



April 10, 2009

Memorandum

To: Members of the Board

From: Eileen W. Parlow, Assistant Director

Through: Wendy M. Payne, Executive Director

Subj: Fiscal Sustainability Reporting – **Tab A**¹

MEETING OBJECTIVES

To review revisions to the attached preballot draft Statement of Federal Financial Accounting Standards (SFFAS) based upon Board decisions at the February 2009 Board meeting. The Board decisions are listed below under “Background.”

<p>Specific questions for the Board appear on pages 6, 10, 14, and 15 of this memorandum.</p>
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As a result of the meeting, staff expects to be able to produce a ballot draft SFFAS, *Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government*, for the June 2009 Board meeting.

BRIEFING MATERIAL

This transmittal memorandum includes a discussion of conclusions reached by a majority of members at the February 2009 Board meeting. In addition, the following items are attached:

- Attachment 1 – History of Board decisions
- Attachment 2 – Timeline for issuance of SFFAS
- Attachment 3 – Letter and e-mail from Stephen Goss
- Attachment 4 – Preballot draft SFFAS, changes marked

¹ The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

BACKGROUND

The Board's decisions at the February 2009 Board meeting resulted in (a) specific edits and (b) action items.

Per the Board's direction, the following specific edits have been made to the attached preballot draft as indicated.

- a) Add language adapted from GAO's explanatory language about the distinction between projections and predictions. [See paragraph 39(c).]
- b) The requirements in paragraphs 41(e), 42(a), 42(b), 42(c) and 42(d) of the exposure draft (ED) should remain as RSI permanently. [See paragraphs 41-43.]
- c) Edit the time horizon requirement in paragraph 34(a) of the ED to require a finite projection period sufficient to illustrate long-term sustainability for the basic financial statement, with an additional requirement to discuss in RSI the implications of the sustainability information after the finite period ends and explain that the latter requirement could be met with infinite horizon projections. [See paragraph 35.]
- d) Re-work the language regarding alternative scenarios to remove the requirement to report alternative scenario data for each line item of the basic financial statement, but to retain the detailed illustration in Appendix B. [See paragraph 42(d).]
- e) Edit the illustrative financial statement in Appendix B to add lines for "Major Program A" and "Major Program B" to more clearly reflect the reporting requirement regarding disaggregation on the basic financial statement. [See Illustrative basic financial statement on page 34 of the preballot draft].

The following action items resulted from the Board's February 2009 meeting and are described further in this memorandum:

- f) Illustrations 8a and 8b should be deleted from Appendix B and staff should re-draft paragraph 38 towards a broader requirement that fiscal cap should be explained and disclosed, for example: "Fiscal gap information should be disclosed, either on the face of the financial statement or in the disclosures."
- g) Staff should work with GAO to finalize new language for paragraph 31 (consistency of economic assumptions with the SOSI) that would be more specific about potential exceptions.
- h) Staff should research the SOSI requirements to see if the GAO recommendation for additional disclosure might be redundant to information already required for the SOSI. If the item is not redundant, staff will draft language to include it as an optional illustration of how to put the information into context in paragraph 41(e).
- i) Staff should explore options to enhance the illustrations as well as convey options developed by Mr. Stephen Goss for consideration.
- j) Some members questioned why the basic financial statement does not include interest expense but the cash flow illustrations do include interest expense. Staff has drafted an explanation to supplement note 20 in the preballot draft.

Members were asked to contact staff about any concerns that they believe were not resolved at the meeting.

DETAILED DESCRIPTION OF ACTION ITEMS PER BOARD DECISIONS, FEBRUARY 2009

- f) Illustrations 8a and 8b will be deleted from Appendix B and staff will re-draft paragraph 38 towards a broader requirement that fiscal cap should be explained and disclosed, for example: "Fiscal gap information should be disclosed, either on the face of the financial statement or in the disclosures."

Paragraph 38 of the preballot draft SFFAS has been edited as follows:

[39] Fiscal gap information should be explained and reported provided either on the face of the financial statement or in the disclosures. ~~Fiscal gap should be presented in present value dollars and as a percentage of the net present value of (a) GDP, (b) receipts, and (c) non-interest spending during the projection period. Information may be provided for a single target debt to GDP ratio, multiple ratios or over a continuum of ratios (for example, in the form of a graph or graphs). Illustrative examples are shown in Appendix B for both options: (a) narrative on the face of the illustrative basic financial statement and (b) in the disclosures, as Illustration 8.~~

In Appendix B, the narrative and illustrations have been deleted, except for the following:

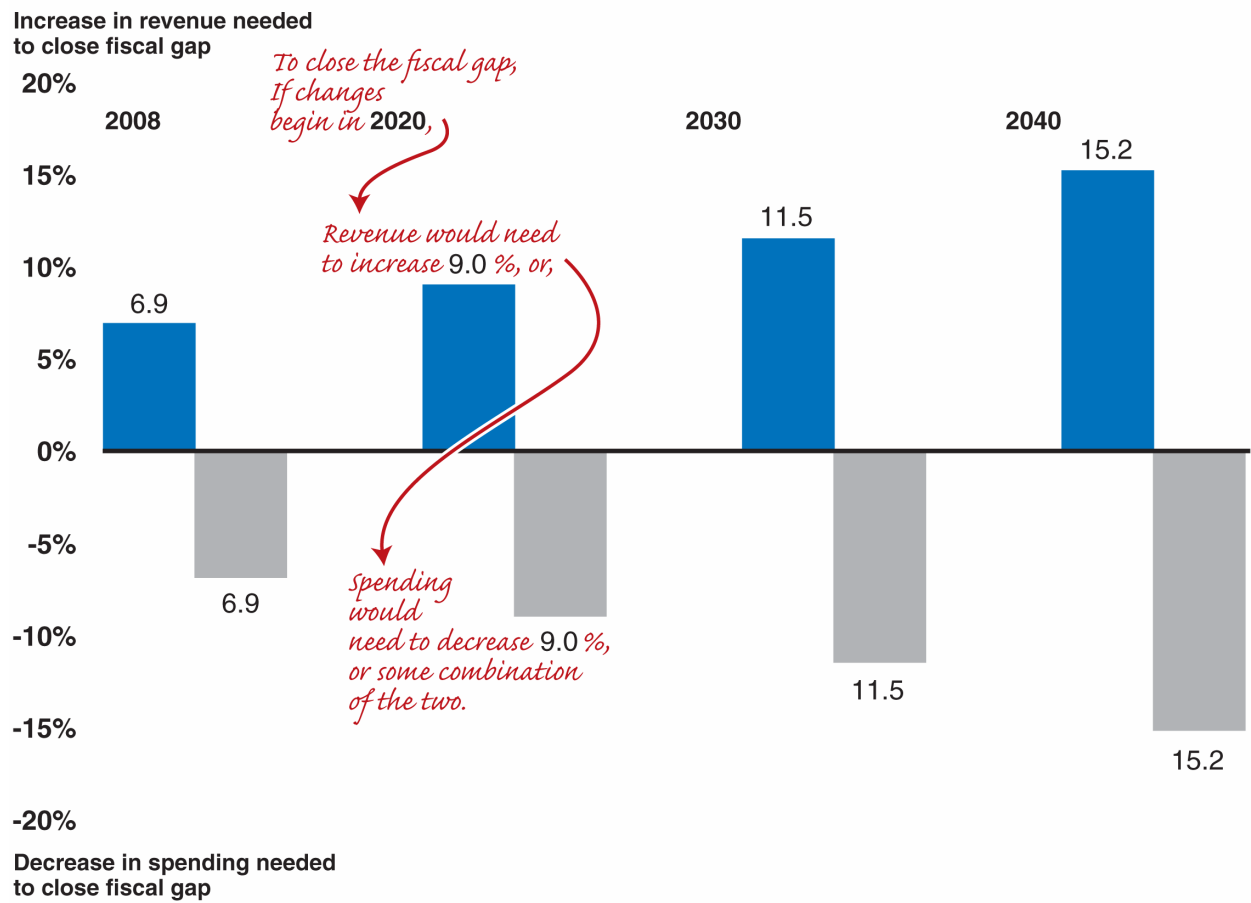
Appendix B: 8. Fiscal Gap

Paragraph 39 requires that information about fiscal gap be included on the face of the basic financial statement or in the disclosures. The fiscal gap is the change in spending or revenue that would be necessary to maintain public debt at or below a target percentage of GDP.

How much public debt is sustainable? While many experts agree that some level of public debt is reasonable and acceptable, there is no universally agreed-upon "sustainable" percentage of debt to GDP. However, all experts agree that a continually increasing level of debt to GDP is not sustainable. The chart in Note X¹ displays how the debt as a percentage of GDP has varied over time. Debt was 36.8% of GDP as of September 30, 2007, but has risen as high as 109% of GDP (during World War II). Many economists believe that persistent debt-to-GDP levels over 100% are unhealthy.

Staff also consulted with GAO graphics staff. The GAO graphics staff developed draft alternative illustrative graphics for fiscal gap, which are displayed on the following pages. At this writing, GAO staff are continuing to refine the displays, for example by inserting actual projections rather than partially notional data, and expect to have revised graphics by mid-May, 2009.

Optional Fiscal Gap Illustration A: Changes that would be needed to keep fiscal gap constant



Optional Fiscal Gap Illustration B:

Borrowing needed to cover the fiscal gap over a range of debt levels

Size of fiscal gap in trillions of dollars

\$70 –

If having more debt is generally bad, why do the challenges presented by the fiscal gap get smaller when we borrow more?

\$65 –

Borrowing more means we have more cash on hand and less spending cuts or revenue increases are needed, so the “fiscal gap,” (the amount we need to cut spending or increase revenue) is smaller.

\$60 –

\$55 –

\$50 –

\$45 –

\$40 –

Amount of borrowing (Debt ratio as a % of GDP)

0%

20%

40%

60%

80%

100%

120%

Why is borrowing too much a bad thing?

While many experts agree that some borrowing is ok, there is no agreed upon amount of borrowing that is accepted by everyone.

Why can't we continue to borrow?

Furthermore, all experts agree that we can't keep borrowing and borrowing more.



Higher



Economic growth



Lower

Higher



Private investment



Lower

Lower



Interest cost



Higher

Lower



Burden placed
future generations



Higher

Optional Fiscal Gap Illustration C

Changes needed to keep the fiscal gap constant over a range of debt levels

	Debt ratios (as a percentage of GDP)			
	36.8% (Current level)	?%	?%	109.0% (Historical high)
What increase in revenue would be needed? The amount of additional revenue (including taxes from U.S. citizens) that the U.S. Government would have to raise	36.0%	?%	?%	31.5%
What decrease in spending would be needed? The amount of spending (including government programs and services) that would need to cut from the federal budget	26.0%	?%	?%	22.5%
What are the potential advantages or disadvantages to this debt level? Description	<ul style="list-style-type: none"> Bullet 1 Bullet 2 	<ul style="list-style-type: none"> Bullet 1 Bullet 2 	<ul style="list-style-type: none"> Bullet 1 Bullet 2 	<ul style="list-style-type: none"> Bullet 1 Bullet 2
What effect might this have on the economy? Description	<ul style="list-style-type: none"> Bullet 1 Bullet 2 	<ul style="list-style-type: none"> Bullet 1 Bullet 2 	<ul style="list-style-type: none"> Bullet 1 Bullet 2 	<ul style="list-style-type: none"> Bullet 1 Bullet 2

Source: Falls in this space.

Staff recommendation:

Staff recommends that all three illustrations be added to Appendix B as illustrative examples when finalized.

Questions for the Board:

- 1) Should illustrations A, B, and/or C be added to Appendix B as non-authoritative illustrative examples of reporting on fiscal gap?
- 2) Are there any changes that should be made to the illustrations?

- g) Staff worked with GAO to finalize new language for paragraph 31 (consistency of economic assumptions with the SOSI) that would be more specific about potential exceptions.

Staff drafted the following edits for paragraphs 31 and 40(c) based upon GAO's written comments on the ED; GAO did not object to the edits.

[31] The same economic and demographic assumptions generally should be used for the basic financial statement for Fiscal Sustainability Reporting and for Social Security and/or Medicare in the Statement of Social Insurance (SOSI) although exceptions may be necessary when considering all projected receipts and spending. For example, an appropriate unified discount rate for all projected receipts and spending in the basic financial statement may differ from either the Social Security or Medicare discount rate. (See paragraph 40(c).)

[40] Disclosures should include... [c] any significant differences in economic and demographic assumptions from those used for Social Security and/or Medicare in the preparation of the SOSI and a reference to the note presenting assumptions used in the SOSI.

- h) Staff researched the SOSI requirements to see if the GAO recommendation for additional disclosure might be redundant to information already required for the SOSI. If the item is not redundant, staff will draft language to include it as an optional illustration of how to put the information into context in paragraph 41(e).

GAO wrote (Q3 response):

However, it is our view that the excess of spending over receipts attributed to Medicare Part A and Social Security should be required to be disclosed in the footnotes. This would provide policy-makers and the public with critical information on the composition of the excess between the Social Security and Medicare Part A programs, which are supported by dedicated earmarked funding, and the remaining spending, which is supported by general revenues. This should be accompanied by appropriate narrative that discusses the significance of the different funding mechanisms and the competing demands of Medicare Parts B and D and other discretionary spending (e.g., Defense, and Homeland Security) on general revenues.

Staff was tasked with researching the SOSI requirements in order to avoid redundancy and, where not redundant, to draft new language that could be added to the "significance/context" paragraph 41 of the preballot draft.

Existing requirements for the SOSI in the CFR (**most relevant items in bold**):

SFFAS 17, par 31:

The consolidated governmentwide financial report should include, as required supplementary stewardship information (RSSI), a summary of the entities' descriptions of their social insurance programs (see paragraph 24). The description should include a discussion of the long-term sustainability and financial conditions of the programs, illustrate and explain the trends revealed in the data, and **explain the relationship of the social insurance program(s) to governmentwide financing, especially regarding the intra-governmental nature of trust fund assets and government debt.**

(Par. 24, referenced in par. 31 above:

[24] The entity responsible for the social insurance program should include in its financial report, as required supplementary stewardship information (RSSI), a clear and concise description of the program, **how it is financed**, how benefits are calculated, and its financial and actuarial status. The description should include a discussion of the long-term sustainability and financial condition of the program. A

display should illustrate and the discussion should explain the trends revealed in the data. The entity should consider both narrative and graphic presentations. Statutory or other material changes affecting the program after the current fiscal year, including those enacted between the fiscal year end and the date of the report, should be described, along with the implications thereof.

SFFAS 17, par. 32 (1)

[32] The information on financial and actuarial status should include the following measures and data:

(1) Cashflow Projections -

(a) **Cashflow projections should be made for all social insurance programs** as described under the component entity standard (see par. 27), except that only cash inflow from the public (that is, excluding interest on intragovernmental borrowing/lending) and total cash outflow are required. **At a minimum the OASDI, HI, and SMI programs should be separately identified.** The projection period of the display should be based on those used by the component entities, which may require summarization or presentation techniques such as using more than one graph (e.g., a 10-year graph and a 30-year graph). **The presentation should include an explanation of material crossover points, if any, where cash outflow exceeds cash inflow and the possible reasons therefore.**

(b) **For the programs indicated immediately below, estimated future cash inflow (excluding net interest on intergovernmental borrowing/lending) and outflow for the projection period described in paragraph 27 as a percent of**

(i) **taxable payroll for OASDI and HI, presenting each program separately, and**

(ii) **GDP for OASDI, HI, and SMI, presenting each program separately.**

GAO proposed draft language to add to requirements for mandatory disclosures (paragraph 40) of the preballot draft SFFAS:

[40] Disclosures should include:

[e] the excess of spending between Social Security and Medicare Part A programs, which are supported by dedicated earmarked funding, and the remaining spending, which is supported by general revenues. This should be accompanied by appropriate narrative that discusses the significance of the different funding mechanisms and the competing demands of Medicare Parts B and D and other discretionary spending (e.g., Defense and Homeland Security) on general revenues.

Bob Dacey offered the following in support of the GAO's proposed requirement: GAO strongly believes that it is necessary to provide the type of information discussed in GAO's comment in the disclosures related to the statement of fiscal sustainability (or whatever we end up calling it). Our reasoning includes the following:

a. The requirements in paragraph 36 [of the ED] would seem to lead to separating the receipts from the spending. As such, the portion of the difference between projected receipts and projected noninterest spending that relates to the Social Security and Medicare Part A programs will likely not be evident. Hence, we believe that it should be disclosed, along with narrative that explains the significance of the funding of these two programs in relation to other federal programs.

b. while some of this type of information may be included in different places in the social insurance disclosures (both footnotes and RSI), we believe that it is important to include a succinct discussion in the fiscal sustainability disclosures so that readers understand that, under current law, Social Security and Medicare Part A are funded by dedicated revenue streams and not by general revenues and that Medicare Parts B and D as well as discretionary programs are funded by general revenues.

c. We do not believe that the current SOSI disclosures provide information about the competing demands on general revenues by Medicare Parts B and D and other discretionary spending (e.g., Defense, and Homeland Security) and the related policy decisions the federal government will face in addressing fiscal sustainability challenges.

d. The numbers in the statement of fiscal sustainability may differ from the SOSI, for example through the use of a unified discount rate (see paragraph 31).

e. We envisioned that the disclosure referred to in our letter would likely be addressed in one paragraph, so as not to add a lot of information to the CFR. Also, it would help ensure that user's obtain and understand this important information and ease the user's ability to find this information within the CFR, realizing that the average user may not be aware of this information and know to look for it.

Staff analysis

Staff believes that there are two options for resolving this issue: no action, or adding new language to paragraph 40.

Option 1

It appears that the GAO's recommended information is already required in the SOSI requirements, in particular paragraph 31 of SFFAS 17, so one option would be no action. This option would be in accordance with the Board's decision at the February meeting to take no action if the SOSI requirements already require disclosure of funding mechanisms. In addition, although funding mechanisms for social programs are significant, the funding mechanisms have no impact on "fiscal sustainability" (the overall "bottom line" totals for comprehensive government-wide projections), which is the focus of the proposed SFFAS. As noted in SFFAS 27, "When the earmarked fund redeems its Treasury securities to make expenditures, the U.S. Treasury will finance those expenditures in the same manner that it finances all other expenditures."²

² SFFAS 27, paragraph 27; also see paragraph 33.

Option 2

New language could be added to paragraph 40 of the preballot draft SFFAS. This might present two difficulties:

- (a) using "principle-based" language, such as "earmarked revenues," may produce a result with insufficient focus on social insurance, as evidenced by implementation of SFFAS 27 (Earmarked funds): there are many, many programs funded by earmarked revenues. (See Note 21 in the 2008 CFR.)
- (b) naming specific programs may produce quick obsolescence of the new SFFAS, since Congress is free to re-organize and re-name programs, or to change them so that they are in balance (a distinct possibility with Social Security).

That being said, staff has drafted the following revised language that is principle-based in order to address the potential difficulties described in (a) and (b) above:

[40] Disclosures should include:

[e] the excess of spending over revenues should be disaggregated between ~~Social Security and Medicare Part A~~ major social insurance programs³ ~~which~~ that are supported by dedicated earmarked funding, and the remaining spending, which is supported by general revenues. This should be accompanied by appropriate narrative that discusses the significance of the different funding mechanisms and the competing demands of ~~Medicare Parts B and D~~ major social insurance programs and sub-programs that are supported by general revenues and other discretionary spending (e.g., Defense and Homeland Security) on general revenues.

Staff recommendation

Staff is neutral regarding Options 1 and 2 but offers the following comments:

- Option 1 most closely reflects the Board's decision at the February 2009 Board meeting.
- The revised language for Option 2 avoids potential problems if Congress makes changes to major social insurance programs, in particular if future legislation includes changes to the funding mechanisms or the names of major social insurance programs.

Question for the Board:

Regarding item (h) above (research regarding existing requirements for the SOSI), do the members prefer option 1 above (no action) or option 2 (new subparagraph d for paragraph 42)? If Option 2, should the revised principle-based wording be used?

³ **Social insurance programs** are income transfer programs financed by compulsory earmarked taxes and also, in certain cases, general revenues of the federal government. Social insurance programs are identified in SFFAS 17, as amended.

[Staff note: The first sentence of this definition is quoted verbatim from the existing definition in FASAB's Original Pronouncements Glossary.]

- i) Staff will explore options to enhance the illustrations as well as convey options developed by Mr. Stephen Goss for consideration. (See attachment 3.)

Staff has been working with GAO graphics staff to enhance the appearance and consistency of the illustrations in Appendix B. The enhanced graphics will be forwarded to the Board when they are available (expected by mid-May, 2009).

In addition, Mr. Goss sent a letter including draft illustrations on March 8, 2009 (see Attachment 3). Mr. Goss proposes two illustrations. The first illustration contains a bar chart that displays two pairs of bars – total obligations and revenue needed as well as total tax revenue and obligations payable – based on maintaining a target debt level of 100% of GDP. The second illustration is a stacked bar chart similar to Illustration 3 in the ED, but without revenue and with various ordering of the items in the bar chart.

Staff analysis and recommendation:

Staff believes that there are several difficulties in Mr. Goss' Illustration 1. The most serious drawback is that it uses a target debt level of 100% of GDP, which may imply that the Board has established a target debt level. After much deliberation, the Board decided that in the absence of a legislated target, the Board has no objective basis for establishing a target level of debt to GDP and therefore the draft illustrations in this memorandum regarding fiscal gap display multiple levels of debt to GDP.⁴ In addition, the illustration uses technical terms – “obligations” and “payable” – that appear to have a different meaning from other federal financial statements. For example, “obligations” is used in the Statement of Budgetary Resources and it refers to actual historical obligation of budget authority, including orders that have been placed but not yet received. The term “obligations” also implies a liability, which is defined as a “present obligation.”⁵ In both instances, the term “obligation” refers to transactions that took place prior to the financial statement date. In contrast, the focus of the projections is on future cash flows.

Mr. Goss suggests that in his illustration, “Obligations here represent the intended amounts that the government is scheduled to spend on all programs for the year.” Staff finds this definition confusing, because it is unclear whether amounts “spent” indicate the cash, modified cash, or full accrual basis of accounting, and, if the latter, whether “spent” includes the accumulation of unpaid items such as civil service retirement benefits, environmental cleanup liabilities, and/or social insurance obligations.

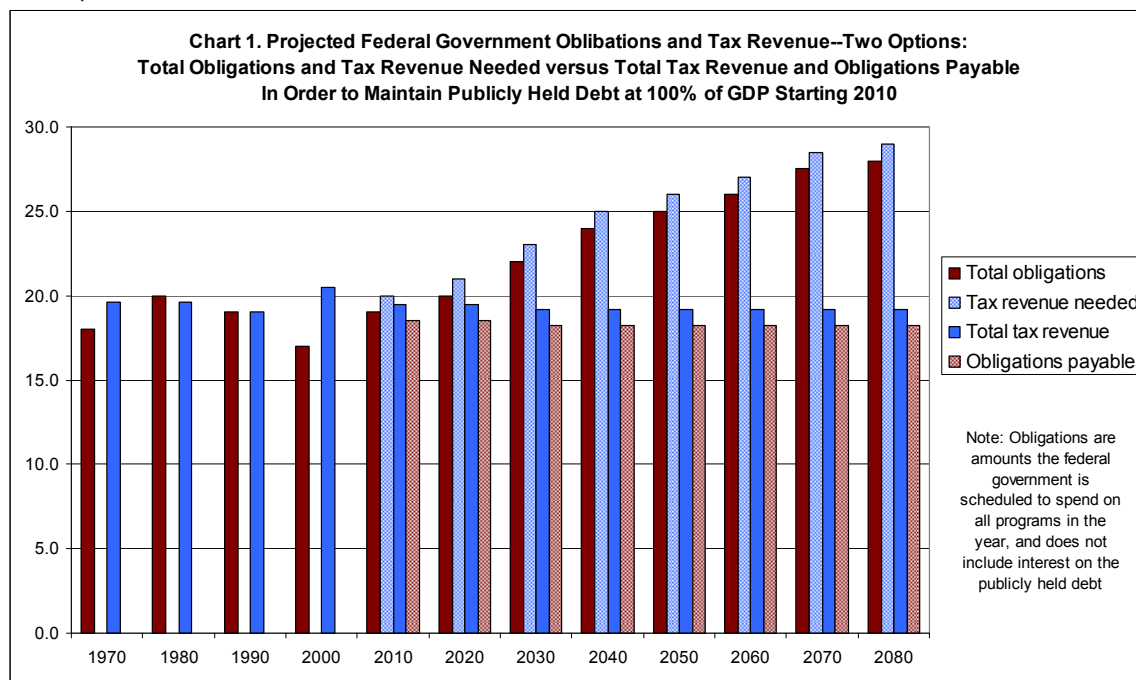
The other term, “payables” is used in the Statement of Net Position/Balance Sheet, and it refers to balances as of a historical date. For example, the amount recognized as “payable” for Social Security is limited to the amount due and payable to current retirees. Mr. Goss proposed that “the light red (pink) bar shows, alternatively, the level

⁴ The narrative below the illustrative basic financial statement in Appendix B refers to an unspecified debt-to-GDP level.

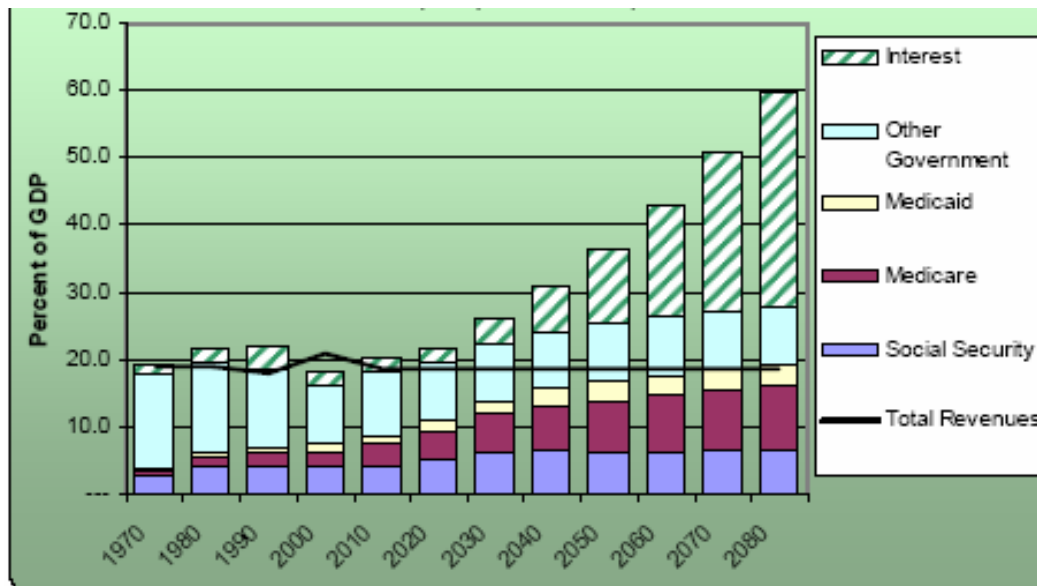
⁵ Paragraph 9 of Statement of Federal Financial Accounting Concepts 5 defines a liability as “a present obligation of the federal government to provide assets or services to another entity at a determinable date, when a specific event occurs, or on demand.”

of obligations that would actually be payable in the year with the scheduled tax revenue in current law, while maintaining debt at 100 percent of GDP.” Staff believes that another term would have to be found for “payable” and it is unclear what that term would be. In addition, Staff believes that Mr. Goss’ illustration 1 presents similar information to the information presented in the ED’s Illustration 3 but in a more confusing manner. (Both illustrations are shown below.)

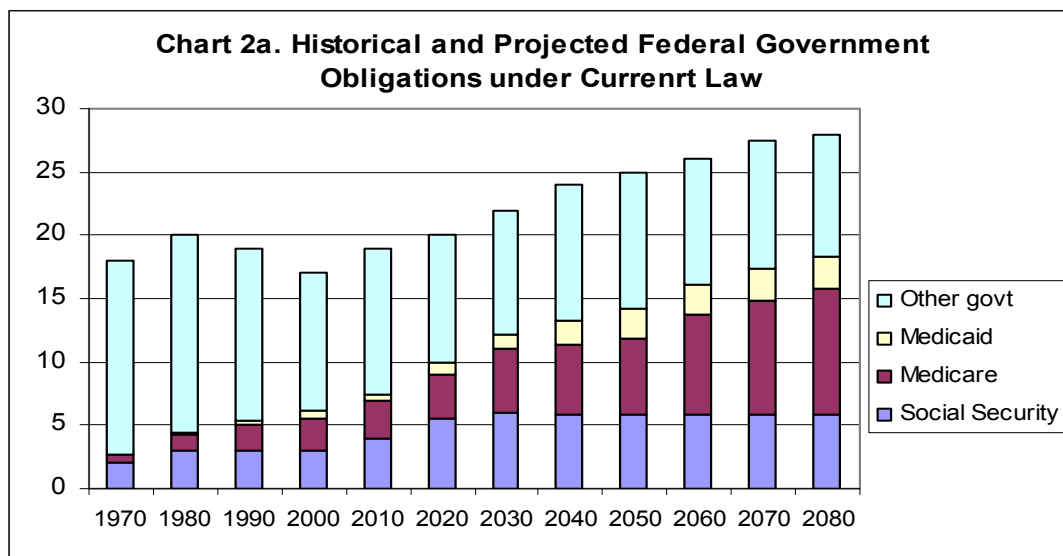
Goss, Illustration 1

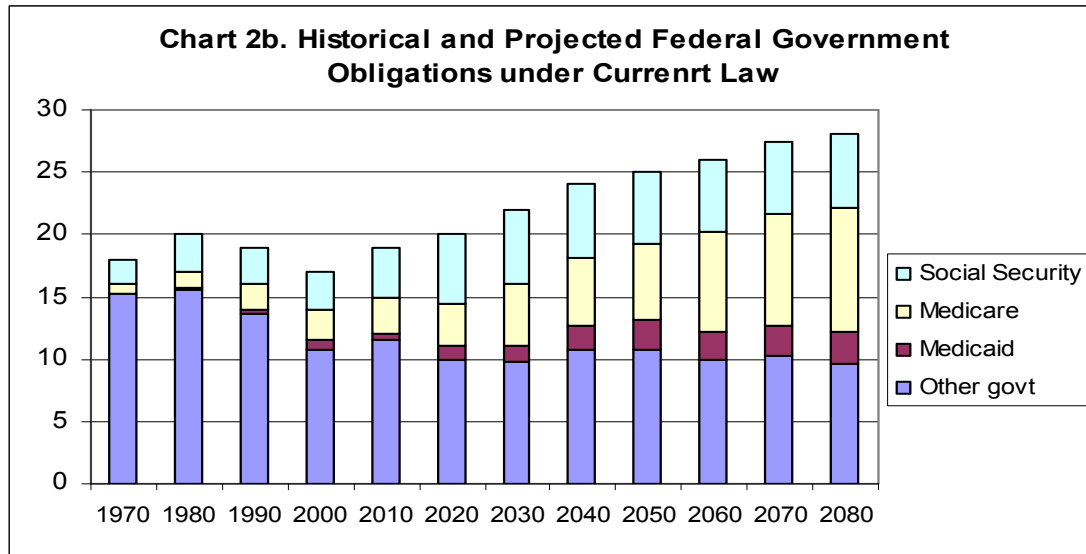


Projected U.S. Government Receipts and Spending
(As a percent of GDP)



Mr. Goss' Illustrations 2a and 2b (shown below and on the following page) are similar to Illustration 3 in the ED (shown above) except that they omit projected revenue and interest expense. At the February 2009 Board meeting, Mr. Jackson said that it is important for the display to show projected revenue as shown in Illustration 3 and none of the members indicated a desire to delete the revenue element from the ED's Illustration 3. Regarding the order in which various types of spending are placed in the stacked bar graphs, staff is currently working with GAO graphics staff to enhance the appearance of this illustration, which will likely include more than one way or ordering the spending categories. Mr. Goss' Illustrations 2a and 2b are shown below.





Staff recommends that the final Illustration 3 include more than one option for ordering the elements in the stacked bar graph. Revised Illustration 3 will be forwarded to members when received from GAO graphics staff (expected by mid-May, 2009).

Question for the Board:

Does the Board agree with staff recommendation that Illustration 3 display more than one way of ordering the categories of projected spending?

- j) At the February meeting, some members questioned why the basic financial statement does not display interest expense but the cash flow illustrations do display interest expense.

Staff has drafted the following case study example to help explain why present value summary amounts do not explicitly include interest. The present value can be defined by asking the question: "How many dollars would I need today to come up with X dollars at date X, assuming a discount (interest) rate of X percent?"

In this example, assume:

- debt of \$100 at the beginning of the projection period,
- a projection period of one year, and
- a discount rate of 3%.

In this example, the \$100 debt would accumulate \$3 of interest. At the end of the one-year projection period, the total amount due (debt plus interest) would be \$103.

The present value calculation (to calculate how much is needed at the beginning of the projection period to come up with \$103, assuming an interest rate of 3%) would be \$100. In effect, the \$103 total of debt plus interest at the end of the projection period is

reduced by the amount of interest expense during the projection period. Accordingly, the amount of explicit interest expense would be zero. A “fiscal imbalance” calculation for this case study (the amount needed at the beginning of the projection period to bring the debt level to zero) would be \$100. If that amount (\$100) were on hand at the beginning of the projection period, the interest expense would be offset by the interest earned on the \$100 during the projection period.

In contrast, a projection of cash flows would show the \$3 in interest expense as an explicit separate category of expense during the one-year projection period. Cash flow projections assume that any shortfall of receipts to spending will be borrowed but generally do not allocate the amount borrowed to the various categories of spending. Accordingly, interest expense is generally displayed explicitly rather than being included implicitly in the various categories of spending.

Staff has drafted a footnote to update the preballot draft so that it reflects the Board’s decision that the “bottom line” of the basic financial statement should not display fiscal gap, but rather simply the difference between projected receipts and projected non-interest spending. This footnote would replace footnote 29⁶ to explain why the basic financial statement requirement should exclude interest (paragraph 36(b)).

Since interest is factored into the calculation of present value summary amounts, the element of interest impacts each line item of the basic financial statement and accordingly is not displayed as a separate item.

Question for the Board:

Should the footnote (in bold above) be added as a footnote to the requirement for the basic financial statement (paragraph 36(b)) to explain why interest is not explicitly displayed in the basic financial statement?

NEXT STEPS

Staff will make edits per the Board’s decision regarding paragraph 42 above and any other edits identified by members at the April 2009 meeting. Unless there are additional edits identified that require development of new language, a ballot draft will be sent to members prior to the June 2009 Board meeting. Upon approval of a ballot draft by a majority of members, the SFFAS will be sent to the FASAB principals for a 90-day review period.

⁶ In the ED, footnote 29 was simply a cross reference to footnote 20. Footnote 20 is an explanation of present value in relation to fiscal gap, which was previously the “bottom line” of the basic financial statement. Footnote 20, which is still a relevant explanation of fiscal gap, states that:

Since interest is factored into the present value calculation, the fiscal gap as a share of spending is expressed as a share of spending excluding interest (“noninterest spending”).

ATTACHMENTS:

- 1 – History of Board Decisions
- 2 – Timeline
- 3 – Letter and e-mail from Stephen Goss
- 4 – Preballot draft SFFAS, changes marked