Accrual Accounting and Social Security
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Standards Watch

Accrual Accounting and Social Security

By: David Mosso, CPA

The Federal Accounting Standards Advisory Board (FASAB) is considering whether to require accrual accounting for the Social Security program. In this article, I will give only my personal views on the subject, not those of FASAB.

The federal unified budget reports Social Security program results on a cash flow basis. Policy is established through projections of cash flows for 75 years into the future. I believe reliance on cash flow accounting and projections disguises an inherent upside cash flow bias. This bias makes the program's finances look better than they really are and, when combined with the longstanding pay-as-you-go funding policy, leads to periodic solvency crises.

In this article, I explore the possible application of accrual accounting to the Social Security program for financial reporting. Note that I am not talking about changing the budgetary accounting basis from cash to accrual. I am only talking about reporting on an accrual basis in the financial reports of the Social Security Administration (SSA) and the *Financial Report of the United States Government.*

A look at the actual and projected Social Security cash flows from 1970 to 2078 shows a deficit projected in the out years. Three different measures of surplus or deficit have been used to project the current status of Social Security: federal budget, closed group and open group. These three measures of the Social Security surplus or deficit are very different and measure different things. The federal budget is the projection of cash flows through the end of the period covered by the budget. The closed group measure is a cash flow projection for all existing participants at a point in time until the last participant dies. The open group measure covers that same closed group population and adds in all new entrants to the work force over the next 75 years; the open group measure has been the primary guide for policy decisions made in the past. The closed group number is one possible accrual accounting measure of the deficit. It is substantially larger than the other two because the upside bias has been removed.

Together the measures are complementary and reinforcing; separately they can be misleading. They should be used together but are usually not.

FIGURE 1: Cash Flow Basis

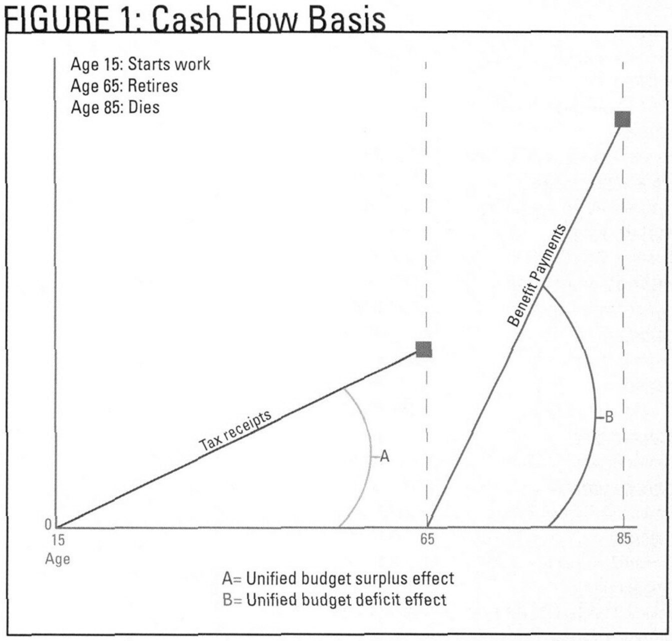
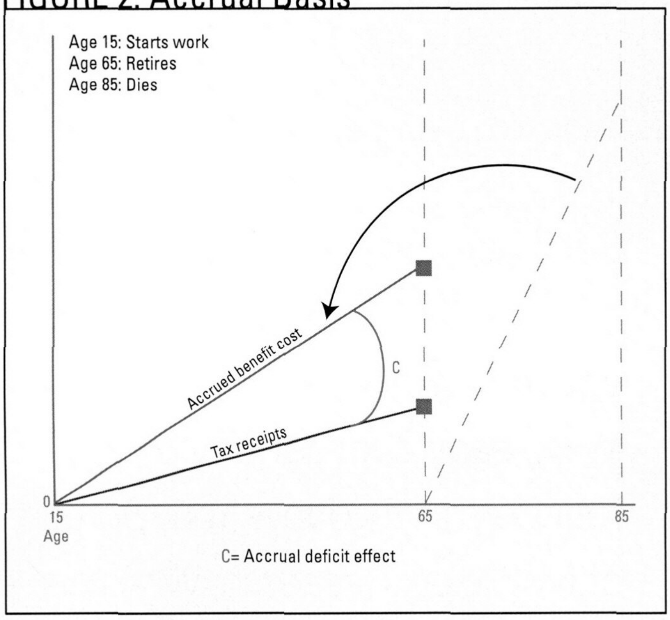


Figure 1 shows the cash flow pattern for a hypothetical individual who starts work at age 15, retires at age 65 and dies at age 85. The cash flow bias shows in that there are 50 years of unified budget surplus effect before there is a deficit effect in the final 20 years. It is those 50 years of leading receipts that put the bias into the unified budget and the open group projection.

All Social Security participants have the same pattern—cash inflows precede cash outflows. The bias expands if the work force grows, bringing in more of those leading-edge tax receipts. The bias contracts some if the worker-to-retiree ratio falls and benefit payments begin to catch up a little. But the bias is always there because there are always new entrants to puff up the receipt inflows. Therefore, on an open-group cash flow basis, the program always looks financially healthier than it really is.

Figure 2 shows how the preceding chart of cash basis accounting could be converted to accrual basis accounting. Mechanically, the diagonal dotted line in this chart is the footprint of the old benefit payments line in the preceding chart. The old benefit payments line has been transformed into the new accrued benefit cost line, which is now stretched over the first 50 years. Note that revenue minus cost is a deficit in this depiction but for any given individual it can be either a surplus or deficit.

FIGURE 2: Accrual Basis



Conceptually, that is the essence of accrual accounting—put all of the cash flow consequences of an event into the period when the event occurs. Accrual accounting discounts the later outflows and brings them back to the periods in which they accumulated. Accountants call that process "matching costs & revenues."

As I said earlier, the 75-year open group projection has been the primary tool used for setting policy. Projected surpluses have signaled that the program is in balance. Projected deficits have signaled a need to adjust taxes and/or benefits to return to balance.

Pay-as-you-go means that today's generation of workers pays the benefits for yesterday's generation and so on, leap-frogging into the future. Relative to 75-year spending, not much money accumulates in the trust fund. The implicit financial objective of pay-as-you-go funding is minimal solvency. It leaves no wiggle room and leads to periodic solvency crises.

The accrual chart above raises the question of whether different measures might be needed to signal the long-range sustainability of the Social Security program. An accrual-based liability is one guide to sustainability. Inordinate growth of the liability could bring attention to the potential for severe fiscal problems.

A recent Standard & Poor's credit report projected that if current fiscal trends continue, U.S. Treasury securities might be downgraded to "speculative" or "junk" status within the next 25 years. The myth that sovereign invincibility guarantees risk-free federal debt does not impress the capital markets.

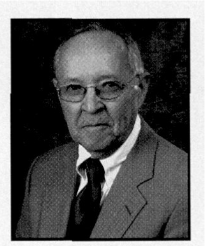
A. Haeworth Robertson, former chief actuary at SSA, said it well in his 1992 book *Social Security: What Every Taxpayer Should Know.* With regard to accrued liabilities based on prior work in covered employment for Social Security and Medicare, he stated:

"The fact we must face is that we have made promises worth $12 trillion [as of January 1, 1990] more than we have collected in taxes in the past. The choices are not many. We can make good on the promises by collecting higher future taxes than would have been required otherwise, or we can renounce some of the promises already made. Some would favor continuing to hide this unfunded accrued liability; but, whether hidden or explicitly acknowledged, it represents a significant lien on the nation's goods and services to be produced in the future."

Robertson summarized well the dilemma policy-makers face. The dilemma for accounting standard-setters is deciding how to deal with an arguably "hidden" liability. My own conclusions are three-fold:

- First, accrual accounting would remove the cash flow bias now embodied in reported Social Security financial reports and projections.
- Second, accrual accounting would provide additional useful information for Social Security policy-making.
- Third, accrual accounting would cast doubt on the viability of the pay-as-you-go policy, perhaps pointing to something more like a pay-your-own-way policy.

This article was adapted from a speech Mosso delivered to the American Accounting Association at the Kennedy School of Government, Harvard University, on April 1-2, 2005. To obtain Mr. Mosso's full remarks and a copy of the slides used for his presentation, go to www.fasab.gov and click on the link to "News Releases" in the left-hand column. For an update on the board's progress on various projects, including social insurance, click on the link to "Active Projects."



David Mosso, CPA, is the chairman of the Federal Accounting Standards Advisory Board. Prior to joining FASAB in 1997, he served for 10 years on the Financial Accounting Standards Board and was fiscal assistant secretary at the U.S. Department of the Treasury. Mosso has lectured and written on a variety of financial accounting issues.