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Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

May 7, 2007

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

Dear ~~Ms. Comes~~ Wendy:

The U.S. Government Accountability Office (GAO) is pleased to provide its comments on the Federal Accounting Standards Advisory Board (FASAB) Preliminary Views document entitled Accounting for Social Insurance, Revised.

We have strongly supported efforts to improve the transparency of social insurance programs, including the FASAB's addition of the Statement of Social Insurance as an audited basic financial statement. We believe the FASAB's current deliberations on the presentation of social insurance programs represent an important step in recognizing the need for greater transparency in connection with the federal government's current financial condition and future fiscal path.

We strongly support the need to refine the federal government's current reporting model to fully achieve the stewardship financial reporting objective and to provide greater transparency and more useful information to the readers of the financial statements. At the same time, we strongly believe that the alternative view is, by far, the best means of fully and effectively communicating important information to readers about the long-term financial condition of social insurance and other federal government programs. More specifically, we support the presentation of a Statement of Fiscal Sustainability and annual changes therein and recognition of deferred revenue (an additional liability) for the amount of the trust fund balances. The Alternative View provides full accountability and disclosure to the American public of the fiscal condition of the social insurance programs and of the complex interrelationship of these programs with the overall fiscal condition of the federal government. We do not believe that the Primary View achieves similar results. In fact, we believe it is inappropriate and would result in certain inconsistencies and expectation gaps in connection with public reporting of our nation's social insurance programs.

To build public awareness of our Social Security, Medicare, and other long-term fiscal challenges and the hard decisions that must be made, I have engaged in a number of actions, including participating in public presentations and town hall forums in over 20 states to discuss the federal government's current financial condition and deteriorating long-term fiscal outlook, including the challenges posed by our nation's current social insurance commitments. These forums, popularly referred to as the "Fiscal Wake-up Tour," are led by the Concord Coalition and also include the Heritage Foundation, the Brookings Institution, and a range of other "good government" groups.

The Fiscal Wake-up Tour is designed to state the facts and speak the truth in order to increase public awareness and accelerate actions by appropriate federal, state, and local officials. Based on my first hand experiences, including extensive interaction with town hall participants and conversations with a number of my colleagues worldwide, the best and most effective way to communicate our current obligations and future commitments in the financial statements would be the one outlined in the Alternative View. Furthermore, the position outlined in the Alternative View is more consistent with the current international practice than the primary view.

Our comments, which are detailed in the enclosure to this letter, provide our responses to the questions put forth in the Preliminary Views document. If you have any questions on our comments, we are available for further discussions. Please call me at (202) 512-5500 or Robert Dacey, Chief Accountant at (202) 512-7439.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

Enclosure

GAO Responses to Questions Set Forth in the Accounting for Social Insurance, Revised Preliminary Views Document

Introduction

We agree with the Board on the financial reporting objectives that are intended to be achieved by the revisions to social insurance reporting. Specifically, as stated in Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, "federal financial reporting should provide information that helps the reader to determine whether:

- The government's financial position improved or deteriorated over the period, [and]
- Future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due…"

Therefore, any revisions to social insurance reporting should be designed to achieve these objectives.

Question 1:

Which obligating event do you believe creates a liability and expense that should be recognized? Please provide the rationale for your answer.

Response:
We strongly agree with the Alternative View. The obligating event for liability recognition for social insurance benefits should continue to be considered the point when an individual meets all eligibility requirements for benefits and the benefit payments become "due and payable." There should be no change to the current liability and expense recognition standards for social insurance benefits, as discussed in Statement of Federal Financial Accounting Standard (SFFAS) No. 17, Accounting for Social Insurance.

In summary, as stated in the Alternative View,

- Social insurance benefits beyond the due and payable amount are not present obligations of the federal government;
- Recognition of such future social insurance benefits as current expenses and liabilities would result in a substantial mismatch of net costs for nonexchange programs in the current year and the services provided in that year – disrupting an alignment that allows programs to match costs with results;
- Recognition of future social insurance benefits on the financial statements would diminish significantly the relative size and importance of other expenses and liabilities shown on the financial statements. As a result the financial statements would contain misleading information about the Government's true financial position and would inappropriately shift the focus away from other expenses and liabilities that are managed by federal agencies; and
- Given the ability of the federal government to change the laws relating to

social insurance programs and the certainty of its doing so given the unsustainability of current benefit payments with current financing, about which beneficiaries are on notice, amounts of benefit payments that will be made are uncertain and not reliably estimable.

First, social insurance and other nonexchange transactions are unique to the government. They are fundamentally different from exchange transactions and should continue to be accounted for differently. The compulsory payment of social insurance taxes by an individual and the subsequent receipt of social insurance benefits by that same individual constitute separate nonexchange transactions. For example, the compulsory payment of social insurance taxes does not entitle an individual to a benefit in a legal, contractual sense and benefits paid to an individual are not directly based upon taxes paid or employment services rendered. For nonexchange transactions like social insurance benefits, in general, the federal government has a legal liability only for benefits that are "due and payable". Other non-exchange benefits, such as Medicaid and food stamps, are currently recognized only on a "due and payable" basis. Social benefits (non-exchange transactions) differ from employer provided benefit plans (exchange transactions) in that they do not represent an exchange of current service for deferred compensation and the benefits do not vest. Specifically, under social insurance programs, the individual does not exchange his or her labor for a benefit from their employer, the recipient of his or her labor; rather, collectively the citizenry pays benefits to those who have worked before.

Second, SFFAC No. 1 established the principle that, since the federal government had little earned revenue and no profit motive, but had instead the goal of providing services that are collectively chosen to improve the well-being of citizens, government costs should be matched year-by-year with the delivery of such services. Thus, cost could be matched with program delivery, and analyzed in relation to outputs, outcomes, and other relevant performance measures. These measures would improve resource allocation and program management, improving the effectiveness and efficiency with which services are delivered and permitting accountability to citizens for service delivery. This principle has been successfully applied in the development of FASAB standards over the past fifteen years. The Alternative View would continue to record costs only for services provided during that year for social insurance and other federal programs. In contrast, the Primary View would record a cost in the current year for services (e.g., benefits) that are not provided for many years.

Third, under the Primary View, the projected social insurance liability and expense amounts would be very large and overwhelming in relation to other recognized liabilities. In addition, the balance sheet and the statement of net cost could fluctuate year to year by large amounts, potentially in the trillions of dollars, due to the uncertain nature of projected social insurance estimates. As such, adoption of the Primary View of adding significant liabilities to the balance sheet and significant expenses to the statement of net cost will diminish the usefulness of financial statements in improving financial management and will undermine the credibility and value of the balance sheet and the statement of net cost.

Finally, there is general agreement that the Social Security and Medicare programs, as currently structured, are unsustainable and that social insurance reforms are a certainty. However, it is not possible to predict what specific actions the Congress will undertake to modify or change future benefits. The inherent uncertainty surrounding agreement and settlement for amounts projected for social insurance benefits, outside of what is currently "due and payable," does not lend itself to recognizing a liability and expense as proposed by the Primary View. There is a history of Congressional benefit adjustments that affect not only future beneficiaries, but current beneficiaries as well. The "Your Social Security Statement" periodically sent to individuals states that "Your estimated benefits are based on current law. Congress has made changes to the law in the past and can do so at anytime. The law covering benefit amounts may change because, by 2040, the payroll taxes collected will be enough to pay only about 74 percent of scheduled benefits." These statements highlight the fact that Social Security (as currently structured) cannot be sustained and that the Congress can and has changed the rules regarding eligibility for social insurance benefits, at any time, and will undoubtedly do so in the future.

In summary, the Alternative View best defines the obligating event in that a liability and expense is created when an individual meets <u>all</u> eligibility requirements and benefits become "due and payable."

Question 2:

Do you believe that the Social Security and Medicare obligations are measurable for purposes of recording a liability after 40 quarters or equivalent of work in covered employment as proposed in the Primary View? Please provide the rationale for your answer.

Response:
No. As noted above, we do not believe that an additional liability beyond "due and payable" for social insurance benefits exists (see response to question 5 re: liability for deferred revenue). As stated in response to question 1, there is general agreement that Social Security and Medicare, as currently structured, are unsustainable and that social insurance reforms can be expected. The unsustainable nature of these programs and the certainty of modification to these programs, as evidenced by past Congressional reforms, highlight the fact that estimates of this nature are inherently uncertain to measure with confidence, may not be reliable, and therefore could affect the integrity of the financial statements.

Question 3.1:

Do you believe that the Primary View proposal to add lines 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?

Response:
No. Consistent with our position that the liability for social insurance benefits should be those that are "due and payable," we do not believe that any change is necessary to the current format of the Statement of Social Insurance.

The SOSI, as currently illustrated in SFFAS No. 17, Accounting for Social Insurance, is approximately two pages. The format of presentation as proposed by the Primary View results in a longer and more complex SOSI and will not easily be understood by readers of the financial statements.

The SOSI, which became an audited, basic financial statement in fiscal year 2006, and related disclosures provide important information about earmarked revenues and scheduled benefits related to the social insurance programs. The sustainability information in the SOSI is based on long-term cash flow projections that assume that the program will continue as currently structured. As the programs will undoubtedly be changed due to their unsustainability, the SOSI does not purport to present what is actually expected to occur. In that respect, it clearly serves a different role than the balance sheet. Therefore, tying the SOSI to the balance sheet is unnecessary and not relevant.

Question 3.2:

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 (1) as proposed by the Primary View, (2) as proposed by the Alternative View, or (3) some other approach? Please provide the rationale for your answers.

Response:
We believe that the reasons for changes in SOSI amounts during the reporting period should be reported and support the Alternative View of presenting changes in social insurance that will (1) reconcile beginning and ending net present values reported in the SOSI for social insurance programs, and (2) provide the significant reasons for changes in the net present value during the reporting period. This information can be presented in either a new, complementary Statement of Changes in Social Insurance or incorporated into the existing Statement of Social Insurance.

The presentation of changes in social insurance, as proposed by the Alternative View, will present the full extent of changes in the net present value of projected revenues and scheduled benefits and identify and analyze those changes. This information will highlight the reasons for any improvement or deterioration in the financial condition of these programs and will provide useful information to the reader. We believe it is important for the reader to take note of the relative changes in the SOSI in order to draw comparisons with prior year results and obtain a better understanding of the factors affecting social insurance projections.

Question 4:

Do you believe the proposal to create a governmentwide Statement of Fiscal Sustainability should be adopted? Please provide the rationale for your answer.

Response:
Yes. We are in strong agreement with the Alternative View that a Statement of Fiscal Sustainability should be presented that would include future revenue and expense for all federal government programs. Such a statement will clearly communicate important information to readers about the long-term financial condition of the federal government, including the long-term sustainability of federal programs, inter-generational equity issues, projected annual cash flows, sensitivity of assumptions, and changes in fiscal sustainability during the year. This statement will also provide greater transparency of federal programs and a more comprehensive view of the nation's overall fiscal outlook to the readers. Further, we are in agreement with the Alternative View that an appropriate understanding of the sustainability of social insurance requires a consideration of not only the social insurance programs, but also of the government as a whole. For example, the Statement of Fiscal Sustainability will highlight the extent to which Medicare Supplementary Medical Insurance (about 75% of which is funded through general revenues) competes with other federal programs for scarce general revenue dollars.

The term "financial condition," as used in the financial reporting objectives, is broader than the "financial position" included in the balance sheet. The Statement of Fiscal Sustainability, most appropriately addresses financial condition, recognizes a broad range of future outcomes, and discloses the impact of multiple scenarios, most of which lack the degree of certainty consistent with other amounts used to describe financial position. The Statement of Fiscal Sustainability provides a clear and comprehensive analysis of the extent to which future budgetary resources would be sufficient to sustain public services and meet obligations as they become due. Also, presentation of changes in fiscal sustainability during the year provides a clear and comprehensive measure of the extent to which the federal government's financial condition improved or deteriorated during the year.

We support the Board's new project to develop fiscal sustainability reporting and strongly believe that it should be prioritized over any further work on social insurance reporting.

Question 5:

Do you believe that the Board should consider recognizing deferred revenue for earmarked revenues in excess of related program costs? Please provide the rationale for your answer.

Response:
Yes. Earmarked revenues received in excess of benefits incurred (which are invested in special U.S. Treasury securities) should be recorded as deferred revenue. In our view, excess earmarked revenues should not be recorded as revenue in the current period because they are held for designated purposes and should not offset non-earmarked costs in determining net operating cost. The social insurance benefit expense should be recorded in the period in which services are provided and such earmarked revenues should be recognized in the period in which they are used. We believe the approach presented by the Alternative View for earmarked revenues will best capture the true financial picture associated with these revenues.

In addition, the creation and the structure of "trust funds" in the United States is unique, which highlights the need for different approaches to properly reflect their economic substance. In our view, the best way to do this is to record a liability for deferred revenues.

Question 6.1:

Please offer any comments that you wish to make on the Primary View provisions.

The goal of the deliberations surrounding social insurance programs is to provide greater transparency of the financial condition of the federal government to the readers of the financial statements. In this regard, we do not believe the Primary View would provide the level of transparency or completeness that will be of the most benefit to the readers of the financial statements.

Further, the Primary View does not fully address the financial reporting objectives discussed in SFFAC No. 1. The Primary View does not communicate the full extent to which the government's financial position improved or deteriorated over the period, and it does not provide sufficient information to determine whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due. Also, we do not believe that the creation and recognition of a long-term liability, as defined in the Primary View, reflects the true nature of social insurance programs, the extent of the federal government's responsibilities for these and other programs, and the federal government's ability to revise these responsibilities.

We also note the following specific concerns about the proposals in the Primary View:

- The creation and recognition of a long-term liability, without recognizing the earmarked and other tax revenue to be collected over the projection period to fund the liability will create confusion on the part of the readers of the financial statements as to whether future resources are likely to be sufficient to sustain federal programs and if the federal government's financial condition has improved or deteriorated over the past year. Also, it could lead to misinterpretation of the financial condition of those programs by the reader as well as impair the credibility of the financial statements.
- The Primary View does not provide an understanding of the interaction of all future revenues and expenditures for social insurance and other federal programs to the readers of the financial statements. Therefore, the readers are unable to obtain a true understanding of the financial condition and long-term sustainability of social insurance and other federal programs.
- Recognition of inherently uncertain liabilities could affect the integrity of the financial statements, thereby, leading to further confusion on the part of the readers as to the sustainability of federal programs and the actual condition of the federal government.
- Recording a liability after 40 quarters or equivalent of work in covered employment does not take into consideration the differing requirements of

eligibility for social insurance benefits. For example, minimum work experience is not required to receive Medicare benefits. All U.S. citizens, at birth, and qualified resident aliens are entitled to participate in the Medicare program at age 65, whether or not they have worked 40 quarters.

- Payment of Social Security and Medicare—Part A benefits are limited to the earmarked revenues held in the respective trust funds (unlike Medicare—SMI trust funds that receive automatic general fund transfers). Therefore, recognizing a liability in excess of trust fund balances for Social Security and Medicare--Part A benefits does not reflect the legal or economic reality of the programs. Recording deferred revenue would recognize this reality.
- Participation in the Medicare—SMI (Parts B and D) is voluntary and dependent on the payment of monthly premiums by participants

Question 6.2:

Please offer any comments that you wish to make on the Alternative View provisions.

The Alternative View, by far, provides the level of transparency that will be of the most benefit to the readers of the financial statements. The Alternative View best achieves the financial reporting objectives as presented in SFFAC No. 1 and meets the unique reporting requirements of the federal government. The Alternative View measures the government's long-term financial condition and improvement or deterioration in such financial condition during the year. Further, the Alternative View measures the ability of the federal government to meet long-term obligations as they become due.

The Alternative View will clearly communicate important information to readers about the long-term financial condition of the federal government, including the long-term sustainability of federal government programs, inter-generational equity issues, and the annual changes therein. The Alternative View will also provide greater transparency of federal government programs, including social insurance programs, and a more comprehensive view of the nation's overall fiscal outlook to the readers.

Further, the Alternative View would provide several key measures of the federal government's financial condition and changes therein:

- End of year measures (balance sheet, statement of social insurance, statement of fiscal sustainability)

- Annual measures (budget (cash) results, accrual results, changes in social insurance, changes in fiscal sustainability)

In addition, the Alternative View is more consistent with current state and direction of international practice. Based on research and conversations with colleagues worldwide, we are not aware of any country that records a long-term liability for social insurance programs such as that proposed by the Primary View. Also, at its last meeting, the International Public Sector Accounting Standards Board (IPSASB) reaffirmed that its exposure draft on social benefits will deal only with disclosure requirements for cash transfer programs and will not address recognition of a liability for social benefits. Further, as noted in the Alternative View, the Governmental Accounting Standards Board Statement 33, *Accounting and Financial Reporting for Nonexchange Transactions, par. 2, states that* "providers [of nonexchange benefits] should recognize liabilities (or a decrease in assets) and expenses from government-mandated or voluntary nonexchange transactions, and recognize receivables (or a decrease in liabilities) and revenues (net of estimated uncollectible amounts), when all eligibility requirements, including time requirements, are met.

Rather, there is increasing interest in the international community on fiscal sustainability reporting as a vehicle for reporting on a government's financial condition. For example, the United Kingdom and the EU annually report on fiscal sustainability and other countries have or are planning to report on fiscal sustainability. Also, at its last meeting, the IPSASB placed a high priority on and plans to initiate a project on long-term fiscal sustainability reporting in 2007. As noted above, we are in strong agreement with the Alternative View that a Statement of Fiscal Sustainability should be presented and support the Board's new project to develop fiscal sustainability reporting.