April 16, 2007

Wendy M. Comes
Federal Accounting Standards Advisory Board
Mailstop 6K17V
441 G Street, NW, Suite 6814
Washington, DC 20548

Re: Request for Comments on Accounting for Social Insurance, Revised.

Dear Ms. Comes:

AARP is writing to comment on the Federal Accounting Standards Advisory Board's (FASAB) document, *Preliminary Views – Accounting for Social Insurance, Revised*. This document presents two views, the Primary and Alternative View, on how the federal government ought to account for social insurance programs. In general, AARP supports the Alternative View.

AARP is a nonprofit, nonpartisan membership organization that helps people 50+ have independence, choice and control in ways that are beneficial and affordable to them and society as a whole. We produce AARP The Magazine, AARP Bulletin, AARP Segunda Juventud, NRTA Live & Learn, and provide information via our website, www.aarp.org. AARP publications reach more households than any other publication in the United States.

AARP advocates for policies that enhance and protect the economic security of individuals as they move from work to retirement. Through its research, publications, advocacy, and training programs, AARP seeks to eliminate ageist stereotypes; encourage employers to hire and to retain older workers; and help older workers overcome obstacles in the workplace. This is important to AARP because approximately 45 percent of our more than 35 million members are working.

From time to time the FASAB reexamines how the federal government accounts for social insurance programs. Currently, social insurance programs, including Social Security and Medicare, are accounted for using a "due and payable" or cash balance standard. How social insurance programs are accounted for in the federal ledger and in the consolidated Financial Report of the U.S. Government has a significant effect on the way these programs are viewed and could influence the timing and specifics of changes to these important programs. Contemplated changes to social insurance accounting standards should take into account how accurate, useful, and consistent with the spirit of the law the revised standards are.

AARP believes that the Alternative View, which maintains the “due and payable” standard with added reporting on the sustainability of social insurance programs, depicts the status of these programs in a way that is accurate as well as useful to lawmakers and the general public. The Primary View, in proposing to recognize a financial liability at an early point in an individual’s work life, does not create a standard that accurately represents the nature of our pay-as-you-go social insurance programs.

At what point should a liability and expense be recognized?

The key difference between the Primary View and Alternative View is the point at which sufficient eligibility conditions are met to create a liability and a “present obligation.” The Primary View holds that a liability and related expenses should be recognized when participants become “fully insured,” i.e., they have 40 quarters of covered earnings. The proponents of the Alternative View continue to support the recognition of obligations for social insurance programs when participants have met all eligibility requirements and benefits are “due and payable” (this is essentially a cash, or pay as you go, concept).

AARP supports the Alternative View’s recognition of a benefit obligation because it acknowledges that benefits are uncertain until they are actually paid. Even the age of eligibility for Social Security benefits (62) or Medicare (65) cannot be regarded as the sole condition creating a present obligation, since individual choices and program changes can still alter the benefit.

The Primary View uses the term “liability” to refer to accrued benefits, suggesting a contractually binding commitment that cannot be altered by the government. Private sector accounting rules recognize these types of commitments because private sector entities can be legally bound by government. For example, federal law governing defined benefit pension plans (ERISA) requires that pension benefits that are accrued cannot be reduced by the employer. The concept of accrued benefits in ERISA does not translate meaningfully to the world of social insurance programs, such as Social Security and Medicare. Government social insurance obligations do not have the same legal status that accrued pension benefits do under ERISA or that individual or corporate tax liabilities have.

Social insurance programs, while not subject to annual scrutiny like appropriated programs, are subject to changes in authorizing legislation by the committees of jurisdiction. Changes in law could affect benefits for future and current retirees. It has long been held that one Congress cannot bind the hands of another: so there are no promised benefits from Social Security or Medicare that cannot be altered at any time by Congress to the benefit or the detriment of beneficiaries -- current or future. Members of Congress and the Administration recommend changes to benefits that may or may not be law. For example, the 1983 Social Security Amendments, which were adopted to strengthen the program, included a 6-month delay of the July 1983 Social Security Cost of Living Adjustment (COLA) and a change to annual rather than semi-annual updates thereafter, which affected current and future beneficiaries. The Kolbe-Stenholm Bill, which was reintroduced over several Congresses, included several benefit changes, such as accelerating the increase in retirement age. Flexibility is helpful in shaping social insurance programs that respond to a changing social, demographic and fiscal environment.

There may also be practical reasons for not treating fully insured status as an obligating event. Some analysts have argued that treating expected benefits as liabilities may make it more difficult politically to gain consensus on the reforms needed to achieve long term solvency for the programs.

Are Social Security and Medicare obligations measurable for purposes of recording a liability after 40 quarters or equivalent of covered?

The issue of whether social insurance obligations are measurable after 40 quarters is related, but secondary to, the issue of when conditions are met to create an obligation, or legally binding commitment. It is difficult to determine the precise obligations for Social Security or Medicare until they are due and payable. Obligations can be changed by acts of Congress before full eligibility is established, and they can even be changed once a worker becomes a beneficiary.

The issue of when Social Security and Medicare obligations are measurable may depend on what is meant by “measurable” -- a word which is used only twice in the document but not defined. Measurement implies a precision that does not occur in social insurance programs until benefits are actually paid. Currently both the Social Security Trustees’ Report and the Congressional Budget Office provide estimates, however even 75-year projections are subject to estimating errors, and projections that go beyond that are little more than rough extrapolations. To consider obligations that are far in the future as “measurable” for the purpose of recording a liability is totally unrealistic.

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

The Statement of Social Insurance (SOSI) is one of the principal financial statements of the U.S. Government and shows the financial standing of social insurance programs. It appropriately presents information on social insurance programs in a context that is well-suited to the very specific and specialized nature of these programs. As we have noted above, future benefits are different from the definite and measurable liabilities that are created by various other government activities, such as liabilities to contractors, interest payments to holders of Treasury securities, or social insurance benefits that have become "due and payable."

Linking SOSI line items to the balance sheet and the statement of net cost could, in fact, be detrimental to the over-arching goal of providing helpful and transparent information for several reasons.

First, placing only present value obligations for social insurance programs onto the balance sheet would overwhelm and diminish the information presented on the balance sheet concerning other present obligations and activities of the federal government. In addition, there is a serious risk that changes in the balance sheet position from year to year could be largely driven by changes in the assumptions used to calculate the large present value amounts for social insurance programs. For example, the calculation of the present value of obligations can be greatly affected by even small changes to the discount rate used, and this creates volatility that is magnified with each additional year that the forecast period is extended. Typical forecasts for social insurance programs extend 75 years, or even over infinity; corporations often use shorter horizons.

Moreover, presenting social insurance obligations on the balance sheet does not present these obligations in a framework that addresses the programs' abilities to meet their obligations. In particular, the financial condition of these programs is also affected by Congress' ability to raise revenues, which would not be reflected on the balance sheet. The SOSI, on the other hand, provides this context and, as a result, presents a more complete picture of the financing of these programs.

As other commentators have pointed out, the government is engaged across a wide range of activities to promote the general welfare, including education, defense, transportation et cetera. There is no expectation that the government would cease to provide these services, yet most people would agree that future spending on these activities should not be included as liabilities. AARP objects to overwhelming the balance sheet with potential future benefits to be paid by social insurance programs as it differentiate these costs from other important financial responsibilities of the U.S. Government. Therefore, we view the proposal as unnecessarily focusing on the long-term social insurance obligations.

Do you believe that the reasons for changes in SOSI amounts during the reporting period should be reported and, if so, do you favor such reporting as proposed by the Primary View, as proposed by the Alternate View, or some other approach?

The SOSI should be modified to include the reasons for changes in a way that is understandable and increases transparency. The changes proposed by the

Alternative View are preferable because they recognize an obligation at the point when benefits become "due and payable." Two improvements that ought to be made to the Alternative View's proposal include using language that is more understandable for the general public and incorporating the reasons for changes into the body of the SOSI rather than having them in a separate document.

The Primary View's proposal is unacceptable due to its recognition of liabilities and expenses prior to their becoming "due and payable."

Do you believe that a statement of fiscal sustainability should be presented in the consolidated Financial Report of the United States Government?

AARP does not object to a statement of fiscal sustainability, but has strong concerns about the proposed use of infinite horizon forecasting (see the section regarding infinite horizon forecasting below). We also have some concerns over how this proposal could be implemented, given the scope of the required forecasting effort and the very difficult forecasting issues that would arise from the wide range of government activities.

The goal of the Statement of Fiscal Sustainability would be to project all future revenues, and costs for all Federal programs, over the same long-range period that is used for Medicare and Social Security. This effort would require forecasters to make assumptions about the scope and nature of future economic activity for the next 75 years and into perpetuity. For example, future tax revenues will depend on the characteristics of future tax bases in a future economy that may well be very different from the present economy. Similarly, projecting future government expenditures would require assumptions about future requirements in the areas of defense, education, transportation, et cetera. For a 75-year forecasting horizon, this effort would require the sustained effort of a team of expert researchers. We do not believe that it would be possible to make meaningful projections for the entire budget over the infinite horizon.

Predicting sustainability for the Medicare program over the long term is particularly difficult because it depends on estimates of health care spending growth. Factors influencing medical care expenditure growth include: expansions of health insurance coverage; relative medical price inflation; supplier-induced demand and defensive medicine; and technological change. All of these factors are challenging, if not impossible, to predict.

Do you believe that the Board should consider recognizing deferred revenue for earmarked revenues in excess of related program costs?

As the Alternative View states, "any earmarked social insurance program revenues in excess of program costs incurred by the earmarked funds during the period are invested in Government securities." These investments in Treasury securities are assets held by the trust funds but are a liability to the U. S Treasury, which must redeem the securities with interest at a future date. These securities are treated as offsetting amounts in government financial statements. The result of this treatment is that the financing provided by earmarked funds for other government activities, which would otherwise be financed through issuing debt to the public, increasing taxes, or reducing spending , is not shown on the U.S. balance sheet.

The Alternative View states that consideration should be given to reporting and recording such excess earmarked revenues as “deferred earmarked revenues,” and not counting them as revenue in the current period. The rationale for this treatment is that, social insurance benefits should be recorded in the period in which they are paid and earmarked revenues should be recognized in the period in which they are used. The revenues would be reported as deferred earmarked revenues, but would be classified as a liability on the balance sheet (Paragraph A148, page 91).

In the discussion of the Alternative View in the FASAB document, paragraph 48 on page 38 says that the supporters of the Alternative View “believe that the balance sheet, which shows what the Government owns and owes as a result of past operations, should include as liabilities only those items that are present obligations of the Government.” But the general thrust of the Alternative View seems to be that social insurance benefits do not become obligations until they are due and payable, and these “deferred earmarked” revenues represent future spending and not present obligations. This would seem to argue from a logical standpoint that these revenues not show up as liabilities on the balance sheet.

On the other hand, showing a liability would indicate that the Treasury does have an obligation to pay Social Security for those outstanding securities. This might have a beneficial effect in demonstrating that these are real obligations and not, as has sometimes been argued, “worthless IOUs.” On balance, it seems that the presentation of these revenues as liabilities may appear contradictory to the Alternative View that there are no present obligations until benefits are “due and payable.”

The reform limiting consequences of the Primary View provisions.

The Primary View’s proposal to change the method of accounting for social insurance from cash balance accounting to accrual accounting could diminish the likelihood of adopting meaningful reforms.

Recent reform proposals have promised not to alter benefits for retirees or near-retirees; however, such a stipulation still allows those reforms to affect people who, under the Primary View’s proposal, are “fully insured,” i.e. all workers who have completed 40 quarters of covered work. This reference to “fully insured” individuals and to a liability would create a false sense among future beneficiaries that their benefits are guaranteed. If such a guarantee were to exist when a participant reached 40 quarters of covered work, it would mean reform could not affect these “entitled” individuals. Thus, any benefit changes could take effect only when participants who are not currently insured begin to retire. This postponement would undermine the programs’ financing.

AARP understands that the proposed standard does not create a legally binding obligation. Nonetheless, the “appearance” of such an obligation could create additional political pressure to retain current benefits and could make substantive reform harder. It is important that any changes intended to make the financial position of social insurance clearer ought not make reform more difficult.

The weakness of infinite horizon forecasting in the Alternative View.

AARP believes that the infinite horizon forecasting concept is not helpful and may, in fact, mislead the public. There are several flaws in this concept.

First, infinite horizon forecasts for Social Security and Medicare have, to date, been presented as single-point estimates, and have not been accompanied even by routine measures of statistical reliability. For example, forecast results are sensitive to very small changes in assumptions, particularly when very long-term forecasts are at issue.

In addition, for an infinite horizon forecast to be helpful, it needs to be put into the context of how large the rest of the economy will be over the same infinite horizon. Such comparisons appropriately shift the emphasis from a figure that appears to be very large in the context of today’s economy to a figure that could potentially be managed in a future, larger economy.

The result is that infinite horizon forecasts create a false sense of certainty around the number being presented. In a letter to the Social Security trustees dated December 19, 2003, the American Academy of Actuaries argued that infinite horizon forecasts are “on balance, a detriment” to the Trustees’ annual presentation because the measures provide “little if any useful information about the program’s long-range finances and indeed are likely to mislead anyone lacking technical expertise in the demographic, economic and actuarial aspects of the program’s finances into believing that the program is in far worse financial condition than is actually indicated.”[1]

Moreover, the 2004 Technical Review Panel on the Medicare Trustees Report noted that long-range forecasts of the use and costs of medical services could be more problematic than forecasting economic and demographic variables. As a consequence, they concluded that any long-range forecasts beyond 75 years were extremely uncertain.

[1] American Academy of Actuaries, letter to the Trustees of the Social Security System dated December 19, 2003. Available at: http://www.actuary.org/pdf/socialsecurity/tech_dec03.pdf.

Given the evident uncertainty of extremely long-term forecasts, and the speed of economic change, it would be unwise to emphasize forecasts over the infinite horizon. Forecasts over infinity confuse, rather than illuminate, the discussion about Social Security and Medicare.

Conclusion

Accounting standards for social insurance should promote an understanding of the fiscal situation of social insurance programs. Any such standard must take into account the structure of social insurance programs and recognize Congress' ability to modify these programs as required.

AARP generally supports the Alternative View, finding it to be a much more accurate representation of the financial situation of social insurance programs. We urge the board to take into account the effects of each proposal and create a standard which informs both lawmakers and the public clearly without limiting the flexibility of lawmakers or misrepresenting how social insurance operates. We feel that the Primary View does not accomplish these goals.

AARP appreciates the opportunity to comment on the preliminary views document, *Accounting for Social Insurance, Revised*. If you have any questions or need further assistance, please do not hesitate to contact Evelyn Morton of the Federal Affairs staff at (202) 434-3760.

Sincerely,

David Certner

David Certner
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Government Relations and Advocacy