May 10, 2010

United States Government's
Consolidated Financial Statements

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In 1976, the U.S. Department of the Treasury began preparing consolidated financial statements (CFS) for the United States Government on a proto type basis. The preparation of CFS was greatly facilitated by the 1990 Chief Financial Officers Act requirement of audited agency-wide financial statements and the availability of U.S. Generally Accepted Accounting Principles set by the Federal Accounting Standards Advisory Board (FASAB). In 1998, the U.S. General Accounting Office (now Government Accountability Office) conducted the first audit of the government-wide CFS. Unfortunately the first disclaimer of audit opinion was followed by a continuous series to the latest CFS for FY 2009. This paper explains the structure and contents of the CFS for the U.S. Government.

1. Reporting Entity

Since the late 1960s, the Federal Government has been following the principle of a "unified budget." The basic idea is that for the federal budget to fully reflect the Federal Government's impact on the economy, it should include *all* federal departments, agencies, programs and activities. As such, exclusions should be few and be justifiable. The same decision rule applies to the determination of the reporting entity "the United States Government."

The Consolidated Financial Statements encompass all three branches of the Federal Government, even though the legislative branch and the judicial branch are not subject to the control of the executive branch or covered by the CFO Act. If a department, agency, program or activity (organization in short) is included in the Budget of the United States, it definitely has to be included in the CFS. An organization could also be included because it exercises the Federal Government's power, carries out its missions and functions, is owned or control by the Federal Government, or has a fiduciary relationship with the Federal Government.

There are two major exclusions from the CFS. The first is the Federal Reserve System, consisting of the policy-making Board of Governors and the Federal Reserve Banks. The Federal Reserve makes monetary policies affecting money supply and interest rates. The Federal Reserve Bank in New York handles financial transactions on behalf of the U.S. Government. The chairman of the "Fed" and the governors are nominated by the President and confirmed by the Senate. However, it is excluded from the CFS by virtue of its independence in making monetary policy.

The second major exclusion concerns the financial institutions that are chartered by the Federal Government but are privately owned. These institutions are called government sponsored enterprises (GSE), and include: Federal National Mortgage Association, Federal Home Loan Banks, Farm Credit Banks. They were established to serve as financial intermediaries for channeling investment funds to specific segments (such as housing) and are subject to the oversight of a specific federal agency. Their private ownership is deemed the decisive basis for excluding them from the CFS and the budget of the U.S. Government.

The Consolidated Financial Statements show the data for the entire U.S. Government in one column for a particular fiscal year. The three branches of government are not distinguished. No distinction is made for the varying degree of presidential control over cabinet departments (e.g. the Defense Department), independent agencies (e.g. Securities and Exchange Commission), and government corporations (e.g. Postal Service). Governmental activities that exercise the power of the state and business-type activities are not separated either. This method of presentation is based on the notion that the American people hold the President and Congress accountable for managing the financial affairs of the entire government.

2. The Structure of the CFS

The Federal Government's financial statements describe its financial position at the end of a fiscal year, its financial performance during the fiscal year, and reconcile the accrual-based and cash-based financial results. Specifically, the five CFS in the order of their presentation are:

1. Statement of Net Cost
2. Statement of Operations and Changes in Net Position
3. Reconciliation of Net Operating Cost and Unified Budget Deficit
4. Statement of Changes in Cash Balance from Unified Budget and Other Activities
5. Balance Sheet
6. Statement of Social Insurance (since 2006)
7. Statement of Fiscal Sustainability (to begin in FY 2010)

The third and fourth financial statements listed above are in substance reconciliation schedules, in contrast to the primary financial statements of financial position and results of operations. The "unified *budget* deficit" mentioned in those two schedules is *actual* cash-based deficit. In other words, the correct interpretation of the term "unified budget deficit" in those schedules is: the deficit that resulted from implementing the unified budget concept. The term "**unified budget**" is used apparently to emphasize the fact that entities that are labeled as off-budget in the unified budget (mainly Social Security and Postal Service) are nevertheless included in the whole-of-government financial statements.

Exhibit 1 shows the relationships among the primary financial statements. The major elements of financial statements are described and related to each other in the left column. The middle column points out how revenue and expense items impact financial position. The right column identifies the primary financial statements, other than the reconciliation schedules. The statement of net cost and a statement of operations and change in financial position together make up the equivalent of the income statement of a business firm. The "net cost" statement is designed to answer the questions: How much of the cost of the Federal Government service was paid by customers, leaving the rest to be shouldered by taxpayers? The "operations" statement answers two question: Was tax revenue sufficient to cover the net cost? Consequently, did this fiscal year's operations improve or worsen the government's net financial position?

Exhibit 1 The Relationships Among the CFS

Description	Assets –	Liabilities =	Net Position	Financial Statements
Beginning position	xxx	xxx	xxx	Balance Sheet
Gross cost	Decrease	Increase	Decrease	Statement of Net Cost
-) Service revenue	Increase	Decrease	Increase	
= Net cost			Decrease	
Net cost			Decrease	Statement of Operations and Change in Financial Position
-) Tax revenue	Increase		Increase	
= Net operating cost			Decrease	
Ending position	xxx	xxx	xxx	Balance Sheet

The following sections will explain the contents of balance sheets, operating statements and the reconciliation between the cash deficit and accrual deficit.

3. Balance Sheets

The balance sheets of the Federal Government report its economic resources that are recognized as assets, and financial obligations that are recognized as liabilities, and the residual, i.e. net position. In principle, the Federal Government has chosen a broad measurement focus in presenting its financial position. Broad measurement focus means that all economic resources, including but not limited to financial resources, are recognized as assets. Similarly, both current and long-term liabilities are reported on the balance sheet.

The Federal Government has a variety of financial and non-financial resources, namely:

- Cash and other monetary assets.
- Accounts receivable.
- Direct loans receivable.
- Taxes receivable – only uncollected tax assessments, penalties, and interest
- Inventories and related property.
- Property, plant, and equipment.

As a consequence of its interventions in the 2008-09 credit crisis, the federal government's balance sheet at the end of FY 2009 shows TARP (Trouble Asset Relief

Program) direct loans and equity investments, beneficial interest in trust, and investments in government sponsored enterprises.

This extensive catalog of Federal assets nevertheless leaves out many valuable resources that are owned by the Federal Government, but are not amenable to financial measurement. These "stewardship assets" include federal land and heritage assets: natural heritage assets, cultural heritage assets and collection-type heritage assets. The assets also do not include so-called "stewardship investments," which are federal expenditures in physical property not owned by the federal government, investments in human capital (e.g. education) and research and development costs.

In general, liability is an obligation incurred in consequence of having received benefits or undertaking certain responsibilities. The Federal Government has liabilities arising from both of these sources, namely:

- Accounts payable
- Federal debt securities held by the public
- Interest payable
- Federal employee and veteran benefits payable
- Environmental and disposal liabilities
- Social insurance benefits due and payable
- Loan guarantee liabilities

Again, during the recent credit crisis, the federal government created insurance and guarantee, especially liquidity guarantee, programs. These gave rise to substantial liabilities for the federal government.

It should be noted that the federal government does not recognize as liabilities its *responsibilities* to make benefits payments under social insurance programs (such as Social Security and Medicare) as provided for in law. The amounts of future expenditures and revenues and the underfunding over 75 years in terms of present value are reported in the Statement of Social Insurance.

Following realization principle, the federal government does not recognize contractual obligations for undelivered goods as liability. These are disclosed in the notes to the financial statements.

4. Statements of Financial Performance

As the titles of the financial statements indicate, Federal accounting and financial reporting uses a number of special terms:

- In general, **cost** means expense calculated on the accrual basis.
- **Gross cost** refers to the gross expense of providing service, which is offset by **earned** (i.e. sales) revenue to result in **net cost** or equivalently net expense.
- Net cost of service is matched against **unearned revenue** (i.e. mostly tax revenue) to arrive at the result of operations during a period.
- When tax revenue exceeds net expense, the result is called **net operating revenue**, which is actual surplus measured by the accrual basis. When tax revenue

is insufficient to cover net cost, the result is called **net operating cost** or actual deficit measured by the accrual basis.

- "**Net position**" stands for net financial position or net assets.

As illustrated in Exhibit 1, the Federal Government presents its financial performance in two stages of matching. In the first stage, user fees offset gross cost (or expense) of service produced by a department to result in the net cost to taxpayers. In the second stage, tax revenues matches this net cost to produce the final net result of financial performance. For most recent years and in the foreseeable future, this net result is negative: the accrual deficit.

5. Reconciliation between Accrual Deficit and Cash Deficit

The Treasury Department keeps track of the Federal Government's cash receipts, outlays and balances throughout the fiscal year, and reports the annul and year-end amounts. This annual information is available in the Financial Highlights section of the Combined Statements of Receipts, Outlays and Balances. The CFS provides one schedule to reconcile the accrual deficit to the cash deficit and another schedule to reconcile the accrual deficit to the end-year cash balance.

In recent years, the accrual deficit numbers were larger than the cash deficit numbers mainly because the increases in liabilities for pension and benefits for civilian and military employees as well as veterans (recognized as expenses, thus increasing accrual deficit) were much larger than capital expenditures (increasing cash deficit, but only depreciation expense increases accrual deficit). However, during FY 2009, the relationship is reversed because the federal government spent huge amounts of borrowed cash (thus increasing cash deficit) to buy assets or shares of failing financial institutions and companies (which became assets of the federal government, thus not raising accrual deficit).

6. The Value and Limitations of the CFS

The Federal Government makes its budget documents public, issues agency financial statements, and frequently releases its "check book" (cash) information. When there is already so much financial information, one may legitimately wonder about the value of the Consolidated Financial Statements (CFS) of the United States Government.

The Consolidated Financial Statements add value to the federal budget disclosures in several ways. In contrast to budget scoring rules, accounting rules are more explicit, detailed and public. These financial statements are based on transactions and events that have occurred. As such, they provide largely factual information to verify the intentions, promises and forecasts made in the budget. Furthermore, while the budget emphasizes the budgetary resources authorized by Congress and the eventual cash outlays, the CFS take into account the liabilities for goods and services received. More generally, in contrast to the one-year cash projections in the federal budget, the CFS provide a comprehensive picture of the Federal Government's accumulated assets and liabilities.

Whereas federal financial statements demonstrate executive branch accountability to Congress, the Consolidated Financial Statements discharges the Federal Government's accountability to the American public. They drastically reduce the reader's costs of acquiring and analyzing the Federal Government's financial information. They present the financial consequences of presidential and congressional decisions and actions, which are beyond agency control. Furthermore, it is only through the consolidation process that the irreconcilable transactions between agency accounts were exposed.

The Consolidated Financial Statements are prepared under the accrual basis of accounting. In conjunction with the broad measurement of the balance sheet, the accrual basis compels the measurement and disclosure of costs that are deferred to the future. This long-range view contrasts sharply with the one-year focus on cash receipts and outlays in the annual budget. When the Federal Government has a "credit card" with virtually no credit limit on it, it is all the more essential to monitor the Federal Government's hidden – or at least obscure – debts.

Finally, the auditor's report provides valuable insights about the weaknesses in the federal government's internal control, as well as broader financial management issues. The billions of dollars of irreconcilable transactions undermine the credibility of published financial statements, but they also raise awareness of the need to invest in the federal government's accounting and financial management systems.

The federal government's consolidated financial statements also have a number of limitations. They have eliminated the effects of inter-departmental and inter-fund transactions, including borrowing (from the general fund by the social security trust fund) and subsidies (of Supplemental Medicare Insurance by the general fund). Some of these transactions have significant economic and political significance. What the federal government has done amounts to a "super-consolidation," with one column for the whole government. Given the diversity and complication of federal programs and activities, perhaps the federal government should consider a less aggregated form of reporting. As we will learn later in this course, state and local governments report their financial position and performance in terms of governmental activities, business-type activities, and fiduciary activities. The federal government also undertakes these three types of activities. However, the format of the current CFS does not allow users to separate them.

The contents and validity of the CFS are subject to the limitations imposed by capability of financial measurement. Perhaps the greatest weakness in federal accounting is the inability to meaningfully measure the so-called stewardship assets and responsibilities.

The presentations in the CFS are constrained by accounting and financial reporting standards. The tighter the recognition criteria, the more information is left off the financial statements. For example, the only Social Security liability recognized on the balance sheet is the very short-term "benefits due and payable." As another example, the narrowest possible interpretation of "legally enforceable claim" results in virtually no information about the potentially much larger amount of taxes due to the federal government under current tax laws.

The quality of the data in the CFS is jeopardized by the unreliability of underlying accounting systems. The flaws in the systems are so serious that the GAO has declined to express even a qualified opinion (define) twelve years in a row.

The GAO's disclaimer of audit opinion and description of serious weakness in the federal government's system of internal control and accounting practices put users of the federal government's consolidated financial statements in a suspenseful position. If the federal government's CFS had received a qualified opinion or even adverse opinion, the reader would at least be informed about instances of non-conformity with GAAP and their seriousness. A disclaimer has the tendency to cast pervasive doubts on the reliability and therefore credibility of the whole set of financial statements. This unfortunate state of affair is testament either to the GAO's high standards and/or the successive Administrations' failure to significantly improve the basic infrastructure of the Federal Government's financial management and accounting system. The federal government has been on a thirty-five journey of perfecting its financial reporting. Judging from the comments of the GAO, it still has a long way to go.