Federal Accounting Standards Advisory Board

December 16, 2005

Memorandum

To: Members of the Board

Wendy M. Comes

From: Wendy M. Comes, Executive Director

Subj: **Letters Regarding Social Insurance Project – TAB C**

We have received three letters expressing concerns regarding the consensus position of the Board on social insurance liabilities. The first two – from David Walker, Comptroller General of the United States, and Steve Goss, Chief Actuary of the Social Security Administration -- were submitted in connection with our Invitation to Comment on the Technical Agenda. The third was received in late November from John Snow, Secretary of the Treasury. These letters are attached to this memorandum so that you will be fully informed of the views expressed in advance of considering the exposure draft prepared by staff.

If you have any questions regarding the letters, please feel free to contact me at 202 512-7357.

GAO
Accountability • Integrity • Reliability

Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

September 2, 2005

Ms. Wendy M. Comes, Executive Director
Federal Accounting Standards Advisory Board
Mailstop 6K17V
441 G Street, NW
Washington, DC 20548

Dear Ms. ~~Comes~~ Wendy:

This letter provides the U.S. Government Accountability Office's (GAO) comments on the FASAB's Invitation to Comment document titled Technical Agenda Options.

One of the four principal objectives of federal financial reporting, as outlined in Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, is to assist users in "assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial condition has changed **and may change in the future**." As noted in SFFAC No. 1, financial condition is a broader and more forward-looking concept than that of financial position. SFFAC No. 1 specifically discusses that "federal financial information should provide information that helps the reader to determine whether the government's financial position improved or deteriorated over the period and **whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due**."

Our current reporting model provides information on financial position and changes in such position during the year, as well as budget results. However, more important than current and short-term deficits, we face large and growing structural deficits in the future due primarily to known demographic trends, rising health care costs and relatively low federal revenues as a percentage of the economy. Our current fiscal path is unsustainable and failure to highlight, analyze and appropriately respond to the resulting long-term consequences could have significant adverse consequences on our future economy and standard of living. While the Statement of Social Insurance will provide long-term information for those specific programs, in our view, more comprehensive reporting is necessary to fully and fairly reflect the nation's longer-term fiscal challenges.

Consequently, in our view, the FASAB's top priority should be communicating important information to users about the long-term financial condition of the U.S. government and annual changes therein. In particular, the government's financial statements should clearly communicate to the user:

- the long term sustainability of federal government programs – areas to consider include:
  - o the relationship of the federal government's existing commitments/responsibilities, including social insurance, to appropriate measures, such as Gross Domestic Product (GDP) and per capita amounts;
  - o the government's long-term fiscal imbalance in relation to appropriate measures, such as GDP (This type of information has been published for selected countries, including the European Union)
  - o the magnitude of the potential alternatives for resolving the long term deficits, such as the rate of tax increases or spending reductions necessary to balance the government's long-term finances

- inter-generational equity issues, e.g., assessing the extent to which different age groups may be required to assume financial burdens for commitments already made.

The government's financial statements should consider both the long-term financial condition of the government at the end of the fiscal year, as well as changes in the financial condition as the result of legislative and other events during the year. For example, as reported in the fiscal year 2004 financial statements of the United States government, the U.S. government's reported liabilities and unfunded social insurance and other obligations grew by over $13 trillion in fiscal year 2004, primarily due to enactment of the new Medicare prescription drug benefit, and exceeded $43 trillion as of the end of the fiscal year, representing close to four times GDP. Federal financial reporting should assist users in understanding the magnitude and potential implications of the serious fiscal imbalance we face and whether it has improved or worsened during the year. This would provide important contextual information as a supplement to the present focus on current results. It is also essential to provide a more comprehensive view of the nation's overall fiscal outlook.

As discussed in the Invitation to Comment, this above referenced work would be performed as part of the acceleration of the conceptual framework. This segment of the conceptual framework and the development of related accounting standards should be a top priority for the Board's agenda. On a related matter, we do not believe that the current liability project should be as high a priority as the above referenced matter. In addition, we are concerned that the current discussions surrounding possible additional liability reporting for social insurance seem to be geared toward an employer-based model rather than a social insurance model.

Of the four project options in the Invitation to Comment, the federal entity project should be a second priority. It is important to revisit those entities that have strong economic links to federal entities, such as federally funded research and development centers, but are not consistently considered federal entities. If, upon reconsideration, such entities are not deemed federal entities, the board should consider whether additional disclosures should be required to adequately explain the nature of the economic relationships that exist with such entities.

In summary, we believe the conceptual framework needs to be accelerated to address needed information about our nation's large and growing fiscal imbalance. Citizens need to know the sustainability of government programs and have accessible and consistent measures of the strength of government's finances and indicators of its financial health.

We appreciate the opportunity to express our view on these important matters and would be pleased to discuss them with the FASAB and you in further detail.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

cc: Honorable Joshua Bolten, OMB
Honorable John Snow, Treasury
Mr. David Mosso, Chair, FASAB

SOCIAL SECURITY
Office of the Chief Actuary

September 16, 2005

Wendy M. Comes, Executive Director
Federal Accounting Standards Advisory Board
Mailstop 6K17V
441 G Street, NW
Washington, DC 20548

Dear Ms. Comes:

I appreciate the opportunity to comment on the Federal Accounting Standards Advisory Board's Technical Agenda Options. The comments below reflect positions with which you are familiar, as we have talked about these issues extensively. These comments also reflect the careful thinking and input of Alvin Winters and Alice Wade of the Office of the Chief Actuary.

The Board requested commentators to rank the importance of several proposed projects. This letter provides my response, along with further explanation of views expressed on the specific project related to social insurance.

**Ranking Projects**

The Board requested a ranking, from high to low, of the priority that should be placed on four proposed projects: (1) the Federal Entity, (2) Leases, (3) Conceptual Framework Acceleration, and (4) Appropriate Source for GAAP. My expertise, and that of others in our office, lies principally in the area of social insurance, and Social Security in particular. Therefore I am not in a good position to suggest a full ranking of these four projects.

However, I can speak to the social insurance project, which falls within the Conceptual Framework Acceleration project. In regard to social insurance liability, it is my opinion that the current methodology for recognition of liability in the financial statements, using a due and payable approach, is not only adequate, it is the only appropriate measure of liability for the Social Security program as it is now specified in the law. For other social insurance programs under consideration, I believe the liability recognition and definition should be the same as recommended for the Social Security program.

For this reason, I believe that the Board should assign a low priority to examining the liability measures of social insurance, and should divert its limited resources to other topics based on the comments received from other respondents. The balance of my comments detail why the current set of financial statements meet the stewardship reporting objective in regard to social insurance under current accounting standards and under the working list of the characteristics of a liability that the Board has developed.

SOCIAL SECURITY ADMINISTRATION BALTIMORE MD 21235-0001

**Social Insurance Liabilities under Current Accounting Standards**

Under current accounting guidelines, as stated in SFFAS 5, a liability requires:

1. Present obligation,
2. Probable future outflow, and
3. Past transaction or event

Since future benefit obligations are clearly non-exchange transactions (as recognized in the past by the FASAB), the third condition is not met. In addition, unfunded future obligations fail to meet the requirements of the second condition. We cannot suggest that the unfunded obligations represent a probable future outflow when the best estimate is that these obligations will not be met under current law. In addition, as you well understand, even those future obligations for which funding is now projected to be adequate are subject to change at any time by the Congress. The failure to satisfy these two criteria leaves the due and payable definition as the only appropriate measure of the social insurance liability for the programs as currently specified in the law.

**Social Insurance Liabilities under the Working List of Characteristics of a Liability**

It is my understanding that in the course of the Constructive Framework Acceleration project, the Board has developed a working list of the characteristics of a liability. We believe that the due and payable definition should remain as the method for determining the liabilities of social insurance under these characteristics.

In a FASAB staff memorandum, dated June 10, 2005, the following liability characteristics were presented:

1. The federal entity has a present obligation to another entity
2. The obligation is to provide assets or services to the other entity
3. The obligated entity has very little possibility of avoiding settlement at a determinable date, when a specified event occurs or on demand

It is my opinion that future scheduled benefits are not present obligations. According to the June 10, 2005 draft, to have a present obligation means, "that the obligation arose as a result of a past transaction or other event that has not yet been settled". In the case of Social Security, the only obligating event that causes benefit payments to become present obligations is when they become both due and payable.

If we were to deviate from this standard and assume that future scheduled benefits constitute a present obligation of the federal government, we would be assuming that the remaining unmet conditions for benefits are: (1) beyond the control of the federal government, and (2) the likelihood that the conditions will remain unmet is remote to varying degrees within the population. By making these assumptions the Board would be ignoring the fundamental prerogative of the federal government; the power to make changes to the program at its discretion. Therefore, the conditions for future benefits to be paid are wholly and totally within the control of the federal government.

Congress has the power to change both the amount of and qualifications necessary to receive benefits at any time. It is clear that Congress purposely reserved such power for itself when it wrote Section 1104 of the Social Security Act, entitled "Reservation of Power" which states that "the right to alter, amend, or repeal any provision of this Act is hereby reserved to the Congress."

Evidence of the execution of this power is shown in both the 1977 and 1983 Social Security Amendments. Each of these reduced future benefit obligations substantially. In addition, many of the social security reform proposals currently being considered also provide for substantial future reductions to scheduled benefits. In a 1960 case, Flemming vs. Nestor, the Supreme Court ruled that Social Security benefits were not a contractual obligation and could be terminated or altered at the federal government's discretion.

Furthermore, the agency mails each participant an annual statement that provides an estimate of the individual's scheduled benefit and also points out that benefits can be changed at any time. The most recent statements included the following disclaimer; "Congress has made changes to the law in the past and can do so at any time. The law governing benefit amounts may change because, by 2041, the payroll taxes collected will be enough to pay only about 74 percent of scheduled benefits.".

In regard to the third characteristic, the federal government is under no legal, political, or contractual requirement to pay scheduled benefits until they become due and payable. The above points, which show that the federal government has the ability to change provisions of the program, also illustrate that no such requirement exists and that is possible that the federal government will alter the amount of and conditions for receiving benefits. Once again, a quote from the June 10, 2005 Board memo seems pertinent; "If the entity can unilaterally specify the settlement date or event, it has no liability because it can avoid the future provision of assets or services by, for example, indefinitely postponing the settlement date". Since the federal government has reserved the power to change the date or conditions for the payment of benefits, it seems clear that a liability for such future scheduled benefits cannot exist.

## Conclusion

By using current accounting standards, which only recognize future scheduled benefit payments as liabilities as they become due and payable, the true nature of social insurance is clearly identified in the federal government's financial statements. Users of the statements are informed that future scheduled benefits are not present obligations and the only liability is for benefits that are both due and payable. This allows the user to come to the conclusion that the federal government can change both the amount and timing of such payments at its own discretion without adverse economic, political, or legal consequences.

Since the Board began examining the measurement of liabilities in regard to social insurance, some members of the Board have expressed a desire to apply accrual accounting standards, similar to those used in accounting for private sector pension plans, to social insurance. We urge the Board to be very cautious in this approach. Social insurance benefits and private pensions may seem to share certain characteristics; however, in actuality the two are very different in both form and function. Private pensions are required to be advance funded while social insurance programs are designed to be financed on a pay-as-you go basis. Applying pension accounting standards to the evaluation of financing for future scheduled social insurance benefits would be entirely inappropriate.

The attached power point presentation that I made to the American Accounting Association on April 1, 2005 includes many of the points discussed above. It also addresses the issue of constructive obligation, which by the criteria considered by the FASAB appears clearly to provide no basis for recognition of future scheduled benefits as liabilities.

Finally, if the Board were to deem future social security benefits beyond those due and payable to be liabilities for the government, a fundamental feature of the program would be obscured and possibly hidden from financial statement readers. Users might infer that a contractual obligation exists when in fact none does, or that the government is bound to honor those payments. This misrepresentation would seem to contradict one of the primary purposes of financial reporting, the fair and accurate portrayal of the government's finances and activities. Moreover, if this misrepresentation were widely accepted, it might make it more difficult for the Congress to act when necessary, or might effectively limit options considered by the Congress.

Therefore we recommend that the Board accept the due and payable concept for the accounting of social insurance liabilities.

Sincerely,

Stephen C. Goss

Stephen C. Goss, ASA, MAAA
Chief Actuary
Social Security Administration
6401 Security Blvd
700 Altmeyer
Baltimore MD, 21235

cc:
Jo Anne Barnhart, SSA
Linda Combs, OMB
Don Hammond, Treasury
David Mosso, FASAB

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 29, 2005

David Mosso
Chairman
Federal Accounting Standards Advisory Board
441 G Street, NW
Washington, DC 20548

Dear Mr. Mosso:

I am writing to comment on an important issue of current interest to the Federal Accounting Standards Advisory Board (FASAB): the presentation of liabilities for major social insurance programs on the Federal government's financial statements. I am strongly opposed to recording a liability for social insurance other than on a due and payable basis.

Emphasizing a new and different liability calculation in the financial statements may create confusion with measures of financial status that are presented in the Social Security and Medicare Trustees Reports (TR) and elsewhere in the Financial Report of the United States (FR). These measures have long been central to discussions of reform. Also, new large balances on the United States balance sheet may receive a negative interpretation by the international community, as other countries generally do not record such amounts on their financial statements.

I would also like to suggest an area where increased attention could be quite informative, namely, examination of expanded disclosures to facilitate a better understanding of Federal long-term responsibilities from various programs that are expected to exert significant pressure on future Federal resources. This approach would help to further fulfill the stewardship objective for Federal financial statements contained in FASAB concept statements.

**Social Insurance Obligations in Federal Reports**

Over the past several years, the Treasury Department expended considerable effort to improve the completeness, accuracy, clarity and transparency of reporting on the financial status of the two major social insurance programs, Social Security, and Medicare. This effort affected the TR and the FR. With respect to the FR, we paid careful attention to the Stewardship information needs described in *Accounting for Social Insurance* (SFFAS 17). With respect to the TR, the enhancements are the product of the Social Security and Medicare Boards of Trustees.

For example, after careful deliberation, the Boards of Trustees decided that, beginning with the 2003 Social Security Report, the reports should provide present value estimates of open-group unfunded obligations over both seventy-five years and the infinite horizon, as well as increased emphasis on annual cash flows. Closed-group unfunded obligations are also included. The Trustees also included details on the relationship between the Trust Funds and the Federal Budget in the Medicare Report.

Beginning with the 2003 FR, the Treasury Department made significant revisions to the Stewardship section that captured the new measures of unfunded obligations from the TR and added new material on the relationship of the Trust Funds and Federal Budget.

We now have many useful measures of future obligations for the two major social insurance programs in the TR and FR that are very helpful in evaluating program sustainability. Concepts that include future obligations, such as the maximum transition cost, while useful for some analytical purposes, would likely create confusion if portrayed as accounting liabilities and considered next to the measures of future obligations already in the reports.

**The Potential for Policy Inflexibility and Confusion**

Descriptions of the financial status of social insurance programs in the TR or FR have been constructed very carefully. The present value of future obligations is based on benefits that are scheduled under current law. Scheduled benefits are *not* present obligations. If these future obligations were recorded on the Government's financial statements they could be interpreted by many as "booked" and immutable, which is not the case in law. Identifying benefits as liabilities accords those benefits a stronger degree of protection from change than is warranted by law, and could limit flexibility in designing reform plans.

**Other Program Disclosures**

I am aware that FASAB has devoted considerable resources to the study of liability concepts and to the identification of obligating events for liability recognition for a range of Government programs. This effort has been educational and no doubt has led to many useful insights. Yet, as you know, this is an inherently difficult and controversial area.

In my view, FASAB resources should focus on expanding disclosures in the FR for other major Federal programs particularly those that have an aspect of intergenerational transfer payments. For example, Federal payments for long-term care under the Medicaid program demand a growing share of Federal resources yet the FR (or any other official source) has very little data on potential future obligations, unlike benefit programs that are currently disclosed and that are otherwise similar in important respects, such as Parts B and D of the Medicare program. Such new information on Medicaid and similar programs could contribute significantly to the expressed purpose of the FR, namely "…to give the President, Congress, and the American people information about the financial results and position of the Federal Government."

Sincerely,

John W Snow

John W. Snow