>>> "Robert Herz" <rhherz@fasb.org> 2/6/2007 11:23 AM >>>
Dear Ms. Comes:

As Chairman of the Financial Accounting Standards Board (FASB) and as a U.S. citizen and taxpayer I read with great interest your preliminary views document, Accounting for Social Insurance, Revised. I also asked one of our senior technical staff members, Jules Cassel, to read the document. Jules has had very extensive involvement over many years in FASB projects relating to pension and other benefit matters. Attached please find Jules's comments on your preliminary views document. While these represent his personal views on some of the major issues discussed in the document and do not represent an official position of the FASB on such matters. I thought they may be helpful to FASAB in your deliberations.

Thanks!

Bob

I am a member of the staff of the Financial Accounting Standards Board (FASB) and have read the Preliminary Views (PV) regarding a proposed Statement of Federal Financial Accounting Standards, *Accounting for Social Insurance, Revised* issued by the Federal Accounting Standards Advisory Board (Board) and offer the following comments for the Board's consideration. The FASB has not considered the following and this letter does not represent the official position of the FASB on any matter addressed in the PV.

I believe the PV articulates very well the primary and alternative views, and supporting rationale, taken by different members of the Board. Much of that discussion naturally focuses on the Board's conceptual framework, relevant existing Standards, and related projects in process or proposed. Because of my lack of expertise in accounting for the Federal government, it would take an inordinate amount of time for me to study each of those references to determine which view I would judge as being most consistent with that literature. Likewise, I have not determined whether I would agree with the Board's conclusions on the matters addressed in that literature if I was being asked to comment on it. However, there are some elements of the current debate that are common to issues the FASB has addressed in past projects addressing the accounting by employers for employee benefit arrangements, and in projects relating to the Board's underlying conceptual framework. As a member of the FASB's staff that has had extensive involvement in those projects over a very long period of time, I offer my comments from that perspective with the hope that that would be useful. I believe the Primary View represents a major, evolutionary change in the accounting for the programs within the scope of the PV, and I support that change. There have been similar evolutionary steps in FASB projects, most notably relating to the accounting for retiree health care benefits and employee stock options. The evolutionary processes that ultimately led to the issuance of FASB Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, and FASB Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, has reinforced my belief that enhanced disclosure is not an adequate alternative to recognizing items that should be reported in the basic financial statements. Accordingly, I do not support the Alternative View that retains essentially a cash basis approach to the recognition of the obligation to pay the programs' benefits and would supplement the information reported in the basic financial statements with supplementary disclosures of information related to assessing the sustainability of the programs. I agree that such supplemental disclosures may be needed, but not as an alternative to recognition in the basic financial statements of extant obligations. FASAB members disagree as to how to proceed with developing a standard that would require additional sustainability information. My reading of the PV did not provide me with enough information to form an opinion regarding the alternative positions. It also was not clear to me whether the Alternative View would retain its position on that issue if the Primary View regarding the liability to be recognized was adopted in a final standard.

An essential element of the contrasting views regarding the liability to be recognized is whether the programs represent nonexchange transactions. I do not support the Alternative View that focuses heavily on the conclusion that such programs represent nonexchange transactions. I agree with the Primary View that an expense may be incurred and a liability arise equally for exchange, nonexchange, or quasi-exchange transactions so long as a present obligation exists.

I note, however, that both views seem to depart from their fundamental views of what constitutes a liability. The Primary View takes the position that no recognizable liability exists until participants are fully insured. That is, no liability exists during the period participants may be contributing (for example, by paying FICA taxes) to the programs if they have not fully satisfied the eligibility criteria. The Alternative View takes the position that no liability exists until the benefit is due and payable, yet it recognizes "deferred revenue" if earmarked revenues exceed program costs.

I believe a present obligation exists for those present participants who have not yet satisfied the eligibility criteria but who are expected to do so. I believe an obligation exists in the same way that an obligation exists during the period that pension and other postretirement benefits are nonvested. The measure of the obligation will change over time, but the obligation starts when participation in the program commences. While the transaction during the vesting period that gives rise to the pensions earned by members of the armed services is somewhat different from the transaction during the covered employment period that gives rise to social security benefits, I believe there is an obligating event during such periods for participants in both programs. I also believe the Federal government's actions have created an expectation on the part of those participants that they are entitled to rely on (and a corresponding obligation of the Federal government to satisfy) notwithstanding the theoretical argument that some obligations could be voided by Congressional action. We reject the argument in support of the Alternative View that, just as future government spending on programs such as defense, education or Medicaid is not a present obligation of the government, future social insurance spending is not a present obligation. Future government expenditures for defense, for example, will be made in exchange for services received *in the future* from suppliers of services needed for defense. Accordingly, there is no present obligation for those future services no matter how probable it is that those services will be acquired. However, for participants presently contributing to social security or fully eligible to collect social security, there has been a past transaction and no future services will be received by the government in exchange for the benefits paid. Accordingly, I believe the proper accounting during the “vesting period” should reflect the likelihood of forfeiture by participants in the measurement of the present obligation, rather than assume that no obligation exists. Thus, in response to Question 1 raised in the PV, I support the view that the obligating events begin when participants begin work in covered employment.

In response to Question 5, there likely would be no need to address the proper accounting for excess earmarked revenues if my view as to when obligating events begin was adopted. If that view was rejected, then I would support the “deferred revenue” approach under the Alternative View if that approach was adopted because it is directionally closer to what I believe is the better accounting.

Both views attempt to reconcile the aforementioned departures from what I see as their underlying basic principles with arguments regarding how such accounting better reflects the costs incurred during the period. Such arguments seem to be based on the “matching principle.” In formulating its conceptual framework, the FASB determined that was not a sound basis on which to define assets or liabilities.

An additional argument supporting the Alternative View is that characterizing future benefits as current expenses and liabilities might undermine needed efforts to reform the programs. The FASB’s conceptual framework recognizes neutrality as a desirable qualitative characteristic of useful financial information. Accounting should not be used to influence a particular outcome on the part of users of the financial statements. Accordingly, I reject that argument in support of the Alternative View. I understand that those members supporting the Alternative View place significant weight on the supplementary information they would provide users in order for them to make informed decisions. Nevertheless, I believe the basic financial statements would not be a faithful representation of the programs’ current financial conditions if what I believe to be liabilities were omitted.

My preceding comments have focused on what I believe is the critical issue addressed by the PV, the recognition in the basic financial statements of program liabilities. I have chosen not to comment on certain less significant issues. However, I offer the following observations that the Board may wish to consider as it proceeds to an exposure draft or in subsequent projects. The PV retains many aspects of actuarial practice in the accounting for the programs. While certain actuarially based assumptions are necessary to measure properly the funded status of the programs, others are not. In addressing the selection of discount rates and the measurement attribute for plan assets, the FASB determined that users would be better served by utilizing market-based assumptions rather than retain approaches used by actuaries for funding purposes.

I also note that the PV would recognize actuarial gains or losses during the period they occur. Therefore, there would be no apparent deferred recognition of those items. However, the guidance for measuring program investments and selecting assumptions implicitly provides for a stealth form of deferral. Investments would be measured at acquisition cost, adjusted for amortization. The guidance regarding assumptions states that actuarial assumptions should be based on the actual past experience of the covered group but should emphasize expected long-term future trends rather than give undue weight to recent past experience. Relevant FASB Statements have previously required disclosure, and more recently recognition, of the funded status of retirement plans based on current conditions rather than expected long-term trends. Disclosure of actuarial gains or losses that result from market-based measures of plan assets and obligations that are not recognized currently in operations is also provided to users of the financial statements.

I understand that the Board is facing significant challenges as it tries to implement the major change proposed by the Primary View regarding recognition in the basic financial statements of the programs' liabilities. I accept that some issues might be better addressed after a more fundamental change has been accepted by the Board's constituents. However, when the time is right, I would encourage the Board to focus on the secondary issues I have noted because they can significantly affect the amounts recognized in the basic financial statements.

Should you wish to discuss my comments further, I would be pleased to do so.

Jules M. Cassel
Senior Technical Advisor
Financial Accounting Standards Board