



Federal Accounting Standards Advisory Board

---

January 4, 2007

TO: Members of FASAB

FROM: Richard Fontenrose, Assistant Director

THROUGH: Wendy Comes, Executive Director

SUBJECT: Standard re Reporting Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates and a Note on Social Insurance – Tab F

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.

### **Standard re Reporting Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates**

The proposed standard on reporting gains and losses from changes in assumptions and selecting discount rates and valuation dates addresses the following three areas:

- (1) Reporting gains and losses from changes in assumptions (the “display standard”),
- (2) Selecting discount rates (the “discount rate standard”), and
- (3) Selecting valuation dates (the “valuation date standard”).

At the November meeting, the Board considered the latest edition of an exposure draft (ED). The Board generally approved the approach but directed staff to consider expanding the scope of the standard so that it would apply generally to liabilities measured using long-range assumptions, rather than only to pensions, other retirement benefits (ORB), and other post-employment benefits (OPEB).

The attached staff paper (Tab F-1) discusses the following four topics and offers recommendations for each for the Board’s consideration:

- (1) two questions with respect to expanding the scope of the display standard along with staff recommendations,
- (2) the staff’s recommended wording regarding the discount rate standard,
- (3) a discussion of the “best estimate” issue and a preliminary recommendation, and
- (4) a recommendation regarding Governmentwide display of gains and losses from changes in assumptions, including pro forma illustrations.

A “track changes” edition of the draft ED is at Tab F-2. It reflects changes made pursuant to Board decisions in November and includes the staff recommendations discussed in the paper at Tab F-1. Specific paragraphs are cross-referenced.

### ***Social Insurance***

Tab F-3 contains a draft article written by Tom Allen and myself for the *Journal of Accountancy* or other publication. The objective is a “plain language” document for the general public that would result in additional feedback. We would seek wide distribution for the “plain language” document.

We sent the article to a GAO editor who may be able to improve the “plain language” aspects.

We would appreciate any comments on tone or comprehensiveness.

Also, more broadly, we would appreciate your thoughts on the viability of plain language documents accompanying technical requests for comments. For example, is such a document desirable? What is the appropriate content of such a document?

## **Tab F1 – Staff Issues Paper Display Standard – Question #1**

The proposed standard on reporting gains and losses from changes in assumptions and selecting discount rates and valuation dates addresses the following three areas:

- (1) Reporting gains and losses from changes in assumptions (the “display standard”),
- (2) Selecting discount rates (the “discount rate standard”), and
- (3) Selecting valuation dates (the “valuation date standard”).

At the November meeting, the Board generally approved the approach but directed staff to consider expanding the scope of the standard so that it would apply generally to liabilities measured using long-range assumptions rather than only to pensions, other retirement benefits (ORB), and other post-employment benefits (OPEB).

This paper discusses the following four topics and offers recommendations for each for the Board’s consideration:

- (1) two questions with respect to expanding the scope of the display standard,
- (2) an issue involving the discount rate,
- (3) the “best estimate” issue and
- (4) the Governmentwide display of the effect on changes in assumptions.

### ***Display Standard***

The display standard currently requires the entity to present gains or losses from changes in assumptions, if any, as a separate line item on the statement of net costs. Note disclosure of the components of expense is required, including gains and losses from changes in assumptions.

In November, the Board decided to consider applying the display standard generally, along with the discount rate and valuation date standards. The staff raises two questions in that regard.

Display Question #1 – Should the scope of the display standard be limited to certain assumptions, for example, “actuarial assumptions” or “long-range assumptions;” in other words, should the standard refer merely to “assumptions” and allow all assumptions to be considered potential candidates for separate display on the SNC?

### ***Discussion***

To date the Board’s discussion has focused on the type of major assumptions that affect the financial report of the United States Government (FR). For example, Treasury reports that the change in VA’s “actuarial cost” from year to year accounts for the majority of the change in the Government’s net cost in most years (the percentage was 54% in FY 06); and that the change in VA’s and other “actuarial costs” (e.g., pensions) accounted for nearly 80% of the \$310 billion decrease in total net operating costs between 2006 and 2005.<sup>1</sup>

FASAB standards and other publications frequently use the word “actuarial” and the phrase “actuarial assumptions” to denote the type of significant, long-range assumptions of interest to users. The 2006 FR employs the adjective “actuarial” frequently, stating, for example, that total “actuarial cost” in 2006 was \$187.2 billion and that this represents most of the annual differences between the Government’s budget deficit and net cost (93% in 2006), “as it does in most years, and ostensibly between the cash and accrual bases of accounting in the federal

---

<sup>1</sup> 2006 FR, Executive Summary, p. 5.

**Tab F1 – Staff Issues Paper**  
**Display Standard – Question #1**

Government.”<sup>2</sup> Also, the FR reports that the Energy Department (DOE) experienced the greatest percentage increase in its net cost (+52.7%) in 2006 while VA experienced the greatest decrease (-58.3%), DOE’s increase was mainly attributable to revisions to its estimate of environmental clean-up costs. “Both changes resulted from each agency’s need to estimate future costs and liabilities based on complex assumptions and cost models.” It states that VA uses several variables (e.g., number of eligible recipients, discount rates, and life expectancy) to estimate its “actuarial liability” for veterans’ compensation.<sup>3</sup>

If the standard merely requires “change in assumptions” to be reported, preparers might reasonably be uncertain about which assumptions to report and what the threshold for reporting is. The question is therefore whether the standard requiring the separate display of gains and losses from changes in assumptions on the statement of net cost should be explicitly limited to certain assumptions.

*Types of Assumptions*

The use of assumptions in accounting is routine and pervasive. Most assumptions and changes therein affect the entities’ costs.

The following lists some of the applications:

1. assumptions for pension and other retirement liabilities:
  - a. demographic, for example:
    - i. mortality
    - ii. morbidity
    - iii. terminations
    - iv. others
  - b. economic, for example:
    - i. inflation
    - ii. healthcare cost increases
    - iii. salary increases
    - iv. interest/discount rate
    - v. others
2. assumptions for post-employment benefit liabilities, including workers’ compensation and veterans’ compensation and other VA liabilities, for example:
  - a. disability

---

<sup>2</sup> 2006 FR Executive Summary, p. 5.

<sup>3</sup> 2006 FR MD&A p. 15. In fact, the FR states that large fluctuations in actuarial costs render the VA’s annual actuarial cost information not useful for predicting future costs. “The (VA) liability balance increase during the year represents the actuarial cost amount for that year. Because a small change in interest rate assumptions produces ... large actuarial cost fluctuations ... reported annual VA actuarial costs are not useful in predicting future annual costs.” (Emphasis added)

**Tab F1 – Staff Issues Paper**  
**Display Standard – Question #1**

- b. mortality
  - c. claims incurred but not reported
  - d. interest/discount rate
  - e. others
3. for loans and loan guarantee liabilities, for example:
- a. defaults
  - b. foreclosures
  - c. interest/discount rate
  - d. others
4. for environmental and disposal liabilities, for example:
- a. remediation costs
  - b. inflation rates
  - c. interest/discount rates
  - d. others
5. for accounts and grants payable, for example:
- a. credit and grant activity
6. for contingent liabilities, for example:
- a. claims incurred
  - b. probability of adverse judicial outcome
  - c. others
7. for doubtful accounts receivable, for example:
- a. defaults
  - b. recoveries
8. others, for example:
- a. obsolete inventory and OM&S balances
  - b. insurance claims and settlements
  - c. allocation of trust fund receipts
  - d. receipts inflows
  - e. indirect common costs to construction-in-progress
  - f. depreciation
  - g. service life
  - h. fines, penalties

*Assumptions Definitions*

The FASAB Consolidated Glossary in *Original Pronouncements* provides the following definition and examples of “assumptions”:

**Assumptions** – Basic beliefs about the future operating and functional characteristics.

**Tab F1 – Staff Issues Paper**  
**Display Standard – Question #1**

Types of assumptions include:

**Actuarial:** Assumptions as to the occurrence of future events affecting projected costs, such as mortality, withdrawal, disability, and future interest rates.

**Cash flow assumptions** - all known and/or forecasted information about the characteristics and performance of a cash flow ...

**Hospital assumptions:** Assumptions related to medical treatment ...

**Key assumptions** - Assumptions that have been established, through sensitivity analysis or other means, to be the elements that have a large impact on estimates, and thus are the most important factors in determining the cost of a loan or group of loans or loan guarantees.

**Model assumptions** - determinations of how cash flow assumptions are applied through the life of the cohort. ...

**Social Security:** Values relating to future trends in certain key factors. Demographic assumptions include fertility, mortality, net immigration, marriage, divorce, retirement patterns, disability incidence and termination rates, and changes in the labor force. Economic assumptions include unemployment, average earnings, inflation, interest rates, and productivity. Projections are normally provided based on the following three sets of economic assumptions

- the “low cost” set (Alternative I) that assumes relatively rapid economic growth, low inflation, and demographic conditions favorable to the plan;
- the “intermediate cost” set (Alternative II) that represents the trustees’ “best estimate” of future trends; and
- the “high cost” set (Alternative III) that assumes slow economic growth, more rapid inflation, and demographic conditions unfavorable to the plan.

Frequently the focus is on “actuarial assumptions” and therefore that term is a prime candidate for use in this standard. Webster’s Dictionary defines “actuarial” as: (1) of or having to do with actuaries; (2) relating to statistical calculation especially of life expectancy.

Actuarial Standard of Practice No. 4 (section 5.2.4) provides guidance for actuaries when selecting “actuarial assumptions” as follows:

**Actuarial Assumptions**—The actuarial assumptions individually and in combination should reflect the actuary’s best judgment. The actuary should consider the actual experience of the covered group but should emphasize expected long-term future trends rather than give undue weight to recent past experience. In choosing the assumptions, the actuary should take into account, to the extent deemed suitable, general or specific information from other sources, including the plan sponsor, plan administrator, investment managers, accountants, etc.

a. **Identification of Assumptions**—In preparing actuarial present value calculations in accordance with this standard, the actuary should consider the

**Tab F1 – Staff Issues Paper**  
**Display Standard – Question #1**

applicability of actuarial assumptions to such [economic and demographic factors].

b. Assumptions Considered Individually and in Aggregate—The actuary should consider the reasonableness of each actuarial assumption independently on the basis of its own merits, its consistency with each other assumption, and the combined impact of all assumptions. ...

c. Effect of Changes on Assumptions—The actuary should consider that changes in plan design or external circumstances may significantly alter the level and trend of expected future experience. ...

d. Plan-Specific Assumptions—In choosing actuarial assumptions, the actuary should consider not only information on general trends but specific information related to the plan. As a result of this information, the actuary may develop actuarial assumptions which differ from plan to plan or from group to group within a plan.

e. Past Experience—Past experience of the covered group is reflected in current costs through actuarial gains and losses. It may also be useful in forming a judgment about future experience. The long-range, prospective nature of pension costs, however, dictates that the assumptions be based on expected long-term future trends.

Thus, the term “actuarial assumptions” has a technical meaning for actuaries. Presumably, “actuarial assumptions” would denote an assumption derived from the work of an actuary, not merely a long-range assumption.

Usage in the FR is problematic. “Actuarial cost” as used in the FR seems to mean either annual accrued cost or changes in “actuarial assumptions” or both. The examples Treasury provides of “actuarial cost” are the present value of expected pension benefits and the annual estimated veterans’ compensation benefits.

*The Objective of the Display Standard*

The objective of the display standard is to provide information regarding gains and losses from changes in assumptions on the face of the statement of net cost. The rationale for this is similar to that expressed in SFFAC 2 (see pars. 94-95) and SFFAS 4 (see par. 92) regarding general “support costs” incurred to administer a program. These standards provide that costs reported for a program should be directly traceable, assignable, or allocable on a reasonable and consistent basis, consistent with the premise that any costs reported for a program should be controllable by that program to at least some degree<sup>4</sup> (emphasis added). Separately identifying “management costs” enables the use of resources for these activities to be justified on their own merit, particularly when it can assist in “evaluating performance” and is cost effective.<sup>5</sup> Standard 4 identifies such costs as “unassigned costs” that are part of the organization costs, and provides that they should be reported on the entity’s statement of net costs as costs not assigned to programs.<sup>6</sup>

---

<sup>4</sup> SFFAC 2, par. 94.

<sup>5</sup> SFFAC 2, par. 95.

<sup>6</sup> SFFAS 4, par. 92.

**Tab F1 – Staff Issues Paper**  
**Display Standard – Question #1**

Unlike “general management and administrative support costs,” the gains and losses from changes in assumptions can be “traced, assigned, or allocated to segments and their outputs;” but they are not controllable by the segment, and reporting them separately presumably will assist in evaluating performance.

Making a conceptual distinction between “actuarial assumptions,” other “long-range assumptions,” and other assumptions that affect financial reporting would be difficult. Assumptions can be “long-range” without necessarily being derived from actuarial processes, for example, the discount rate assumption. Moreover, long-range assumptions do not necessarily significantly affect costs, for example, a change in the service life of a building or a military asset. In addition, short-range assumptions may have a material effect as well, for example, the obsolescence of operating materials and supplies.

***Staff Recommendation #1***

The staff recommends that the standard:

- a. Describe the assumptions of interest as “major” and “long-term,” and provide that such assumptions do not necessarily require an actuary to develop.
- b. Not define the assumptions of interest as “actuarial.”
- c. Provide explicit exceptions for certain assumptions, for example:
  - i. those used to estimate receivables, payables, inventory and related property. Such assumptions will be proved or disproved within a relatively short period of time; and
  - ii. direct loans and loan guarantees for which the FASAB has already provided acceptable accounting procedures.

See ED paragraphs 18-19 and A7.

“Display Question #2” below addresses whether the standard should require the gain or loss reported separately to be “significant” and/or “material,” regardless of which assumptions are of interest.

**Tab F1 – Staff Issues Paper**  
**Display Standard – Question #2**

Display Question #2 – Should the scope of the display standard be explicitly limited to “material” or “significant” changes in assumptions?

*Discussion*

Question #2 is similar to Display Question #1 but differs in that it would apply to whatever assumptions the Board identifies as being within the scope of the standard.

The Board frequently has encountered the question of whether to define “significance” and “material” and has decided not to do so. As the Board is well aware, defining terms like “material” or “significant” in general standards would be very difficult. Moreover, all standards are subject to the FASAB general materiality consideration.

In SFFAS 27, *Identifying and Reporting Earmarked Funds*, the Board developed the following paragraph:

24. Selecting earmarked funds to be presented individually requires judgment. The preparer should consider both quantitative and qualitative criteria. Acceptable criteria include but are not limited to: quantitative factors such as the percentage of the reporting entity’s earmarked revenues or cumulative results of operations from earmarked funds; and qualitative factors such as whether an earmarked fund is of immediate concern to constituents of the fund, whether it is politically sensitive or controversial, whether it is accumulating large balances, or whether the information provided in the financial statements would be the primary source of financial information for the public.

**Staff Recommendation #2**

The staff recommends that the standard not specify that the gains or losses displayed separately be “significant” or “material” changes. Staff suggests a paragraph similar to paragraph 24 in SFFAS 27, for example:

Selecting the long-range assumptions for which gains and losses from changes are to be displayed individually on the statement of net cost requires judgment. The preparer should consider both quantitative and qualitative criteria. Acceptable criteria include but are not limited to quantitative factors such as the percentage of the reporting entity’s cost resulting from changes in assumptions; and qualitative factors include whether the effect of the change in an assumption should be of interest to decision-makers and other users.

See ED paragraph 19.

**Tab F1 – Staff Issues Paper  
Discount Rate Standard**

***Discount Rate Standard***

Paragraphs 23-25 of the ED at Tab F2 reflect the staff's revised wording regarding the discount rate standard. The Board has concluded that the scope of the discount rate standard should be general rather than limited to pensions, ORB, and OPEB, and that it would apply unless FASAB standards provided otherwise. Paragraphs 2 and 23 of the ED provides an "unless otherwise provided" exception. Paragraph A31 provides the rationale.

Paragraph 23 requires the preparer to consider future trends in Treasury rates based on historical experience.

Paragraphs 24-25 distinguish between discount rates for estimating the service cost component of periodic expense, which require consideration of the future year of payment, and the interest rate component, which is an aggregate computation.

***Recommendation #3***

Paragraphs 23-25 present the staff's recommended approach and wording for the discount rate. The staff will be seeking the Board's views of these paragraphs.

## Tab F1 – Staff Issues Paper “Best Estimate”

### **Best Estimate**

The Board directed the staff to explore the possibility of clarifying the meaning of “best estimate” in the standard on reporting gains and losses from changes in assumptions. FASAB standards do not define the term “best estimate,” although several FASAB standards use it, especially in SFFAS 17. SFFAS 25, *Reclassification of Stewardship Responsibilities*, and the FASAB *Consolidated Glossary* identify the Social Security Trustees’ “intermediate cost” set of assumptions as the Trustees’ “best estimate” of future trends.<sup>7</sup>

FASB Concepts Statement 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, (Concepts 7) notes that accounting pronouncements use the term “best estimate” in a variety of contexts. For FASB Concepts 7, “best estimate” are “the single most-likely amount in a range of possible estimated amounts; in statistics, the estimated mode.” In statistics, “mode” means the most frequent value assumed by a random variable, or occurring in a sampling of a random variable. FASB Concepts 7 distinguishes “the single most-likely amount” from the “expected amount;” the latter is a concept that refers to the sum of probability-weighted amounts in a range of possible estimated amounts.<sup>8</sup>

According to Concepts 7, the use of an entity’s own assumptions about future cash flows is compatible with an estimate of fair value, as long as there is no contrary data indicating that marketplace participants would use different assumptions. If such data exists, the entity must adjust its assumptions to incorporate that market information.<sup>9</sup>

FASB Concepts 7 provides that entities develop “best estimates” using information available without “undue cost and effort.”

Actuarial Standard of Practice No. 27, *Selection of Economic Assumptions for Measuring Pension Obligations*, defines “best estimate range,” as “For each economic assumption, the narrowest range within which the actuary reasonably anticipates that the actual results, compounded over the measurement period, are more likely than not to fall.”<sup>10</sup>

### **Staff Recommendation #4**

The staff recommends that the standard define “best estimate” as the “most-likely” amount in a range of possible estimated amounts. Following FASB Concepts 7, the staff also recommends that the standard explain that the entity’s own assumptions about future cash flows may constitute the best estimate assumptions as long as they are not contrary to generally accepted assumptions as evidenced by independent sources, for

---

<sup>7</sup> SFFAS 25, par. 58, and see the Consolidated Glossary entry “Assumptions.”

<sup>8</sup> Concepts Statement 7, Glossary of Terms.

<sup>9</sup> Concepts Statement 7, par. 38.

<sup>10</sup> Actuarial Standard of Practice No. 27, par. 2.1.

**Tab F1 – Staff Issues Paper**  
**“Best Estimate”**

example, those used by the federal Bureau of Economic Analysis for the National Income and Product Accounts. If its assumptions did not reflect such data, the entity would be required to adjust its assumptions to incorporate that information.

See ED paragraph 27.

**Tab F1 – Staff Issues Paper  
Governmentwide Display**

Governmentwide Display

*Discussion*

In November, staff explained that the Governmentwide display standard and pro forma example had been modified from the September ED iteration in response to a Treasury Department request. The pro forma display addressed differences between FR and component entity financial statements. The FR’s “statements of operations and changes in net position” displayed the separate line item containing the pro forma loss from changes in assumptions instead of the FR’s SNC. A member was seriously concerned about excluding the gains/losses from FR’s SNC’s total cost line.

**Recommendation #5**

To address this concern, the staff recommends the following governmentwide display, which involves the FR’s statement of net costs rather than the statements of operations and changes in net position. Staff consulted Treasury Department staff regarding this presentation.

Component Entity:

Governmentwide Entity:

*Pro Forma Statements of Net Cost  
for the Year Ended September 30, 2006*

	<i>Gross Cost</i>	<i>Earned Revenue</i>	<i>Net Cost</i>
Department of Defense.....	\$ 623	\$ 24	\$ 599
Department of Health & Human Services....	679	51	628
* * *			
All Other entities.....	<u>146</u>	<u>92</u>	<u>54</u>
Cost before effect of changes in assumptions.....	3,060	226	2,834
Less loss (plus gain) from changes in assumptions changes:			
DoD.....	35	0	35
OPM.....	1	0	1
VA.....	31	0	31
<b>Total cost .....</b>	<b>\$ 3,128</b>	<b>0</b>	<b>\$ 2,901</b>

The following pages contain examples of the FY 2006 FR statements of net cost and statements of operations and changes in net position for the members’ convenience.

**Tab F1 – Staff Issues Paper  
Governmentwide Display**

Current FR Statement of Net Cost for 2006

**United States Government  
Statements of Net Cost  
for the Years Ended September 30, 2006, and September 30, 2005**

	Gross Cost	Earned Revenue	Net Cost	Gross Cost	Earned Revenue	Net Cost
(In billions of dollars)	2006			2005		
Department of Defense .....	658.0	24.1	633.9	703.9	26.9	677.0
Department of Health & Human Services.....	678.8	51.4	627.4	623.4	39.6	583.8
Social Security Administration .....	593.1	0.3	592.8	572.1	(2.0)	574.1
Interest on Treasury Securities held by the public.....	221.5	-	221.5	181.2	-	181.2
Department of Veterans Affairs .....	117.3	3.5	113.8	276.6	3.4	273.2
Department of Agriculture.....	109.0	11.4	97.6	112.6	19.9	92.7
Department of Education.....	97.3	4.7	92.6	75.6	4.7	70.9
Department of the Treasury.....	85.5	4.1	81.4	82.3	3.1	79.2
Department of Transportation.....	66.6	0.6	66.0	62.4	0.6	61.8
Department of Energy .....	70.9	5.1	65.8	46.8	3.7	43.1
Department of Homeland Security .....	63.4	6.8	56.6	74.6	6.7	67.9
Department of Labor.....	48.2	-	48.2	50.0	-	50.0
Tennessee Valley Authority.....	9.5	10.0	(0.5)	8.6	8.7	(0.1)
Export-Import Bank of the United States .....	-	1.3	(1.3)	(0.2)	2.5	(2.7)
Pension Benefit Guaranty Corporation .....	(0.5)	3.8	(4.3)	5.1	4.3	0.8
U.S. Postal Service .....	58.9	71.6	(12.7)	56.0	68.9	(12.9)
All other entities .....	27.0	(3.5)	30.5	30.3	7.6	22.7
Total .....	<u>3,127.7</u>	<u>226.4</u>	<u>2,901.3</u>	<u>3,174.6</u>	<u>224.8</u>	<u>2,949.8</u>

**Tab F1 – Staff Issues Paper  
Governmentwide Display**

Current FR Statements of Operations and Changes in Net Position for 2006

**United States Government  
Statements of Operations and Changes in Net Position  
for the Years Ended September 30, 2006, and September 30, 2005**

(In billions of dollars)	Non- Earmarked Funds	Earmarked Funds	2006 Consolidated	2005 Consolidated (Restated)
<b>Revenue:</b>				
Individual income tax and tax withholdings .....	1,045.7	800.4	1,846.1	1,690.1
Corporation income taxes .....	350.0	-	350.0	271.8
Unemployment taxes .....	-	41.4	41.4	40.0
Excise taxes .....	24.5	49.6	74.1	71.0
	* * *			
<b>Net position, beginning of period</b> .....	(8,714.1)	247.2	(8,466.9)	(7,709.8)
Prior period adjustments-corrections of errors (Note 17 and Note 26) .....	-	-	-	2.9
Other prior period adjustments (Note 17) .....	-	-	-	0.2
Net Operating (Cost)/Revenue .....	(621.5)	172.0	(449.5)	(760.2)
<b>Net position, end of period</b> .....	(9,335.6)	419.2	(8,916.4)	(8,466.9)
	* * *			
Intragovernmental interest .....	-	185.3	185.3	-
Total revenue .....	1,532.2	1,093.9	2,626.1	-
Eliminations .....	-	-	(185.3)	-
Consolidated revenue .....			2,440.8	2,185.5
<b>Net Cost:</b>				
Net cost .....	1,635.1	1,266.2	2,901.3	2,949.8
Intragovernmental interest .....	185.3	-	185.3	-
Total net cost .....	1,820.4	1,266.2	3,086.6	-
Eliminations .....	-	-	(185.3)	-
Consolidated net cost .....			2,901.3	2,949.8
<b>Intragovernmental transfers</b> .....	(344.3)	344.3	-	-
<b>Other--Unmatched transactions and balances</b> (Note 1) .....	11.0	-	11.0	4.1
<b>Net Operating (Cost)/Revenue</b> .....	(621.5)	172.0	(449.5)	(760.2)

## Is the Social Security and Medicare Commitment an Accounting Liability?

by Tom Allen and Richard Fontenrose

*The authors are responsible for the contents of this article, which may or may not reflect the views of other FASAB members.*

*Tom Allen is chairman of the FASAB and former chairman of GASB. Richard Fontenrose is a FASAB assistant director and staff manager of the social insurance project.*

On October 23 the Federal Accounting Standards Advisory Board (“FASAB” or “the Board”) published a “Preliminary Views” document regarding new accounting for “social insurance.”<sup>1</sup> “Social insurance” comprises five programs but two of them, Social Security and Medicare, predominate. These two programs touch almost all citizens and present daunting fiscal challenges. What’s more, the question of how to incorporate estimates of future cash flows of this magnitude in financial statements has historically been and continues to be a contentious issue.

Fundamental questions about social insurance programs that can be addressed by financial reporting include whether social insurance programs are sustainable for the short- and long-term; whether the government’s finances improved or deteriorated as a result of these and other programs; and whether these programs will be able to provide benefits at current levels to those who are planning on receiving them.

### ***Preliminary Views Document***

The original FASAB project plan called for issuing an exposure draft that would have resulted, following due process, in a final standard. However, as a result of strongly held differing positions among Board members, the Board decided to issue a Preliminary Views document as a better tool to clearly explain the Board members’ positions and seek essential due process feedback from constituents. The Preliminary Views document presents two differing views, supported by different Board members, on accounting for social insurance. (These views are labeled “Primary” and “Alternative.”) Members of the Board have agreed from

#### **Box 1 – The FASAB**

Article I, Section 9 of the Constitution of the United States provides that “No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time.” Various laws have subsequently provided additional accounting and reporting requirements suitable for the needs of each era. The [Chief Financial Officers Act of 1990](#)--as amended by the Government Management Reform Act of 1994—for the first time required annual, audited financial statements for the United States Government and its component entities, referred to as federal reporting entities. All executive agencies, pursuant to the CFO Act and the [Accountability for Tax Dollars Act of 2002](#), are required to prepare and submit audited financial statements to OMB and the Congress.

In conjunction with passage of the CFO Act of 1990, the Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General established FASAB ([www.fasab.gov](http://www.fasab.gov)) to develop the “applicable accounting principles” for the newly required financial statements.

In October 1999 AICPA’s Council designated FASAB as the body that promulgates GAAP for federal entities in the United States.

<sup>1</sup> *Accounting for Social Insurance, Revised*, October 23, 2006 ([http://www.fasab.gov/pdf/files/socialinsurance\\_pv.pdf](http://www.fasab.gov/pdf/files/socialinsurance_pv.pdf)).

the outset of the project on the objectives of financial reporting for social insurance programs and yet have differing views about how best to achieve the objectives. For example, all members agree that it is extremely important to provide useful financial information about the sustainability of social insurance programs, and that in the consolidated Financial Report of the United States Government (FR)<sup>2</sup> such information should be presented for the government as a whole.

Members agree that social insurance information should be included in the balance sheet, and operating statement (call the “statement of net cost”), and other federal financial statements and that it should be audited. They agree that the information should be “transparent” – that is, readily understandable to an interested, non-expert reader. Members also agree that the financial reports should highlight any long-range fiscal imbalances anticipated in social insurance programs.

Both the Primary and Alternative Views note that financial statements resulting from federal financial accounting standards are intended to be accrual-based. That is, the statements strive to recognize the financial effects of events and transactions as they occur rather than only when the cash transfers take place.

### ***When Should Expense and Liability Be Recognized?***

Members have proposed two different points in time when expense and liability for social insurance benefits should be recognized in on the government’s balance sheet and statement of net cost. The Primary View holds that expense and liability for social insurance should be recognized when participants attain 40 quarters of work in covered employment and become fully insured. The Alternative View is that expense and liability should be recognized when paid or due to be paid for the reporting period year (this is referred to as the “due and payable” point). For example, assuming fiscal year reporting periods, a liability would be reflected for Social Security payments due to be paid in the last month of the fiscal year that were not paid until the first month of the next fiscal year. For Medicare, the liability would include amounts for claims incurred in the fiscal year not paid until the following fiscal year.

---

<sup>2</sup> See <http://www.fms.treas.gov/fr/index.html>.

It is important to note that, in conjunction with expense and liability reporting, both Views would require much additional information. Both Views would continue to present a statement of social insurance (SOSI) (see Box 2

for the Social Security section of the 2006 SOSI), which shows the present values of projected future program revenues and scheduled benefits.

Both Views call for enhancing the SOSI by adding an analysis of changes in SOSI present values during the reporting period. The Primary View proposes new sub-sections for the SOSI to display this analysis, while the Alternative View proposes a new basic financial statement.

In addition, the Primary View proposes to link the statement of social insurance to the balance sheet and statements of net cost. The Primary View would add line items to the SOSI that represent the expense and liability amounts reported on the statement of net cost and balance sheet (see Box 3 for the line item from the Primary View pro forma SOSI illustration). The Primary View holds that such linkage among other things will make the statement of social insurance more understandable to citizens and other financial statement users.

Both the Primary and Alternative Views would retain the supplementary information currently in FASAB standards, such as the “dependency ratio” of contributors to beneficiaries and the projections of all future social insurance receipts and outlays over the next 75 years in nominal dollars and as a percent of GDP and taxable payroll.

The Alternative View proposal would not significantly increase the current expense or liability on the statement of net cost or balance sheet. However, it would add a “statement of fiscal sustainability” and other contextual information on all federal programs and as an integral component of social insurance reporting,

**Box 2 – Partial (Social Security only) Government-wide Statement of Social Insurance**

**United States Government  
Statements of Social Insurance  
Present Value of Long-Range (75 Years, except Black Lung) Actuarial Projections**

\*\*\*\*\*UNAUDITED\*\*\*\*\*

(in billions of dollars)	2006	2005	2004	2003	2002
<b>Federal Old-Age, Survivors and Disability Insurance (Social Security): (Note 23)</b>					
<i>Contributions and Earmarked Taxes from:</i>					
Participants who have attained age 62.....	533	464	411	350	348
Participants ages 15-61.....	16,568	15,290	14,388	13,576	13,048
Future participants (under age 15 and births during period).....	15,008	13,896	12,900	12,213	11,893
All current and future participants.....	32,107	29,450	27,699	26,147	25,289
<i>Expenditures for Scheduled Future Benefits for:</i>					
Participants who have attained age 62.....	5,866	5,395	4,933	4,662	4,402
Participants ages 15-61.....	26,211	23,942	22,418	21,015	20,210
Future participants (under age 15 and births during period).....	6,480	5,816	5,578	5,398	5,240
All current and future participants.....	38,557	35,154	32,928	31,075	29,851
Present value of future expenditures less future revenue.....	6,449 <sup>1</sup>	5,704 <sup>2</sup>	5,229 <sup>3</sup>	4,927 <sup>4</sup>	4,562 <sup>5</sup>

**Box 3 – Partial (Social Security only) Pro Forma Illustration (Primary View) of the SOSI – Showing Balance Sheet Liability**

Federal Old-Age, Survivors and Disability Insurance (Social Security) Statement of Social Insurance	
Federal Old-Age, Survivors and Disability Insurance (Social Security)	2005
<i>Present value of future benefits attributable to current participant's <u>past work</u> in covered employment to be paid to:</i>	
e. Current participants who have attained fully insured status and retirement age or disability status.....	5,395
f. Current participants who have attained fully insured status but have not yet attained retirement age or disability status.....	8,979
<b>g. Subtotal – accrued liability for current participants (line e plus f above).....</b>	<b>14,374</b>
h. Current participants who have not yet attained fully insured status.....	2,992
i. Subtotal – “accrued benefit obligation” (line g plus h).....	17,366

subject to additional refinement in connection with a broader FASAB project on sustainability. The Primary View also supports additional sustainability reporting but favors exploring the options in that regard in a separate project, subject to full due process procedures for exposure and comment. As yet the idea has not been fully deliberated by the full Board. The Primary View position is that such reporting would be in addition to the balance sheet and statement of net cost reporting rather than as a substitute for such reporting.

### **Why Do The Members Support These Views?**

Expense and liability recognition for social insurance programs has been a long-standing source of controversy in government accounting. In its fifteen years of operation the FASAB has issued several exposure drafts related to social insurance reporting. The three principal exposure drafts that led to the current reporting model were:

- a 1995 exposure draft entitled *Accounting for Liabilities of the Federal Government*,
- a 1998 exposure draft entitled *Accounting for Social Insurance*, and
- a 2002 exposure draft entitled *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*.

In each of these exposure drafts, the issue of accrual accounting for social insurance programs has been controversial.

### **SFFAS 17**

The issue of social insurance accounting was addressed in SFFAS 17, *Accounting for Social Insurance*,<sup>3</sup> through compromise between strongly opposing views. The compromise resulted in the statement of social insurance mentioned above, and in accompanying disclosures and required supplementary information. SFFAS 17 marked substantial improvement in the information presented in general purpose external financial reports of the U.S. Government and its component entities. Subsequently the FASAB changed the status of the statement of social insurance for financial reporting and auditing purposes from “supplementary stewardship information” to “basic information.”

During its current deliberations, the Board also considered two other obligating events for expense and liability recognition:

- (1) work in covered employment; and
- (2) at 62 or 65 or equivalent years of age when the participants become eligible for immediate benefits, which sometimes is referred to as “threshold eligibility.”

The argument in favor of the “work in covered employment” obligating event is that:

---

<sup>3</sup> August 1999.

- costs accrue immediately with work in covered employment and the payment of payroll taxes by the employee, employer, and self-employed;
- future benefits are based on all work and wages earned; and, therefore,
- waiting until 40 quarters of work have been completed and benefits “vest” before accruing costs ignores growing costs.

This position was rejected by both the Primary View and Alternative View members. The members believe that social insurance programs are governmental in nature, not deferred compensation, and the meeting of eligibility criteria is critical. Until the participant meets eligibility criteria, the government is not obligated to pay benefits.

The argument for “threshold eligibility” is that the criteria for expense and liability recognition for social insurance programs should be the satisfaction of all eligibility conditions, including age. At that point the participants generally will have planned on receiving the benefits for a long time and typically will depend on them. The reduction or termination of such benefits is highly unlikely. The Primary View members rejected this position because it ignored the fact that, once eligibility requirements are met for payments, an obligating event has occurred, and payments become a matter of statistical probability. The Alternative View members rejected this position because they believe a liability does not arise for social insurance programs until payments are due and payable.

### ***Primary View Rationale***

The Primary View reflects the preliminary conclusion of the majority of Board members. They concluded that the compromise that resulted in the issuance of SFFAS 17 is flawed because it fails (1) to recognize the accruing cost of social insurance programs in each reporting period and the accumulated liability for benefits payable at a determinable date under current law, and (2) to fully explain the change in the SOSI present values between fiscal years.

The Primary View is that conditions for receiving a future benefit are *substantially met* when the participants become “fully insured” – that is, when they become eligible for benefits after 40 quarters or equivalent work in covered employment – and the omission of the effects of these events results in an incomplete reporting of costs and liabilities.

The Primary View’s principal focus is on the economic cost being incurred for social insurance programs and the accumulation thereof. The Primary View is that a key objective of the balance sheet and statement of net cost should be to report the estimated costs incurred during the reporting period and the amount of those costs that will have to be financed in future periods. The Primary View asserts that such costs represent the accrued liability portion of long-term actuarial projections.

The Primary View is that the distinction between exchange and non-exchange transactions, which is among the points emphasized in the Alternative View, should not be the sole criterion for recognizing government cost and liability. The Primary View asserts that an expense and a liability may be incurred equally for exchange, non-exchange, or quasi-exchange transactions so long as a present obligation exists. The government has many programs for which it incurs

large liabilities and yet receives nothing or little in exchange other than promotion of the general welfare. In addition, the Primary View notes the quasi-exchange features of social insurance programs such as the relationship between wages earned in covered employment and benefits accrued and payroll taxes paid, both of which are based on wages in covered employment. The Primary View also points to the way the programs are structured, including the use of the term “trust funds” and the “investment” of excess payroll taxes in special Treasury securities, as a possible indication of a current obligation.

### ***Alternative View Rationale***

The Alternative View is that the basis for recognition of a liability and cost for social insurance established in SFFAS 17 (i.e., when payments are “due and payable”) remains appropriate, but that SFFAS 17 does not (1) recognize important information concerning the fiscal sustainability of social insurance programs, or (2) fully explain the change in the net present value of program-related cash flows.

The Alternative View is that expense and liability for social insurance transactions should be recognized when payments are made or are due to be paid (again, this is referred to as the “due and payable” point) as established in the current FASAB standard for all “non-exchange transactions.” The Alternative View holds that that recognition point remains appropriate for non-exchange transactions.

The Alternative View presents a fundamental distinction in financial reporting between exchange transactions, which are seen as voluntary market exchanges of goods and services for a price, and non-exchange transactions, which are seen as the result of decisions made collectively by the Congress and the President to levy taxes and to authorize programs. The Alternative View asserts that this distinction is seen in FASAB concepts, standards, and statements, e.g., the statement of net cost, and that other standard setting bodies differentiate between the reporting of exchange and non-exchange transaction. Also, they note the distinction in federal budgetary accounting between “offsetting collections,” which are exchange-like in nature accounted for differently than taxes and other governmental receipts, which are non-exchange in nature.

The Alternative View is that social insurance programs comprise two separate non-exchange transactions – the compulsory payment of taxes during an individual’s working life and the government’s payment of benefits after the individual has satisfied all eligibility criteria. In the Alternative View, expenses and liabilities are incurred for social insurance programs when the participants have met all eligibility requirements and the amount of the benefit is “due and payable” to or on behalf of beneficiaries. Hence, the Alternative View is that benefits beyond the due and payable amount are not present obligations of the government and should not be recorded as expenses or liabilities in the current period.

The Alternative View argues that recognition of such future social insurance benefits as current expenses and liabilities would result in a substantial mismatch of net costs for non-exchange programs in the current year and the services provided in that year - disrupting an alignment that allows programs to match costs with results. Also, recognition of future social insurance benefits on the balance sheet and statement of net cost would diminish significantly the relative

size and importance of other expenses and liabilities shown on the financial statements; as a result these 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. Moreover, given the ability of the federal government to change the laws relating to social insurance programs and the unsustainability of current benefit payments with current financing, about which beneficiaries are on notice, amounts of benefit payments are uncertain and not reliably estimable. Finally, the Alternative View argues that characterizing future benefits as current expenses and liabilities may undermine needed efforts to reform these programs.

The Alternative View agrees that a key objective of the principal financial statements should be to report the costs incurred during the reporting period. But the Alternative View is that costs are incurred when all eligibility requirements are met and benefits are due and payable.

### ***Should "Excess" Payments of Social Insurance Payroll Taxes Be Recognized as a Liability?***

The Alternative View also notes that earmarked revenues in excess of the amounts needed for current benefit payments have accumulated in large amounts in some social insurance funds. These excess amounts are assets of the funds and are invested in special Treasury securities, which earn interest. The investments in Treasury securities (an asset) held by the various earmarked funds and the liability of the United States Treasury to redeem the securities are treated as intra-governmental eliminations when the consolidated government-wide financial statements are prepared. Therefore, the consolidated net position of the federal government reported on the government-wide financial statements does not include the effect of the claim on the Treasury that the various funds hold, just as the consolidated net position does not include the effect of other intra-governmental claims. Instead, the government-wide financial statements include the cumulative results of operations of earmarked funds – currently a large positive balance – as an offset against the cumulative results of operations of the general fund – currently a large negative balance. The result is that the financing provided by earmarked fund operations to general fund operations – which would otherwise be financed through the issuance of debt to the public, tax increases or other financing sources – is not shown on the face of the United States Government balance sheet. With the implementation in 2006 of SFFAS 27, *Identifying and Reporting Earmarked Funds*,<sup>4</sup> this issue will be illuminated in the agency performance and accountability reports and analyzed in the Financial Report of the United States Government.

The Alternative View is that recognition of deferred revenue equal to the earmarked revenues in excess of program costs should be considered. If this option were adopted, earmarked revenues collected for social insurance programs in excess of program liabilities (as defined above and in existing liability standards) incurred would be recorded as deferred revenues (a liability). During periods when earmarked revenues are deferred because they exceed program costs, the liability for deferred revenue would increase or accumulate and earmarked revenues would equal costs. During periods when previously deferred revenues are used to finance

---

<sup>4</sup> December 28, 2004.

program costs, the liability for deferred revenue would decrease. The Alternative View proposes that this concept should be considered by the Board as a separate project, however, because it would require revising portions of SFFAS 7, *Accounting for Revenue and Other Financing Sources*,<sup>5</sup> and the supporting arguments also may apply to numerous other funds with “excess” earmarked revenues.

### ***Your Comments Are Needed***

While FASAB members do presently have differing opinions on the best method to improve social insurance reporting, all have agreed that due process feedback is critical to help the Board resolve this important federal reporting issue. The Board resolves such differing views through research of the issues, careful deliberation, and due process feedback. The Board is asking you, the interested and likely impacted professional, to take the time to review and comment on the Preliminary Views document. Your views would be especially valued regarding, for example:

- The obligating events necessary to record expense and liability in the financial statements of the federal government.
- The effect of an entity’s (government’s or business’) retention of the right to modify an obligation on liability and expense recognition.
- The value of basic financials statements that to link to each other or “articulate” versus the value of providing essential information in non-articulating basic financial statements.

In addition to writing comments to the Preliminary Views document, which is available on-line at <http://www.fasab.gov/exposure.html>, the FASAB will also be holding a public hearing on May 23, 2007, to receive verbal comments.

---

<sup>5</sup> May 1996.