



**Federal Accounting Standards Advisory Board**

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July 13, 2006

**TO:** Members of FASAB  
**FROM:** Richard Fontenrose, Assistant Director  
**THROUGH:** Wendy Comes, Executive Director  
**SUBJECT:** Social Insurance – Tab E

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

The staff objective for the July meeting is to review the latest draft of the social insurance exposure draft (ED). Changes have been made to reflect the decisions made at the May FASAB meeting. A “track changes” edition of the ED is at Tab E. Since at the July meeting the Board will be focusing on the changes to the May ED and since it is possible that alternative views or other material will be offered before or at the meeting, the staff decided not to include a “clean” ED edition at this time.

The changes from the May draft ED are:

- The Chairman’s cover letter has been expanded to point out to respondents that there is more than one perspective under discussion and to ask them to consider both.
- Questions for respondents –
  - Mr. Werfel and the Office of Management and Budget have redrafted questions 3 and 4 that were in the May draft, which are now numbered 4 and 5. Also, question 14 is newly submitted by OMB and involves international accounting parallels, as mentioned by OMB at the May meeting. These questions were submitted later in the day on Thursday, July 13, and FASAB staff has not reviewed or commented on them as yet.
  - FASAB staff has revised the other questions from the May draft, including adding a new question (#13) to reflect the members’ comments at the May meeting. See questions 3, 9 and 13.
  - All questions now ask respondents to discuss their rationale, whether they agree or disagree.

- Basis for conclusions –
  - In response to member comments in May regarding balancing the arguments, paragraphs have been added (pars. 53-63) arguing a “some-people-believe” position that work in covered employment is the obligating event for social insurance and therefore expense and liabilities should be recognized when such work is performed rather than waiting until 40 quarters. Including this position along with the 40-quarter, retirement, and “due and payable” events, means that a full spectrum of possible obligating events have been surveyed. These paragraphs are cross-referenced to the relevant “questions for respondents.”
  - Also in this vein, paragraphs have been added (pars. 65-69 and 138-144) to represent the “minority view” on the Board – i.e., that the liability is not incurred at 40 quarters but rather is the “due and payable” amount, and that what is needed is additional information on sustainability. These paragraphs are also cross-referenced to the relevant “questions for respondents.”
- An explanatory table has been added to the glossary definition of “fully insured” to illustrate the points when participants become “fully insured,” including permanently fully insured.

Staff anticipates that, absent major changes based on the July meeting, a pre-ballot draft could be circulated in early August with the objective of identifying remaining edits and balloting by the September meeting.

In addition, the members opposed to the position taken in the draft ED have asked that the Board consider the merits of issuing a preliminary views (PV) document. Preliminary views present the Board’s preliminary selection of an alternative solution. The Board may not issue a final statement based on a PV; an exposure draft must precede a final statement. However, the Board has issued PVs in the past on critical issues. For example, the Board issued a PV prior to issuing the exposure draft that led to SFFAS 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*. Because the majority position is thoroughly developed, staff believes that the current ED could be converted to a PV relatively quickly and a pre-ballot draft could be circulated on the same schedule outlined for the ED.

Staff is also conveying a recent op-ed item from *The New Republic* as an attachment to this letter.

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# THE NEWREPUBLIC ONLINE

SOCIAL SECURITY, MEDICARE, AND ACCOUNTING.

## Big Liability

by Howell E. Jackson

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**W**hen Secretary of the Treasury Henry Paulson appeared at his Senate confirmation hearing last month, he identified as a top priority "addressing the long-term unfunded obligations of Social Security and Medicare that threaten to unfairly burden future generations." Early on in his tenure at Treasury, Paulson will confront a simmering accounting controversy that will reveal whether he is serious about this commitment.

At issue are the financial statements of the U.S. government. Since 1990, the Federal Accounting Standards Advisory Board (FASAB) has been developing accounting standards for the federal government comparable to those imposed on private companies. And the board has been making impressive progress. Each fiscal year, the Treasury Department must now prepare financial statements in compliance with FASAB standards. These new financial statements include the accrual of retirement benefits for federal employees and the explosion of Pension Benefit Guaranty Corporation obligations for insolvent pension plans--liabilities that were traditionally absent from the government financial reports. In recognition of the superiority of the FASAB standards, the House Budget Committee voted earlier this year to require the president to employ FASAB-compliant financial statements when presenting future budget proposals to Congress.

Until last month, FASAB shied away from the biggest accounting question facing the federal government: How should it account for programs like Social Security and Medicare, which promise participants expensive retirement benefits in exchange for hefty payroll taxes during their working years? Everyone agrees that there is something fundamentally misleading with current reporting requirements that permitted Congress to adopt a new prescription drug benefit without disclosing to the public that the legislation generates trillions of dollars of new unfunded obligations for future taxpayers. The Bush administration's inability to persuade the public of Social Security's mounting financial distress is further evidence of the inadequacy of current reporting requirements for social insurance programs.

But changing anything that touches upon these politically charged programs causes controversy in Washington. Not surprisingly, FASAB sparked a firestorm of protests this spring when it voted by a margin of 6-4 to move ahead with a new proposal to require the government to account for Social Security and Medicare on an accrual accounting basis similar to what is required of private companies for their pension plans and retiree benefits. The four FASAB members who also hold government posts all dissented from the decision. Throughout the nation's capital there is widespread hostility to the board's proposal.

And there is good reason for official Washington to fear FASAB's initiative. Even

under existing reporting requirements, the federal government has been going through a pretty rough patch. Between 2001 and 2005, federal deficits pushed public debt up by more than a trillion dollars. If the government had reported accrued obligations to Social Security in the manner FASAB proposes, its financial statements would have disclosed another \$4.6 trillion in new liabilities over this five-year period, according to my estimates. Add in Medicare--most notably the new prescription drug benefit--and new federal liabilities spike another \$5.3 trillion in the last half decade. So, roughly speaking, unfunded obligations for our social insurance programs have increased ten times more (about \$10 trillion dollars) this decade than has our public debt (up "only" \$1 trillion). Like executives at Enron, government officials don't want the public to know about off-balance-sheet liabilities of this magnitude.

For years, Washington has been having it both ways with entitlement programs for our senior citizens. Particularly in election years, politicians fall all over themselves promising the elderly that Social Security and Medicare are sacrosanct and that even the most modest of adjustments will not be countenanced. Yet when the accounting profession concludes that commitments of this sort need to be recognized as liabilities on the balance sheet of the federal government, the same officials promptly resort to legal niceties, stressing that the programs cannot possibly represent real financial obligations for the federal government because Congress is free to eliminate them at any time.

This bureaucratic doublespeak is what a majority of FASAB members have proposed to end. Under generally accepted accounting principles, when economic obligations arise out of past events (such as paying payroll taxes) and are ascertainable, they must be recognized as financial liabilities. The commitments that the federal government has made to this country's taxpaying workers and retirees under the Social Security and Medicare programs easily meet this standard. While it may be true that the country cannot afford to honor the magnitude of social insurance obligations our politicians have assumed, the political process will not begin to address this fiscal gap until our financial statements reflect the economic reality of their existence. Under FASAB's new proposal, we will finally be forced to face fiscal reality: We're making more promises to Social Security and Medicare beneficiaries than future generations can possibly afford.

So, getting back to Secretary Paulson. If, as now seems likely, FASAB decides to finalize its new accounting treatment for Social Security and Medicare later this year, its final recommendation will have to be sent to the Treasury Department, which has the power to veto the proposal. No doubt, members of the federal government will urge Paulson to exercise that authority. But when faced with this choice, Paulson should think back to his confirmation hearing. If he ever hopes to address the unfunded obligations of Social Security and Medicare, shouldn't his first step be to support an honest accounting treatment for these programs? Back when he was running Goldman Sachs, Paulson wouldn't have allowed a corporate client to omit material liabilities from its financial statements. He should demand no less of the federal government's financial reports.

**HOWELL E. JACKSON** is the John S. Reid, Jr., professor of law at Harvard Law School.