EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

MAY 1 2006

Mr. David Mosso
Chairman
Federal Accounting Standards Advisory Board
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Mosso:

I am writing to express to you and other members of the Federal Accounting Standards Advisory Board (FASAB) my views regarding the Board's decision on March 29, 2006, to move forward with the proposed Social Insurance Exposure Draft. I share FASAB's interest in ensuring that the Government provides the public with comprehensive financial information about Government operations. In addition, I share FASAB's interest in informing the users of the Government's financial statements of the unsustainable future Government expenditures that will be required if current law is not changed.

With respect to the presentation of the Government's financial condition, the crucial issue for social insurance programs is whether they are sustainable in the long run. A fair and accurate presentation of the financial sustainability of the social insurance programs must include a comprehensive presentation of the sustainability of the Government as a whole. To that end, the Administration has been highlighting the unsustainable nature of Federal social insurance programs and other entitlement programs in the President's annual budget submissions. In particular, since the beginning of his Administration, the President has highlighted the unsustainable structure of the Social Security program and advocated reforms to put this program on a sustainable basis for future generations. While social insurance programs represent the greatest factor, the challenge posed by entitlement programs is not limited to these programs. Medicaid, for example, also contributes to the long-term unsustainable nature of Federal spending.

The President's *Fiscal Year 2007 Budget* summarized the challenge posed by spending on social insurance and other entitlement programs by stating:

> While the near-term outlook for shrinking deficits is encouraging, the long-term picture presents a major challenge due to the expected growth in spending for major entitlement programs. In only two years, the leading edge of the baby boom generation will become eligible for early retirement under Social Security. In five years, these retirees will be eligible for Medicare. The budgetary effects of these milestones will be muted at first. But if we do not take action soon to reform both Social Security and Medicare, the coming demographic bulge

> will drive Federal spending to unprecedented levels and threaten the Nation's future prosperity.[1]

In addition to this statement, the FY 2007 Budget and previous budgets have included extensive analyses of the long-term challenge posed by entitlement programs.[2] Thus, the sustainability presentation that OMB is interested in developing, which is discussed more fully below, is one that would show the long-run fiscal impact of Government programs under current law and would be based, in large part, on information that the Executive Branch has been publishing for many years.[3]

In light of our common interest in disclosing financial information about the Government, I would like to request that the Board, before releasing any Social Insurance Exposure Draft for public comment, address the concerns that have been raised previously by the Secretary of the Treasury, the Comptroller General and the Chief Actuary of the Social Security Administration.[4] OMB shares these concerns and they are outlined in more detail below.

FASAB has already issued several standards that govern the Federal Government's financial accounting for the social insurance programs.[5] OMB believes that these existing standards address adequately the most significant accounting issues involving the social insurance programs. The Exposure Draft would not improve the existing standards and, as discussed below, could present a misleading view of the Government's liabilities and compromise the integrity of the balance sheet.

In lieu of moving forward with the proposed Exposure Draft, OMB would like to recommend that FASAB develop a new "Presentation on Financial Sustainability" for the Government's Financial Report. This new presentation, which OMB would like to work with the Board to develop, would provide the public with a more comprehensive and balanced view of the Government's financial condition than is provided by the existing financial statements. FASAB's *Objectives of Federal Financial Reporting* (issued in 1993) envisioned the development of such an analysis of financial condition, with separate tables building from

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[1] *The Budget of the United States Government, FY 2007*, p. 18.

[2] Pages 18-24 of the *Budget of the United States Government, FY 2007,* include a discussion on the long-term outlook and the unsustainable trajectory of entitlement program spending.

[3] Chapter 13 of the *Analytical Perspectives, The Budget of the United States Government, FY 2007* provides a comprehensive analysis of the sustainability of all Government programs, which include social insurance, defense, education, environmental, transportation and other programs; this analysis has been published since the release of *The Budget of the United States Government, FY 1995.* Annual trustee reports have provided details of the status of the Social Security and the Medicare programs under various sets of assumptions since 1941 and 1965, respectively. The Statement of Social Insurance provides information about the Government's social insurance programs as a part of the Government's Financial Report.

[4] These concerns are set forth in letters to the Board from the Comptroller General (September 2, 2005), the Chief Actuary of the Social Security Administration (September 16, 2005), and the Secretary of the Treasury (November 29, 2005). For your convenience, I have attached these three letters.

[5] *Statement of Federal Financial Accounting Standards No. 17, Accounting for Social Insurance*; *Statement of Federal Financial Accounting Standards No. 25, Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*; *Statement of Federal Financial Accounting Standards No. 26, Presentation of Significant Assumptions for the Statement of Social Insurance: Amending SFFAS 25.*

and complementary to the balance sheet within its Stewardship Objective. There is great interest in such an analysis, as the recent FASAB Stewardship Roundtable discussion emphasized. The Federal Government is unique in its impact on the economy, security and well-being of the United States. For this reason, reporting on the Government's financial condition requires a framework for comprehensive analysis that accurately distinguishes different time periods.

In addition to considering the existence of the current FASAB standards that govern the social insurance programs and OMB's interest in developing a new Presentation on Financial Sustainability, I would like the Board to consider the serious concerns that OMB has with the proposed Social Insurance Exposure Draft. We are concerned that, by inappropriately characterizing future social insurance benefits as current liabilities and current expenses, the proposed standard could mislead users of the financial statements regarding the Government's true financial position.

With respect to the presentation of the Government's financial position, we are concerned that the change proposed in the Exposure Draft could be misleading because it would require showing, as social insurance liabilities on the balance sheet, amounts that do not meet the definition of "liability." The compulsory payment of social insurance taxes by an individual and the subsequent receipt of social insurance benefits by that same individual do not constitute an exchange transaction.[6] Accordingly, the liability for social insurance programs is the liability that applies to non-exchange transactions, which is the amount that is "due and payable." Many other countries have addressed the issue of accounting for social insurance programs, and our research has found none that report more than the "due and payable" amount. In its recent deliberations over this issue, the International Public Sector Accounting Standards Board (IPSASB) defined the liability for social security pensions as the "due and payable" amount.[7] In addition, IPSASB's draft Exposure Draft includes a requirement that an entity shall disclose in a separate statement the present value of future cash payments for current beneficiaries.[8]

"Due and payable" amounts are legal obligations of the Government. By contrast, the proposed social insurance liability under FASAB's Exposure Draft does not represent a legal obligation because Congress has the authority to increase or reduce social insurance benefits at any time.[9] For example, when Congress reformed Social Security in 1983, prospective Social Security benefits were reduced and payroll taxes were increased to eliminate the 75-

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[6] It does not constitute a voluntary transaction involving an exchange of goods or services for a price, such as employee services for salary and deferred compensation. Instead, it is a Government program that pays benefits based on a formula. As noted in Statement of Federal Financial Accounting Standards No. 17, Accounting for Social Insurance, par. 65, the Supreme Court concluded that Social Security benefits are non-contractual in *Flemming v. Nestor*, 363 U.S. 603 (1960).

[7] IPSASB, *Background Paper: Draft Exposure Draft on Social Security Pensions*, par. 27 (March 2006 meeting), www.ifac.org/publicsector.

[8] *Id.* at pars. 35-56.

[9] As noted in Statement of Federal Financial Accounting Standards No. 17, Accounting for Social Insurance, par. 68, Congress has expressly reserved its right (in 42 U.S.C. § 1304) to alter Medicare and Social Security benefits. See also *Flemming v. Nestor*, 363 U.S. 603, 610-11 (1960) (Congress retains authority to alter Social Security benefits).

year Social Security actuarial deficit of 2.09 percent of taxable payroll.[10] There is currently widespread consensus that the social insurance programs are unsustainable in the long run under current law.[11] The President and many others, including Members of Congress, have urged that substantial reforms of the social insurance programs be made soon. Inappropriately adding such a mutable amount of future social insurance benefits to the Government's balance sheet as a liability could hinder efforts to accurately present information about these programs to policymakers who are considering their reform.

We are also concerned that pulling forward in time mutable and uncertain amounts of *future* social insurance benefits, as required by FASAB's Exposure Draft, would compromise the integrity of the balance sheet, which is a statement of what the Government owns and owes others as a result of *past* operations. Any estimate of the proposed social insurance liability would be very large relative to the Government's other liabilities, and would vary from year to year by large amounts, thereby distorting the meaning of the annual statement of net cost and its integration with the balance sheet. This, in turn, would diminish the usefulness of the financial statements as a means to improve financial management.[12] In other words, incorporating such an estimate into the financial statements would likely undermine the credibility and value of both the balance sheet and the statement of net cost.

In addition to the substantive concerns noted above, I am concerned about FASAB moving forward at this time with the proposed Social Insurance Exposure Draft given the apparent sharp disagreement within FASAB between the Federal members and the non-Federal members. I believe that it is most productive for FASAB to move forward with any proposed standard only when a consensus has been reached that encompasses both Federal and non-Federal members, as opposed to a situation in which a proposed standard has garnered the support of only the non-Federal members, with strong concerns having been expressed by the Federal members. I understand that, in the past, FASAB has rarely moved forward with a standard where support for the standard was based entirely on the support of the non-Federal members. For this reason, I believe that the Board, before releasing the Exposure Draft for public comment, should devote further time to considering the concerns that the Federal members have raised and should explore the alternative that we have proposed for a new Presentation on Financial Sustainability.

Finally, I believe that any proposed new social insurance standard should be issued only after FASAB completes two of its current projects, Objectives of Federal Financial Reporting, and Definition and Recognition of Elements of the Financial Statement. These projects ensure that Federal financial accounting standards are based on a sound framework of

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[10] *The 1983 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, p. 81.

[11] *The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, p. 57, shows a 75-year actuarial deficiency of 1.92 percent of taxable payroll. *The 2005 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, p. 60, shows a corresponding deficiency for the Medicare Hospital Insurance program of 3.09 percent.

[12] Adding any amount to the balance sheet that is not an accounting or legal liability, as discussed in the previous paragraph, would diminish the usefulness of the financial statements to the financial managers who use them. Adding such a large amount, as is proposed, would diminish further their usefulness.

objectives and concepts. One such objective, Stewardship, is particularly important because it requires an analysis not only of whether the Government's financial position improved or deteriorated, but also of whether future budgetary resources will be sufficient to sustain public services and meet obligations as they come due. As proposed in this letter, this objective could be accomplished with a new Presentation on Financial Sustainability in the Government's Financial Report, and additional data and analysis. Also, the Elements project is currently developing a definition for "liability" that would determine if future social insurance benefits are indeed liabilities. Issuing the Social Insurance Exposure Draft before completing these projects is premature. It increases the likelihood that inconsistencies could result between the Exposure Draft and the other projects or, alternatively, that the Exposure Draft itself could inappropriately predetermine the outcomes of the other projects. In addition, I believe that any new proposed social insurance standard should be issued only after a successful audit of the new Statement of Social Insurance has been completed, which becomes effective for the first time this year.

In light of the concerns raised above and the interest that we share in disclosing accurate and comprehensive financial information about the Government, I am confident that we can work together to present social insurance and all other programs in a way that reflects fairly and accurately the Government's true financial position and condition. Thank you, in advance, for taking the time to consider my views. Please contact me if you have any questions about the contents of this letter.

Sincerely,

Clay Johnson III
Acting Director

Enclosures