taxes in the future. The existence of the taxing power does not, however, imply that the federal government should not keep track of its financial obligations as they arise. Indeed, by failing to track the growth of federal entitlement programs, we run the risk of incurring unfunded obligations that will be difficult to resolve in the future, either through increased taxes or benefit reductions.

7. The Capacity of Congress to Amend Social Insurance Programs. A related criticism is that the federal government does not need to recognize unfunded obligations of social insurance programs because Congress could, in theory, eliminate those programs through future legislation. But the law as currently enacted does guarantee these benefits, and at least for Social Security, permanent appropriations are currently on the books that provide for payments over the next three decades. Political support for these entitlements is also extremely strong. The economic and political reality is that these social insurance programs represent substantial obligations of the federal government, and an accounting system that ignores these obligations until the date they become payable is seriously misleading.

8. Questions About Other Possible Extensions of Accrual Accounting. In public discussions of accrual accounting for social insurance, critics often raise questions about the appropriate accrual accounting treatment of other kinds of obligations – from future spending on transportation to potential liabilities associated with global warming or shifting national security concerns. While these questions pose interesting theoretical challenges, they are an unnecessary distraction in discussions about social insurance programs. There is an expert body – the Federal Accounting Standards Advisory Board – that is charged with developing accrual accounting standards for the federal government. Over the past few years, that Board has carefully considered its treatment of accrual accounting for social insurance and a majority of the Board now favors the recognition of social insurance costs when beneficiaries become entitled to receive benefits under current statutory requirements, based on years of work and payroll taxes. In time, the Board will no doubt consider other topics for potential reform, but the Board members have quite sensibly given primacy to social insurance – both because of the nature of the obligations these programs entail and their significance for the fiscal well-being of the federal government.

9. Stein's Law: "Things That Can't Go On Forever, Won't." A final response to estimates of the mounting unfunded obligations reported in Table One is to invoke Stein's Law as if this aphorism were a license to ignore unsustainable programs. But Stein's Law is not an excuse to ignore difficult public policy problems. It is a prediction that unsustainable programs will eventually be altered. The value of accrual accounting is that it helps politicians and the general public to appreciate the magnitude of the commitments we are currently making. Accrual accounting may also suggest politically viable reform proposals. Stein's Law depends upon policy analysts to attack hard problems not to ignore them.

One Proposal

10. Testing the Value of Accrual Accounting. The true measure of any accounting system is whether it offers a useful tool to understand and manage financial activities. For several years, I have been arguing that accrual accounting could help reform Social Security and other entitlements. The endorsement of accrual accounting for social insurance by a majority of the FASAB Board reflects a similar view. But the proof of the pudding is still in the tasting. To this end, I propose that the Congressional Budget Office host a conference in one year's time at which leading experts would be invited to present proposals for Social Security and Medicare reform that are presented in terms

of their impact on the unfunded obligations of the federal government, distinguishing as appropriate among classes of beneficiaries. CBO staff and the Office of the Chief Actuary would be invited to participate in these analyses. We will then have the opportunity to see whether these new accounting treatments actually can facilitate public debate and assist the country in reaching a consensus on the appropriate path for fiscal reform.

Mike Shannon – Prepared Remarks

Good afternoon. I would like to thank you all in advance for your time and for the opportunity to address your Advisory Board this afternoon.

Of all the speakers at this public hearing, I am admittedly and far and away the least qualified. However, I may be the only speaker that represents the first of many generations that will feel the true impact of your Board's actions (or lack of action).

I flew here today to appeal to your board, because I believe that our representative democracy is not equipped to avert a long-term fiscal meltdown. As the bulk of our population barrels toward retirement, as voter turnout and voter density are higher among the elderly, resources continue to be disproportionately allocated to the aged and aging. That works as long as the worker-to-retiree ratio remains constant. We all know that it will not.

Retirement security for needy Americans in their golden years is a responsible and compassionate goal of our society. However, we simply cannot afford the levels of benefit payments that have been promised. Using simple percentage-of-GDP math, the annual increase in cost for Social Security, Medicare, and Medicaid in 25 years will be equivalent to an additional 40 concurrent Iraq wars. Just like the leaders of Ford, Chrysler, and General Motors, our nation's leaders have promised too much pension to keep things running during the good years, and our competitiveness will suffer just the same as tougher times approach.

Locked in a partisan stalemate as a result of legislative districts gerrymandered to rig the outcome of over 90% of House elections, Representatives in both parties are unwilling to make the compromises we need to stay afloat. I respectfully submit to you that Congress may be rendering itself *obsolete*.

In other words…The way to become an officer on this ship is to NOT talk about the iceberg that we all plainly see in front of us and have seen for quite some time. In the 1970s former U.S. Secretary of Commerce, Peter Peterson, was saying, "You know, in the year 2008 our social insurance programs are going to be facing a demographic imbalance."

And people said, "2008, that's so far away."…Not so far away.

ATTACHMENT 1 – SPEAKERS' SUMMARIES OF TESTIMONY

The nation's top Accounting Officer, Comptroller General David Walker, who spoke to this board earlier today, has traipsed all over the country holding press conferences trying to sound the alarm bells. He was even featured on 60 Minutes.

Former Fed Chairman Alan Greenspan, who is known for his flighty, hard-to-interpret, nebulas characterizations of economic conditions, testified before Congress and called this situation a quote "Looming Fiscal Crisis." …that's sort of uncharacteristic… clarity.

Ben Bernanke, Greenspan's successor, has testified before Congress twice in the past year and explained that failure to address this imbalance between benefits promised to Baby Boomers and projected revenue collection could undermine the entire U.S. economy.

Yet………..Nothing!

We are witnessing a fundamental flaw in democracy that allows current generations to inflate our own standard-of-living beyond simple security for the needy at the expense of the standard-of-living of future generations.

Your program lists me here as the 2006 Republican Nominee of U.S. Congress in the 9th District of Illinois. Let me be real clear, the reason I ran as a Republican is simple: because I live in a district that is drawn with a predetermined outcome for the Democratic incumbent. She has won election in each of the past five election cycles (that's 10 years) with 76%, 78%, 75%, 76% and 74%. You can understand why it was pretty easy for me to win the Republican Primary. Like 16 other districts in Illinois, my district is "fixed" for the incumbent to win every time. If I lived in a district that was instead crafted for a Republican incumbent to win every time, then I would have run as a Democrat...that simple. This topic of accounting for social insurance programs is beginning to, and will continue to, divide Americans less along party lines and more along generational lines.

My incumbent Congressman is a self-described advocate for the elderly. Alternatively, I characterized myself as an advocate for younger and future Americans. Now I don't have to tell you that that is not very smart if you're trying to get elected. As I mentioned, old people vote in droves, and young people don't vote much or are not yet old enough to vote. But I wasn't trying to get elected. I was trying to make a point.

Do any of you remember the sixties? Does anyone here know what a sit-in is? Rather than sitting in a campus classroom refusing to leave or in a business or in the middle of the street, I was conducting a sit-in in a campaign for U.S. Congress. In protest, I refused to accept campaign contributions. And I am committed to help other candidates from within either party conduct similar protest campaigns in any legislative district that is not competitive…and there are plenty of them. In 2008, I am projecting there will be three "sit-in" candidates in Illinois, one in Iowa, one in Minnesota, and one in Missouri. We will be there on the ballot, refusing to accept any money. It's an uphill battle, but it pales in comparison to the uphill battle that younger and future Americans are up against.

In lieu of a capable Congress, the balance of power and responsibility to govern has shifted to the Judicial Branch and Executive Branch…but perhaps to Advisory Boards like this one.

Now how does all this relate to Accounting standards? You see, when we rig the outcome of elections … there are consequences. If you're a Congressman in Republican America (that's codeword for Rural America), you can get re-elected over and over and over until you're 110 years old by promising, voting for, and delivering tax cuts. And when you're a Congressman in Democratic (Urban) America, you can get re-elected over and over and over by promising, voting for, and protecting ever-increasing retirement benefits.

When there is zero risk to incumbents getting re-elected, there is no incentive to work with the other party to actually accomplish anything. There is no appetite for compromise. And we propel toward the iceberg. When there is zero risk to incumbents, they show up here in Washington with a list of demands, not a willingness to work with others. And we propel toward the iceberg. When there is zero risk to incumbents, they tend to strike a lethal deal, where both sides get what they want! Republicans get tax cuts and Democrats get ever-increasing retirement benefits. The combination of the two is a recipe for fiscal ruin. We are on course to hit that iceberg and drown our children in our own debt.

I speak on occasion at local High Schools in Chicago to educate students about the situation.

Teachers will sometimes say that the kids aren't smart enough to understand this stuff. I disagree. I think that kids are inherently curious and attracted to the truth if you lay out the facts. I draw it right on their blackboard and explain that there are 78 million people in the pipeline who, today, are paying taxes and not collecting benefits that, tomorrow, will not be paying taxes and will start collecting benefits. I ask them how long their family would survive if one spouse made purchases their family couldn't afford, and then the other spouse refused to go to work to bring in any income into the family, and then the first spouse said, "Fine, well I'm just going to continue buying things and put it all on a credit card." Kids understand a dysfunctional marriage. And that is exactly what we have between our two dominant political parties. What most families would never do to their own children (rack up a giant credit card bill and hand it over to the kids), we are all collectively doing to younger and future generations. When I speak at these high schools, I tell kids to tell their parents that there's a guy running for Congress who said to go home and ask for a check for $175,000 (that's each kid). That is the present value, the amount per man, woman, and child that our government needs cash-in-hand today, earning interest, to pay for the retirement benefits promised to future retirees…ironically promised to the same demographic that is unwilling to pay the taxes needed to fund the programs. It's almost $60 Trillion.

ATTACHMENT 1 – SPEAKERS' SUMMARIES OF TESTIMONY

In my role as strategic sourcing professional for a major retailer, I assist various areas of the enterprise negotiate contracts and resolve disputes with suppliers. I have a real passion for the principles of successful negotiation. I have studied and taught these principles originally pioneered by Roger Fisher and William Ury of the Harvard Project on Negotiation. The principles of successful negotiation amount to building trust with your counterpart, while simultaneously pursuing leverage and credibility.

Credibility
Leverage
Relationship

Credibility! Credibility is achieved by being perceived as fair and objective. Objectively speaking, an American born in the first wave of the Baby Boom (1946) will get different Return (on investment) from the taxes paid into… and subsequent benefits consumed from… Social Insurance programs than someone like me (born in 1972) and wildly different than my two daughters (born in 2003 and 2006). Your group coins it "Intergenerational Equity."

Credibility
Leverage
Relationship

Let's talk about Leverage! Young people in America have very little leverage. They are outnumbered and are overwhelmingly outvoted. But young people do have one tiny piece of leverage. It is they, dare I say it is we, who will write the history books of your time. And right now, we are sharpening our pencils to write something like the following: "Every previous American generation left the nation in better fiscal shape than they had found it, until…a generation came along post World War II in a Baby Boom." Let history record that an obscure panel called the Financial Accounting Standards Advisory Board (FASAB) had an opportunity to disclose to the American people the effect of this flaw in our democracy by the treatment of obscure future liabilities as…well…future liabilities. Let history record the names of these board members:

Tom L. Allen
Claire Gorham Cohen
Robert Dacey
John A. Farrell
Norwood J. Jackson, Jr.
Donald B. Marron
<u>James M. Patton</u>
Robert N. Reid
Alan H. Schumacher
Danny Werfel

Credibility
Leverage
Relationship

Let's talk about Relationship! Roger Fisher and William Ury emphasize over and over in their two books "Getting to Yes" and Getting Past No" how important relationship is when navigating a sticky negotiation. As part of building trust and fostering relationship, they offer a crucial tip that is worth more than all the gold in the Federal Reserve.

"Don't declare your position," they write. "Instead, express and work toward your *interests*."

The difference between a position and an interest is subtle. There is only one way to satisfy a position, which is to capitulate. If Company A declares to Company B, "in order to do business with us, you must occupy the vacant building next door to our facility," there is only one way to satisfy that demand. However, if Company A expresses to Company B, "our interest is on-time delivery of inventory," there are many ways to work together to satisfy that interest…and it gives an opening of Company B to take an active role in drafting a solution.

Let me close by saying that I mean no disrespect to any of you individually or collectively as members of the generation[s] that precede mine. This is a sensitive topic and will only become more sensitive over time.

I am not here to demand that your board comply with my position. I certainly don't have all the answers. My *interest* is to educate the American public to, in turn, motivate a "do-nothing" Congress to solve this unyielding, long-term, strategic challenge. My other interest that I'm confident you share is to help preserve the Baby Boom Generation's legacy. And oh is it a legacy worth preserving! Unlike my generation (X), which is arguably asleep at the switch, Baby Boomers yielded tremendous influence and were a voice for change in their teenage and young adult years for such admirable goals as Civil Rights, Voting Rights, and Equal Rights for Women. Unlike today's youth, Baby Boomers were a voice of restraint in a misguided, un-winnable military adventure. And music from the Baby Boom generation is easily the best rock-n-roll music ever recorded.

It's ALL at risk. If nothing changes, those contributions to America and to American culture will be overshadowed by a legacy of fiscal irresponsibility, a lack of stewardship, and the aggregate effect of individual selfishness that could impoverish our country.

Let's bridge a growing gap between generations…not blow up the bridge. A great start would be to keep one set of books with the true cost of future liabilities on those books rather than allowing politicians to ignore the fact that we are closer-and-closer to that iceberg every day.

It is truly an honor to appear before you today on behalf of younger and future Americans. Again, I thank you for the enviable opportunity.

Testimony of Rep. Jim Cooper
FASAB Hearing on
"Accounting for Social Insurance, Revised"
May 24, 2007

Thank you for helping us understand our government's financial condition. Very few issues are as important for the future of our country. And thank you for allowing me to testify at this hearing.

The nation's leading credit rating agency, Standard & Poor's, has already projected that the U.S. Treasury bond will lose its AAA rating by 2012[i] -- just a few years from now -- due primarily to problems with our social insurance programs. I asked Treasury Secretary Paulson last week if this were going to be his legacy, and he dodged the question. As a former investment banker he is well aware of the consequences of a negative credit outlook.

S&P also projects that, by 2015, U.S. credit will have sunk to the level currently held by Estonia or Greece. I don't need to tell you that few Americans know of this threat to our standing in the world. But it gets worse. By 2020, S&P projects that our bonds will be like those of Mexico or Poland. And by 2025, the Treasury bond will have plummeted to junk bond status – below investment grade – like those of Brazil or Panama. In other words, by the time babies born today graduate from high school, the United States could have the credit rating of a banana republic.

We must do everything that we can to make sure that this S&P projection does not come true. America must remain the strongest nation on earth. S&P apparently hopes so too, because they are not yet predicting a U.S. decline, only projecting on the basis of current trends. A prediction would mean that they had given up hope on elected officials intervening to save America's credit.

I am losing hope that Congress will act before it is too late. As a veteran member of Congress, and of the House Budget Committee, I am convinced that most of my colleagues either don't understand the grave fiscal threats we face (including the long lead-time required for solving them), or simply prefer to make excuses for inaction. Have you seen any signs of congressional resolve that I have missed? I know that Secretary Paulson cares deeply about social insurance issues, but he has apparently concluded that the Chinese are easier to negotiate with than the U.S. Congress. I am not faulting him. I have been unable to get my colleagues to move beyond cash accounting in their understanding of our federal government, although we are the last large entity in America allowed to use it.

ATTACHMENT 1 – SPEAKERS' SUMMARIES OF TESTIMONY

Although virtually everyone in politics privately acknowledges a long-term social insurance problem, few will discuss it publicly and even fewer will vote for reform. Secret meetings on the subject take place on the Hill but attendees are afraid to reveal their identity. The Concord Coalition and representatives of the Brookings Institution and Heritage Foundation have been touring the nation on the "Fiscal Wakeup Tour" in order to alert the public to the danger. Other than a few editorials, and a segment on "60 Minutes," there has been little response.

The nature of any legislative body is to be reactive, and Congress reacts best to crisis. Since my colleagues are afraid that messengers bearing bad news will be defeated, they conclude that calamity must be obvious before they are willing to announce it. I was first elected in 1983 when Congress waited until Social Security was within weeks of insolvency before taking action. Will we wait until a few weeks before the Medicare "trigger" is reached in 2012, or Social Security stops running surpluses in 2017? If we wait that long and Standard & Poor's is correct, we will have fallen below Estonia to a Mexican bond rating. Repairing our credit and our social insurance programs then may become impossible.

Of course you realize that it is not the comparison to other nations that hurts. Their names are shorthand for the damage that a drop in our credit rating can produce. As Federal Reserve Chairman Ben Bernanke has said, we have been able to run huge deficits and still keep our interest rates low due to the "global savings glut." President Bush has taken advantage of the glut by borrowing more money from foreigners than all Presidents in American history combined. According to Robert Hormats of Goldman Sachs in his new book, *The Price of Liberty*, we are more dependent on foreign capital than any time since the American Revolution. Dollar assets constitute 70% of the world's central bank reserves.[ii] As a result, the U.S. Treasury bond is arguably the most important piece of paper in the world. If it is damaged, not only will our cost of borrowing rise, we risk losing our status as the world's safe haven and reserve currency.[iii] As long as our domestic savings rate is zero, America must depend, like Blanche DuBois in *Streetcar Named Desire*, on the kindness of strangers.

Despite the fact that most congressmen have never heard of FASAB, and probably never will, your deliberations will have a surprisingly big impact on whether Congress can muster the courage to solve our fiscal problems. If you cut through the accounting jargon, you are diagnosing America's fiscal condition. You are America's fiscal doctors. Does Uncle Sam have a bad cold or cancer? The key is to get the diagnosis right. The ultimate tragedy is not having cancer, but failing to diagnose it in time.

The Primary View helps people understand that Uncle Sam may have cancer because our unfunded liabilities are so large and growing so fast. The Alternative View allows us to think we have the sniffles because that view shows no abnormal growths.

No one wants to undergo radiation or chemotherapy but, if you have cancer, you are suddenly thankful for those treatment options. Once people understand the diagnosis, treatment options become much easier. The main problem with President Bush's failed Social Security reform initiative was not its substance, but the fact that he recommended treatment before diagnosis. FASAB's power to diagnose can change the debate at the highest levels. Fast.

My views are consistent with the Primary View. At the individual level, most Americans think that they have done their part when they have paid their 40 quarters into Social Security or Medicare. At that point, if not earlier, they have a legitimate expectation that the government will start counting them and their future needs. They have listened for decades to politicians who have solemnly promised Social Security and Medicare benefits even though, if you read the fine print, these benefits are not promises but only, as Steve Goss insists, "scheduled benefits." No one has told them about the 1960 Supreme Court case of Fleming v. Nestor which ruled that Social Security benefits may be changed at congressional whim. They never hear these disturbing truths because we know they would be rightly outraged.

Not only does the Primary View fit popular expectations better, the Alternative View's "due and payable" standard of acknowledging obligations at the last minute would strike them as sloppy and even cruel. How dare the federal government overlook me and my benefits after I have paid a decade of regressive taxes! How dare the government not notice when I turn 62 or 65! (AARP starts accruing my benefits when I join up at 50!) By hiding these obligations, the "due and payable" standard looks like the government is hoping you will die before Uncle Sam has to pay your bills. Your own government should not be so callous and grudging.

At the macro level, Howell Jackson has written that the tens of trillions of dollars of unfunded Social Security and Medicare liabilities are increasing at the rate of $3 to $4 trillion annually. To put this in perspective, this is larger than the entire $2.9 trillion annual budget of the federal government. How can the fiscal gap be larger than the budget itself? This demonstrates the urgent need to improve accrual standards for government accounting, as GASB has done and as the United Kingdom, Australia, New Zealand and other advanced nations are doing. An average citizen or policymaker must be able to get at least an order-of-magnitude understanding of our financial condition by looking at our nation's basic financial statements. Today they cannot tell if our "true" deficit 3% of GDP, or 30%.

Both the individual and the macro social insurance problems seem to be metastasizing. When pressed, the White House will admit that your personal share of the national debt is $29,000. Not knowing any better, fiscally-conservative Blue Dog Democrats go along with this view. But David Walker has reported that, using the only audited financial available, each American's share of the national debt is already $170,000, and for a head of household, $440,000. So what size is our share of the national debt? A car loan or a home mortgage? Interest costs resulting from these debts are by far the fastest growing program in the federal government. Soon it will be a better deal to be a creditor of America than a citizen. As Albert Einstein said, the most powerful force on earth is not nuclear power, but compound interest. For most of American history, compound interest was working for us as savers instead of against us as debtors. At the macro level, the fiscal gap is increasing at the rate of roughly $350 million an hour, or $95,000 a second. The average citizen, journalist or politician (or even FASAB member), has no idea of the devastating cost of delay in reducing the gap. The opportunity cost of today's eight-hour hearing could approach $3 billion. It is hard to even imagine a reform proposal that could be implemented fast enough to save more money than its cost of formulation. The fiscal gap is becoming irreversible.

In an effort to reduce the extraordinary cost of delay, let me focus quickly on several common misunderstandings:

1. **Budgets Are Unrelated to Long-Term Problems?** You have seen President Bush, our first MBA President, brag about declining deficits while acknowledging in the same press conference that our long-term entitlement problems are growing rapidly. Most people in Washington don't see the disconnect. They do not seem to realize that today's budgeting decisions determine the size and nature of tomorrow's problems.

2. **Large Liabilities Lock-In Benefits?** Accounting for social insurance benefits does not freeze benefits at those levels. Policymakers retain the discretion, as they should, to lower benefits, raise taxes, or take other steps to insure the viability of entitlement programs. Accurately estimating these obligations gives us a chance to honor them.

3. **Badmouth Estimation?** Actuarial estimates do vary widely with differing assumptions. But it is defeatist to say that we cannot plan for the future, or understand that plan for the future. Certainly no insurance company can claim that, although it can pay future claims, the government has no business trying to prepare for its social insurance obligations. Relying on the government's ability to tax is not realistic. Taxes cannot be doubled without grave damage to the economy. Bottom line: the state does not really have an unlimited power to tax.

4. **Badmouth the Infinite Horizon?** Infinite may sound like a long time but, in the context of actuarial study, it really means a time period longer than 75 years but usually less than 100 years. After a century, the changes are usually too distant to matter. We must protect the interests of those born today. Sweeping those problems under the rug does not help the analysis, only the politics.

5. **More Paper Will Help?** Although a theoretical case can be made for new types of financial statements, or not tying the Statement of Social Insurance to the national balance sheet and statement of net cost, will the

average Rotarian understand it? The purpose of financial statements is to give an accurate snapshot of an enterprise or government. The more extra paper or confusion, the less likely it will be read and understood.

6. **Forget Your Audience?** David Walker and I have had a running discussion about whether an "exchange transaction" takes place after 40 quarters in order to meet the technical accounting definition of a recognition event. He has also told me it's crazy to count future obligations without counting future revenues. I know I am not as smart as a CPA but common sense has a role to play as well. Government has become so complicated that fewer, simpler, more understandable rules would be an improvement, even if they are not as precise. The SEC is looking at "principles-based" reform as in the U.K., not more rules-based complexities. And if we err, let's err on the side of counting earned benefits before counting future payroll taxes.

In a formal hearing like this, it seems hard to believe that anyone would ignore, trivialize, or ridicule the serious problems we are discussing. But after nearly a quarter century in Congress, I can tell you that, in the privacy of the cloakroom, gym, or office, we are all human beings first. Not only are we terrified of a cancer diagnosis, most of us are afraid to go to the doctor if we think there might be a lump. Even after the diagnosis, we are the kings and queens of denial. But our best chance for a cure is to accept our diagnosis and the size of our unfunded liabilities. Our very survival may depend on shortening the time between diagnosis and treatment, between denial and acceptance.

No one wants to rewrite their speeches, especially if it means contradicting themselves. The best members have a false sense of confidence knowing that we were able to work our way out of the Reagan deficits after a decade. They don't realize that today's deficits, properly measured, might take half a century of sustained effort to resolve. When no newspaper reporter or constituent asks you questions about these issues, it is even easier to pretend that they will go away. Interest groups and think tanks are often no different. When they appeal to dogma rather than compromise, the process suffers. My opinion is that this result is not only wrong but dangerous. The economic strength of the nation is at stake while they are playing ideological games of chicken. Our social compact could be stressed to the breaking point in a few years. Voters hate being toyed with. They want the truth.

You have heard a long day of testimony and, even if you think I am making sense, are probably weighing my words against those of some of the most powerful elected officials and interest groups in America: Chairmen and Ranking Members and the AARP itself. How could I be right if they hold different views? Well, here's one way to decide. If you think America is on the right track, and that it will be easy to solve these entitlement program problems, agree with them and the Alternative View because it will delay the day of reckoning. These powerful people and groups represent the *status quo* which they want to preserve as long as possible. But if you worry about our future, think that Standard & Poor's projection may be correct, and believe that these entitlement problems will be hard to solve, support the Primary View which will hasten the day of reckoning.

Although I am no longer the youngest member of Congress, I am speaking for the future; I do not represent the *status quo*. The future is always underrepresented because, by definition, it hasn't had the time or the money to acquire seniority or hire lobbyists.

The majority of you are already on the right track with the Primary View. Stay the course. Remember: Congress will only respond to crisis but by then it may be too late. Without your help, Standard & Poor's projection will become a prediction, because they too will have given up hope. Have the moral courage to stand up to the complacency of today's powerful interests. Lincoln called America the "last best hope of earth." You, with your quiet, but powerful diagnosis, may be America's "last best hope." If not you, who? If not now, when?

# # #

---

[i] Serena Ng, "U.S. Could Lose Top Rating – by 2012," Wall St. Journal, June 7, 2006, p. C6.
Standard & Poor's is not alone in its projection, although it used more graphic terms than most to describe it. The U.S. Treasury's Financial Report of the United States Government, the Government Accountability Office's many reports, the Social Security Trustees' Reports, the Congressional Budget Office, and numerous economists have been sounding various warnings for many years.

[ii] Robert D. Hormats, The Price of Liberty: Paying for America's Wars," Times Books, 2007, p.

266-267.

[iii] See Michael Mandelbaum, The Case for Goliath, , 2006, stating that the greatest foreign policy threat that we face is due to our long-term domestic policy weakness.