# Chapter 7
# U.S. FEDERAL GOVERNMENT FINANCIAL REPORTING AND ANALYSIS

Learning Objectives
- Explain the need for accrual-based financial statements for the U.S. Government.
- Identify the major components of the annual Financial Report of the U.S. Government.
- Describe the structure and contents of Consolidated Financial Statements (CFS) of the U.S. Government.
- Reconcile the accrual-based and cash-based deficits of the U.S. Government.
- Use data from the CFS to measure the U.S. Government's financial condition.

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## I. INTRODUCTION

As Chapter 6 pointed out, the United States Government has been producing consolidated (i.e. whole-of-government) financial statements on the accrual basis since the mid-1970s. Federal Government agencies also began preparing agency-wide financial statements and submitted them to audit as required by the 1990 Chief Financial Officers Act. As the Federal Accounting Standards Advisory Board's standards are developed and become effective periodically, they are implemented in agency and whole-of-government accounting and financial reporting. Agency financial statements have served as the building blocks of the whole-of-government statements. The monumental task of compiling and consolidating (i.e. eliminating the effects of intra-governmental transactions) is performed by the Financial Management Service of the U.S. Department of the Treasury. These accrual-based financial statements, however, have not replaced the Treasury's reporting of cash receipts, disbursements and balances, which is done on a daily basis and eventually at the end of each fiscal year. Since fiscal year (FY) 1997, annual consolidated financial statements (CFS) are audited by the Government Accountability Office (GAO), formerly called the General Accounting Office.

This chapter has four major parts. The first section will identify the major components of the annual financial report of the U.S. Government and explain the structure and contents of the Consolidated Financial Statements. The second section will discuss the Federal Government's financial position and assess its solvency status. The third section is concerned with government's financial performance as it is measured by the accrual basis and cash basis. In view of the sizeable differences between the deficit numbers under these two measurement methods, section four attempts to reconcile these two deficit numbers. The chapter concludes with an appraisal of the value and limitations of the Consolidated Financial Statements. The next chapter will show how accrual-based recognition criteria interpret the consequences of various transactions and events to result in the information in the CFS.

As there will inevitably be a time lag between the contents of these chapters and the Federal Government's current financial reports and accounting standards, the text will stress fundamental knowledge, which the reader can use to understand, monitor and critically analyze the Federal Government's evolving practice. This edition uses the data from Fiscal Years 2005 and 2004. The first few exercises at the end of this chapter will ask the reader to obtain more recent financial reports to the monitor the continuity and changes in Federal accounting and financial reporting over an extended period of time.

## II. ANNUAL FINANCIAL REPORTING

### A. The Duty to Inform the People

The Constitution of the United States (Article I, Section IX, Clause 7) requires 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." In a literal and narrow sense, public money refers to the cash in the government's treasury; its broader modern definition encompasses all the government's financial resources. Thomas Jefferson in

1802 stressed the importance of informing the American people and their representatives about the Federal Government's finances in this way:

> I think it an object of great importance… To simplify our system of finance, and to bring it within the comprehension of every member of Congress… the whole system [has been] involved in impenetrable fog. [T]here is a point… on which I should wish to keep my eye… a simplification of the form of accounts… so as to bring everything to a single center[;] we might hope to see the finances of the Union as clear and intelligible as a merchant's book, so that every member of Congress, and every man of any mind should be able to comprehend them to investigate abuses, and consequently to control them.

Since the Federal Government and its financial systems have expanded tremendously over the past two hundred years, the need for simplification has become even more critical. In order to inform the American people and their representatives about its finances, the Federal Government issues both forward-looking as well as retrospective fiscal documents (see Exhibit 7.1). The first category consists of budget documents that contain the President's budget requests and Congressional decisions on tax, spending and borrowing. The *Economic Report of the President* is included here because the federal budget is fiscal policy instrument designed to influence – and is in turn influenced by - the performance of the economy. The second category consists of interim and annual reports of the Federal Government and its individual departments and funds. These documents reflect the financial consequences of implementing public policy decisions and executing the federal budget.

**Exhibit 7.1 Fiscal Documents of the Federal Government**

| Budgets and Economic Documents | Financial Reports |
|---|---|
| • *The Budget of the U.S. Government* (annually prepared by the Office of Management and Budget and submitted by the President to Congress)<br>• Congressional appropriations and other tax, spending and borrowing decisions<br>• Cost of proposed legislations estimated by the Congressional Budget Office<br>• *Economic Report of the President* and analysis by the President's Council of Economic Advisors | • Cash-based and accrual-based financial statements for the U.S. Government as a whole<br>• Agency accrual-based financial reports.<br>• Treasury Bulletin<br>• Monthly Treasury Statements of Receipts and Outlays<br>• Monthly Statements of the Public Debt of the U.S.<br>• Special reports, such as Reports of the Trustees of the Social Security and Medicare Trust Funds |

For many years, the Treasury Department used its statements of cash receipts, disbursement and balances to discharge its constitutional responsibility for providing "a regular Statement and Account of the Receipts and Expenditures of all public Money." Contemporary interpretation of the government's fiscal accountability and transparency has resulted in the Federal Government's annual financial report, whose core is the Consolidated Financial Statements (CFS) prepared under the accrual basis in accordance with generally accepted accounting principles (GAAP). As promulgator of GAAP applicable to the Federal Government, the Federal Accounting Standards Advisory Board (FASAB) has stated that the objectives of federal external financial reporting are to help the public evaluate the Federal Government's fiscal performance in terms of:

- Budgetary integrity – government's fiduciary responsibility to use tax dollars in accordance with the law.
- Operating performance – the costs and achievements of government agencies and programs.
- Stewardship – government's protection of the nation's resources and actions to secure its financial future.
- Systems and control – adequate policies and procedures to safeguard and efficiently use the government's resources.

These objectives are met primarily through the preparation and publication of annual financial reports discussed in this chapter. The structure of the Consolidated Financial Report will be briefly discussed next, followed by a more detailed analysis of the Consolidated Financial Statements.

## B. Annual Financial Report of the U.S. Government

The annual Financial Report of the United States Government consists of six major sections: management discussion and analysis, Government Accountability Office report, financial statements, stewardship information, notes to the financial statements and supplemental information.

**The Management Discussion and Analysis**. The Management Discussion and Analysis (MD&A) is prepared by the Secretary of the Treasury on behalf of the Administration. It provides his insights into the information contained in the financial statements and other disclosures. Along with narrative overviews, the MD&A presents highlights in summary tables and graphs. It puts the government's financial condition in a broader context. The MD&A in the FY 2005 Financial Report, for example, covered the following topics:

- Financial results, including the impact of the war in Iraq started in that fiscal year. A new feature in the FY 2003 report was a table presenting the Federal Government's "additional responsibilities" for social insurance programs.
- The Federal budget (projected revenue, expenditure and borrowing) in the context of the American economy, including a discussion of the relationship between the budget deficit and the need for borrowing.
- The structure and mission of the U.S. Government, including the creation of the Department of Homeland Security that year.
- Significant accomplishments in management performance, including a scorecard that rates departments by their achievement in different areas (including financial performance) of the President's Management Agenda. Also mentioned were the Administration efforts to improve systems, controls and legal compliance.
- Finally, a concise characterization of the Consolidated Financial Statements (CFS): following FASAB standards, using the accrual basis and government-wide coverage of the financial statements.

**Government Accountability Office Report**. The GAO report presents the results of the GAO's audit of the CFS. In the FY 2005 report, the GAO stated that it was unable to obtain sufficient and reliable information upon which to give an audit opinion; so it gave a disclaimer of opinion. The GAO also gave an adverse opinion on the Federal Government's internal control systems, and identified non-compliance with applicable laws and regulations.

**Financial Statements**. The core of the annual financial report is a series of five related financial statements: Statement of Net Cost, Statement of Operations and Changes in Net Position, Reconciliation of Net Operating Cost and Unified Budget Deficit, Statement of Changes in Cash Balance from United Budget and Other Activities, and the Balances. These terms probably sound unfamiliar to you now and will be explained later. At this time, you need only know that the Federal Government does publish a set of articulated financial statements for the whole government. The primary financial statements describe the government's financial position and financial performance, and are augmented by several supplementary schedules.

**Stewardship Information**. The "Stewardship Information" section of the annual financial report is unique in Federal financial reporting. The Federal Government uses the term **stewardship assets** to describe its economic resources that cannot be quantified reliably by available financial measurement techniques. It also uses the term **stewardship responsibilities** to refer to its financial obligations that are not presently recognized as liabilities. In recent years this section has usually taken over thirty pages to clarify these ambiguous and complex concepts.

**Notes to Financial Statements**. Notes to the financial statement are considered an integral part of the financial statements. The fifty pages of notes elaborate on the elements of financial statements, as well as unrecognized resources and obligations. The first note deserves particular attention because it summarizes the actual accounting policies used to prepare the financial statements.

**Supplemental Information**. Finally, the Supplemental Information is intended to provide additional information about the Federal Government's finances not covered elsewhere in the annual financial report. In recent years, topics have included cost of deferred maintenance, unspent budget authority and distribution of tax burden.

## C. Consolidated Financial Statements

The Consolidated Financial Statements are the core of the Federal Government's annual financial report. They report on the United States Government as a whole. So the very first question we have to address is: What does the United States Government encompass?

**United States Government as the 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."

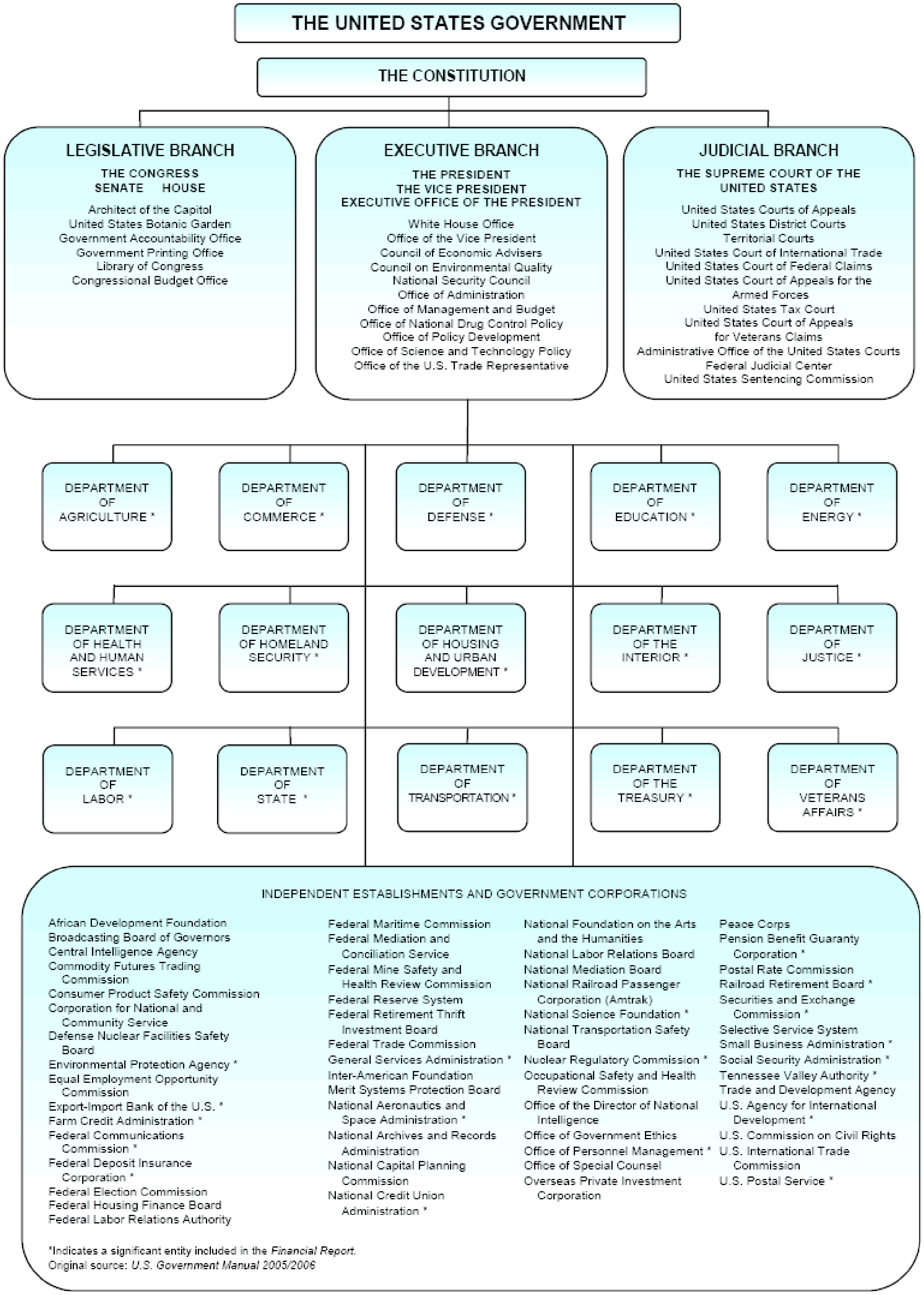
The Consolidated Financial Statements encompass all three branches of the Federal Government (see Exhibit 7.1), even though the legislative branch and the judicial branch are not subject to the control of the executive branch or covered by the CFO Act. If a department, agency, program or activity (organization 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. At the end of the annual financial report is an appendix listing the significant entities included in and excluded from the CFS.

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.

Exhibit 7.2
Organization Chart
Of the United States Government


THE UNITED STATES GOVERNMENT
THE CONSTITUTION
LEGISLATIVE BRANCH
THE CONGRESS
SENATE HOUSE
Architect of the Capitol
United States Botanic Garden
Government Accountability Office
Government Printing Office
Library of Congress
Congressional Budget Office
EXECUTIVE BRANCH
THE PRESIDENT
THE VICE PRESIDENT
EXECUTIVE OFFICE OF THE PRESIDENT
White House Office
Office of the Vice President
Council of Economic Advisers
Council on Environmental Quality
National Security Council
Office of Administration
Office of Management and Budget
Office of National Drug Control Policy
Office of Policy Development
Office of Science and Technology Policy
Office of the U.S. Trade Representative
JUDICIAL BRANCH
THE SUPREME COURT OF THE UNITED STATES
United States Courts of Appeals
United States District Courts
Territorial Courts
United States Court of International Trade
United States Court of Federal Claims
United States Court of Appeals for the Armed Forces
United States Tax Court
United States Court of Appeals for Veterans Claims
Administrative Office of the United States Courts
Federal Judicial Center
United States Sentencing Commission
DEPARTMENT OF AGRICULTURE *
DEPARTMENT OF COMMERCE *
DEPARTMENT OF DEFENSE *
DEPARTMENT OF EDUCATION *
DEPARTMENT OF ENERGY *
DEPARTMENT OF HEALTH AND HUMAN SERVICES *
DEPARTMENT OF HOMELAND SECURITY *
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT *
DEPARTMENT OF THE INTERIOR *
DEPARTMENT OF JUSTICE *
DEPARTMENT OF LABOR *
DEPARTMENT OF STATE *
DEPARTMENT OF TRANSPORTATION *
DEPARTMENT OF THE TREASURY *
DEPARTMENT OF VETERANS AFFAIRS *
INDEPENDENT ESTABLISHMENTS AND GOVERNMENT CORPORATIONS
African Development Foundation
Broadcasting Board of Governors
Central Intelligence Agency
Commodity Futures Trading Commission
Consumer Product Safety Commission
Corporation for National and Community Service
Defense Nuclear Facilities Safety Board
Environmental Protection Agency *
Equal Employment Opportunity Commission
Export-Import Bank of the U.S. *
Farm Credit Administration *
Federal Communications Commission *
Federal Deposit Insurance Corporation *
Federal Election Commission
Federal Housing Finance Board
Federal Labor Relations Authority
Federal Maritime Commission
Federal Mediation and Conciliation Service
Federal Mine Safety and Health Review Commission
Federal Reserve System
Federal Retirement Thrift Investment Board
Federal Trade Commission
General Services Administration *
Inter-American Foundation
Merit Systems Protection Board
National Aeronautics and Space Administration *
National Archives and Records Administration
National Capital Planning Commission
National Credit Union Administration *
National Foundation on the Arts and the Humanities
National Labor Relations Board
National Mediation Board
National Railroad Passenger Corporation (Amtrak)
National Science Foundation *
National Transportation Safety Board
Nuclear Regulatory Commission *
Occupational Safety and Health Review Commission
Office of the Director of National Intelligence
Office of Government Ethics
Office of Personnel Management *
Office of Special Counsel
Overseas Private Investment Corporation
Peace Corps
Pension Benefit Guaranty Corporation *
Postal Rate Commission
Railroad Retirement Board *
Securities and Exchange Commission *
Selective Service System
Small Business Administration *
Social Security Administration *
Tennessee Valley Authority *
Trade and Development Agency
U.S. Agency for International Development *
U.S. Commission on Civil Rights
U.S. International Trade Commission
U.S. Postal Service *
*Indicates a significant entity included in the *Financial Report*.
Original source: *U.S. Government Manual 2005/2006*

**The Structure of the Consolidated Financial Statements**. 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

Beginning in FY 2006, there will be an additional statement, titled the Statement of Social Insurance, which in previous years were included in the "Stewardship Information" section of the annual financial report. This statement shows the amount of money, in present value terms, the Federal Government will need in order to cover the projected long-term commitments of its major social insurance programs, such as Social Security and Medicare.

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.

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. These budget concepts will be explained in Chapter 9.

Exhibit 7.3 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 7.3 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 |
| -) Earned revenue | Increase | Decrease | Increase | |
| = Net cost | | | Decrease | |
| Net cost | | | Decrease | Statement of Operations and Change in Financial Position |
| -) Unearned revenue | Increase | | Increase | |
| = Net operating revenue or cost | | | Increase or decrease | |
| Ending position | xxx | xxx | xxx | Balance Sheet |

The following sections will present and explain the three primary financial statements: the comparative balance sheets at the end of fiscal years 2005 and 2004, the statements of financial performance for those years, and then the reconciliation between the accrual-based and cash-based deficit numbers.

Exhibit 7.4
United States Government
Balance Sheets
As of September 30, 2005, and September 30, 2004

| (in billions of dollars) | 2005 | 2004 |
|---|---|---|
| **Assets** | | |
| Cash and other monetary assets | $86 | $97 |
| Accounts receivable, net | 44 | 35 |
| Loans receivable, net | 222 | 221 |
| Taxes receivable, net | 22 | 21 |
| Inventories and related property, net | 272 | 261 |
| Property, plant and equipment, net | 678 | 653 |
| Securities and investments | 75 | 57 |
| Other assets | 57 | 52 |
| Total assets | $1,456 | $1,397 |
| **Liabilities** | | |
| Accounts payable | 68 | 60 |
| Federal debt securities held by the public and accrued interest | 4,624 | 4,330 |
| Federal employee and veteran benefits payable | 4,492 | 4,062 |
| Environmental and disposal liabilities | 260 | 249 |
| Benefits due and payable | 117 | 103 |
| Insurance program liabilities | 93 | 62 |
| Loan guarantee liabilities | 48 | 43 |
| Other liabilities | 213 | 198 |
| Total Liabilities | $9,915 | $9,107 |
| Contingent liabilities and Commitments | | |
| **Net position** | (8,459) | (7,710) |
| Total liabilities and net position | 1,456 | 1,397 |

## III. FINANCIAL POSITION

### A. Illustrative Balance Sheets

The balance sheets of the Federal Government (see Exhibit 7.4) 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.

### B. Assets and Stewardship Assets

The Federal Government has a variety of financial and non-financial resources, which are identified below.

*Cash and Other Monetary Assets***.** Cash consists of operating cash from revenue collection and debt proceeds, petty cash on hand, and time deposits. Other monetary assets include gold (valued at approximately $42 per ounce, even though the market price was $473 per ounce on September 30, 2005), domestic monetary assets (e.g. coins, silver bullion) and international monetary assets. International monetary assets include U.S. reserve position in the International Monetary Fund (IMF), U.S. holdings of Special Drawing Rights and official reserves of foreign currency and gold. SDR are international monetary reserves issued by the IMF, which acts as a kind of central bank for the world.

*Accounts Receivable*. The Federal Government's accounts receivable result primarily from the sale of good or services, duties, fines, and certain license fees. Accounts receivable are stated in their net realizable value, i.e. contractual amounts net of allowance for uncollectible accounts.

*Direct Loans Receivable*. The reported amounts of loans receivable are the face values of the loans, net of long-term cost of lending. Legislation enacted in 1990 requires the recognition of loans receivable as assets and the cost of lending as expense. For loans obligated since FY 1991, the amount of receivable is based on the present value of the net cash flows estimated over the duration of the loans. Prior loans are valued at their net realizable values. Net realizable value could be calculated by subtracting the amounts of estimated uncollectible from the principal amounts.

*Taxes Receivable*. The Federal Government does not recognize tax revenue using the accrual basis, where the taxes receivable would be the government's legal claims against taxpayers as soon as they earn taxable income. Since this practice is a significant deviation from the accrual basis, it is quoted as follows: "The category taxes receivable consists primary of uncollected tax assessments, penalties, and interest when taxpayers have agreed to the amounts are owed, or a court has determined the assessments are owed. The balance sheets do not include unpaid assessments when neither taxpayers nor a court have agreed that the amounts are owed (compliance assessments) or the Government does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency (write-offs). Taxes receivable are reported net of an allowance for the estimated portion deemed to be uncollectible." This policy amounts to what is called "an accepted modified cash basis of accounting" (*GAO Guide to the CFR*, 2005, p. 6).

*Inventories and Related Property.* The Federal Government holds a variety of inventories for resale, use or repair. A variety of measurement methods are used, including historical cost, net realizable value, and latest acquisition cost. The historical cost methods include first-in-first-out, weighted average, and moving average. A assortment of measurement methods are used to state the amount for operating materials and supplies, stockpile materials, commodities, seized and monetary instruments, and forfeited property.

*Property, Plant, and Equipment.* These fixed assets are carried on the books of the Federal Government at cost, net of accumulated depreciation. Depreciation and amortization expense is calculated for property (except land), plant, and equipment. The straight-line depreciation is generally used.

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 the 648 million acres of federal land and heritage assets: natural heritage assets (e.g. the Yellow Stone National Park), cultural heritage assets (e.g. the Washington Monument) and collection-type heritage assets (e.g. the holdings of the Smithsonian Institution, the National Archive and the Library of Congress). 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.

**C. Liabilities and Stewardship Responsibilities**

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. Following conventional financial accounting principles, the Federal Government does not recognize contractual obligations for undelivered goods as liability. It does readily recognize accounts payable arising from commercial transactions. As to the Federal Government's financial obligations under the Constitution, international treaties and agreements, or statutes, the interpretation of those obligations as reportable liabilities on the balance sheet is not a technical matter. It could raise profound legal and political issues. Be that as it may, following are the liabilities identified in the CFS:

*Accounts Payable.* These are amounts owed for goods ordered and received, and for services rendered by contractors, not Federal employees.

*Federal Debt Securities Held by the Public and Accrued Interest Payable.* The "public" here refers to individuals, corporations, state and local governments, Federal Reserve Banks, foreign governments and central banks. These debt securities are to be distinguished from intra-governmental debt holdings. For example, the funds that administer the social security program and employee pensions loan these excess cash balances to the U.S. Treasury in exchange of interest-bearing Treasury securities. These internal transactions are eliminated in the process of preparing the consolidated financial statements.

*Federal Employee and Veteran Benefits Payable.* The U.S. Government offers its civilian and military employees life and health insurance, pensions and health benefits upon their retirements from federal service. The costs of these benefits are recognized as expenses of the period in which employee services are rendered. The related liabilities for defined benefit pension plans and post-retirement health benefits are recognized primarily for estimated present value of future benefits. The amounts of liabilities and related expenses are significantly affected by the assumptions regarding interest rates, inflation rates and projected rates of salary increases used by actuaries.

One of the notes to the financial statements reveals that the Federal Government does not recognize liabilities for certain pension benefits to veterans and/or their depends for deaths or disabilities that are *not* related to military service. The estimated cost of such future pension benefits amounted to $97 billion in actuarial present value at the end of FY 2005.

*Environmental and Disposal Liabilities*. During World War II and the Cold War, the United States conducted research and produced a large quantity of nuclear and chemical weapons. These activities resulted in environmental contaminations, which the government is required by law to clean up. These clean-up costs are recognized as liabilities because the Federal Government has assumed responsibility for the consequences of its past decisions and actions.

*Benefits Due and Payable*. This liability concerns social insurance programs (e.g. Social Security and Medicare). The Federal Government only acknowledges short-term liabilities under social insurance programs for the amounts due but unpaid as of the balance sheet date. No liability is recognized for future benefits payment not yet due. But the Federal Government does acknowledge its *responsibilities* to make such benefits payments as provided for in law. As indicated in the "Management Discussion and Analysis*" of the FY 2003 CFS,* these additional responsibilities were estimated to be $27.7 billion at the end of FY 2003.

*Loan Guarantee Liabilities.* When the Federal Government provides loan guarantees, the law requires the recognition of liability in the amount of the present value of estimated net cash outflows due to potential defaults on guaranteed loans.

*Other Liabilities*. These include payables owed by the Federal Government pension benefit guarantee and other insurance programs, employee wages and benefits payable, grants payable, deferred revenue for advance payments by customers.

*Contingent Liabilities*. Contingent liabilities that are deemed as probable and measurable are recognized on the balance sheet; and increases in such liabilities during a period are recognized as expense for that period. Those that are regarded as remote are not reported in the financial statements or disclosed in the notes. The intermediate cases are disclosed in the notes.

Having dealt with the Federal Government's assets and liabilities, we are now in a position to assess its solvency status.

**D. The Federal Government's Solvency Status**

The balance sheets in Exhibit 7.4 show that the Federal Government was economically insolvent at the end of FY 2004 and 2005. That is, the government had far more liabilities than it had assets. The liabilities exceeded assets by approximately $8.5 trillion; or equivalently, the liabilities were about eight and one-half times the amounts of assets. This assessment, however, has to be qualified by the perhaps trillion dollars of economic value of the stewardship assets was not included in the asset numbers.

Similarly, at the end of FY 2004 and 2005, the Federal Government had a serious financial solvency problem. It had far more liabilities, all of which are financial in nature, than financial assets (Exhibit 7.5). In fact, the total liabilities were about 26 times total financial assets. This suggests that the Federal Government would have to engage in short-term borrowing to finance its operations. Unfortunately, the balance sheets do not explicitly identify current assets and current liabilities, so we cannot do further financial solvency analysis.

**Exhibit 7.5**
**Financial Solvency Analysis**

| Financial Indicator or Ratio | End of FY 2004 | End of FY 2005 |
|---|---|---|
| Cash and other monetary assets | $97 | $86 |
| Accounts receivable, net | 35 | 44 |
| Loans receivable, net | 221 | 222 |
| Taxes receivable, net | 21 | 22 |
| Total financial assets | $374 | $374 |
| Total liabilities | $9,107 | $9,915 |
| Net financial assets | -$8,733 | -$9,514 |
| Liability/(Total Financial Assets) | 24.4 times | 26.5 times |

In the long-term, the Federal Government has a bigger financial solvency problem. Conspicuously missing from the liability section of the balance sheet is the Federal Government's legal and financial **responsibility** to make payments under social insurance programs. Instead of recognizing this responsibility as a liability, the Federal Government has opted for extensive (30-page) disclosure in the Stewardship Information section of the annual financial report. In addition, the Management Discussion and Analysis displays a schedule that combines these "additional responsibilities" with liabilities to show a more complete and long-range perspective of future resource requirements. In view of the importance and magnitude of these programs, beginning in FY 2006, the Statement of Social Insurance will become the sixth financial statement in the Consolidated Financial Statements. That statement, however, will not be articulated with the other financial statements because of its different recognition criterion and measurement methods.

At the end of FY 2005, in actuarial present value, social insurance programs over the next 75 years would require $35.6 trillion to cover the excess of their benefit payments over their revenues, consisting of:

- $5.7 trillion for Social Security
- $8.8 trillion for Federal Hospital Insurance (Medicare Part A)
- $12.4 trillion for Federal Supplementary Medical Insurance (Medicare Part B)
- $8.7 trillion for Federal Supplementary Medical Insurance (Medicare Part D for prescription drug benefits).

# IV. FINANCIAL PERFORMANCE

## A. Illustrative Statements of Financial Performance

As mentioned earlier, the Federal Government presents its financial performance in two stages of matching. In the first stage, gross cost (or expense) of service produced by a department is offset by related user fees, resulting in net cost to taxpayers. In the second stage, this net cost is matched by taxes recognized for the period to produce the final net result of financial performance (see Exhibits 7.5 and 7.6).

## B. Elements of the Statements of Financial Performance

*Gross Cost or Expense.* The terms “expense” and “cost of service” are used interchangeably. Consistent with broad measurement focus, the expense for fiscal year generally reflect the consumption of economic resources in a period, as well as the incurrence of liabilities, for services received by the Federal Government, regardless of cash payment. Thus the gross cost includes depreciation expense, pension and other benefits earned by federal employees in a particular fiscal year. The implementation of this expense concept has resulted in the huge difference between the accrual-based cost of service with cash outlays – almost $450 billion in FY 2005, as we will see soon.

*Loan Subsidy Cost.* The Federal Government incurs a cost whenever it makes loans at interest rates below its own cost of capital. When it makes loans to individuals with higher default risks or guarantees loans to them, it also incurs a cost in terms of less loan repayments, less interest income, and payments to lenders. Together these interest and default subsidies are called loan subsidy cost. This cost is recognized when the Federal Government makes loans or provides guarantees. The difference between the present value of the net cash outflows and the outstanding principal of the direct loans is recognized as a subsidy cost. The subsidy expense for direct or guaranteed loans disbursed during the period is the present value of their estimated net cash outflows.

*Earned revenues* are recognized to the extent of goods and services are provided as is the case of business firms. The most familiar examples are the postal stamps you buy from the U.S. Postal Service, which is a Federal Government corporation, and the admission fees charged by some national parks.

*Unearned Revenue.* In general, revenue is increase in assets or decrease in liability. Unearned revenue results from the exercise of the government’s power to lay and collect tax and from other non-reciprocal transactions. Revenues from taxes, duties, fines and penalties are recognized when they are collected, adjusted to net measurable and legally collectable amounts. Related measurable and legally payable refunds and other offsets are netted against the recognized revenue. In other words, tax revenue is recognized on the basis of availability of current financial resources, i.e. cash. It is not recognized in the amount of the Federal Government’s enforceable legal claim against the taxpayer for having earned taxable income. This effectively puts the recognition of revenues from non-reciprocal transactions on a near-cash basis. Since expense is recognized on a full accrual basis, this results in what might be called an asymmetric application of accrual.

Exhibit 7.6
United States Government
Statements of Net Cost
For the Years Ended September 30, 2005, and September 30, 2004

| (in billions of dollars) | Gross Cost 2005 | Earned Revenue 2005 | Net Cost 2005 | Gross Cost 2004 | Earned Revenue 2004 | Net Cost 2004 |
|---|---|---|---|---|---|---|
| Department of Defense | 704 | 27 | 677 | 672 | 22 | 650 |
| Department of Health & Human Services | 623 | 40 | 584 | 584 | 44 | 550 |
| Social Security Administration | 572 | (2) | 574 | 535 | 3 | 532 |
| Department of Veterans Affairs | 276 | 3 | 273 | 51 | 3 | 48 |
| Interest on Treasury Securities held by the public | 181 | - | 181 | 158 | - | 158 |
| Department of Agriculture | 113 | 20 | 93 | 84 | 8 | 76 |
| Department of the Treasury | 82 | 3 | 79 | 79 | 4 | 75 |
| Department of Education | 76 | 5 | 71 | 64 | 5 | 59 |
| Department of Homeland Security | 75 | 7 | 68 | 46 | 6 | 40 |
| Department of Transportation | 62 | 0 | 62 | 57 | 1 | 56 |
| Department of Labor | 50 | - | 50 | 59 | - | 59 |
| Department of Energy | 47 | 4 | 43 | 27 | 5 | 22 |
| Department of Housing and Urban Development | 43 | 1 | 42 | 42 | 1 | 41 |
| Department of Justice | 27 | 1 | 26 | 35 | 1 | 34 |
| Office of Personnel Management | 33 | 14 | 19 | 22 | 14 | 8 |
| National Aeronautics and Space Administration | 16 | 0 | 16 | 17 | 0 | 17 |
| Department of the Interior | 19 | 3 | 16 | 19 | 2 | 17 |
| Department of State | 16 | 2 | 14 | 14 | 1 | 13 |
| Agency for International Development | 13 | 0 | 13 | 11 | 0 | 11 |
| Railroad Retirement Board | 10 | - | 10 | 9 | - | 9 |
| Environmental Protection Agency | 9 | 0 | 9 | 9 | 0 | 9 |
| Department of Commerce | 9 | 1 | 8 | 9 | 1 | 8 |
| Federal Communications Commission | 7 | 0 | 7 | 8 | 1 | 7 |
| National Science Foundation | 5 | - | 5 | 5 | - | 5 |
| Federal Deposit Insurance Corporation | 1 | 0 | 1 | 1 | 0 | 1 |
| Small Business Administration | 1 | 0 | 1 | 2 | 0 | 2 |
| Pension Benefit Guaranty Corporation | 5 | 4 | 1 | 17 | 4 | 13 |
| U.S. Nuclear Regulatory Commission | 1 | 1 | 0 | 1 | 1 | 0 |
| Tennessee Valley Authority | 9 | 9 | 0 | 8 | 8 | 0 |
| National Credit Union Administration | 0 | 0 | 0 | 0 | 0 | 0 |
| General Services Administration | 0 | 0 | 0 | - | 1 | (1) |
| Export-Import Bank of the United States | 0 | 3 | (3) | 1 | 3 | (2) |
| U.S. Postal Service | 56 | 69 | 13 | 54 | 68 | (14) |
| All other entities | 30 | 7 | 23 | 31 | 11 | 20 |
| Total | 3,175 | 225 | 2,950 | 2,732 | 207 | 2,525 |

Exhibit 7.7
United States Government
Statements of Operations and Changes in Net Position
For the Years Ended September 30, 2005, and September 30, 2004

| (in billions of dollars) | **2005** | **2004** |
|---|---|---|
| Revenue: | | |
| Individual income tax and tax withholdings | 1,690 | 1,512 |
| Corporation income tax | 272 | 184 |
| Unemployment taxes | 40 | 37 |
| Excise taxes | 71 | 72 |
| Estate and gift taxes | 25 | 25 |
| Customs duties | 22 | 21 |
| Other taxes and receipts | 47 | 48 |
| Miscellaneous earned revenues | 19 | 14 |
| Total revenue | 2,185 | 1,913 |
| Less net cost of Government operations | 2,950 | 2,525 |
| Unreconciled transactions affecting the change in net position * | 4 | (3) |
| Net operating cost | (760) | (616) |
| Net position, beginning of period | (7,710) | (7,094) |
| Change in accounting principle # | 4 | - |
| Prior period adjustments | 7 | - |
| Net operating cost | (760) | (616) |
| Net position, end of period | (8,459) | (7,710) |

* The $4.3 billion "plug" figure was needed in fiscal year 2005 to reconcile the ending balances with the results of operations, after considering adjustments for changes in accounting policy and for prior period's numbers. In other words, $4.3 billion worth of transactions could not be reconciled in that year. This item will be further explained later.

# $3.6 billion of adjustments were needed when the Air Force changed its inventory valuation method from Latest Acquisition Cost to Moving Average Cost. This had a favorable impact on the net position.

While the Federal Government does many things, most of its expenses (gross cost) were incurred in three major areas: (1) domestic security and national defense (including military operations and veteran benefits), (2) income security, health and human services, and (3) interest expense on Treasury securities held by the public. Military and security expenses amounted to about 30%; economic security, health and social services another 40%; and interest expense 6 to 7%. Together they make up ¾ of the cost of federal services.

The Federal Government produces mostly "public goods." There are numerous exceptions. The most notable exception is the social insurance programs that pay benefits individuals. Another exception is the U.S. Postal Service. Tax revenues account for 90% of total federal revenue. Federal individual income tax (including payroll taxes, mostly for social security) and corporate income taxes make up most of federal tax revenue.

## C. Relationship Between Financial Position and Performance

A comparison of the total assets, total liabilities, and total net assets between the end of FY 2004 and FY 2005 shows whether the Federal Government became better off or worse off between those two dates (Exhibit 7.8). While total assets increased by $59 billion, total liabilities increased by a bigger amount of $808 billion. The faster growth of total liabilities over that of total assets, in the amount of $749 billion, pushed net position to a deeper negative level of $8,459 billion.

As Exhibit 7.8 also shows, FY 2005 incurred accrual-based deficit of $765 billion, which was $153 billion larger than the accrual-based deficit for FY 2004. Conceptually, the accrual-based deficit of FY 2004 should be the amount by which net assets decreased during the year. How can the $765 billion of accrual-based deficit and the $749 billion worsening in net position be reconciled?

Exhibit 7.8
Financial Position and Performance

| Financial Indicators | FY 04 | FY 05 |
|---|---|---|
| *Financial Position Indicators* | | |
| Total assets as of end of the fiscal year | +$1,397 | +$1,456 |
| Total liabilities as of end of fiscal year | -$9,107 | -9,915 |
| Net [financial] position as of the end of the fiscal year | -$7,710 | -$8,459 |
| Deterioration of net [financial] position during FY 2005 | **-$749** | |
| *Financial Performance Indicators* | | |
| Total expense ("gross cost") for the fiscal year | -$2,732 | -$3,175 |
| Total service revenue ("earned revenue") for the fiscal year | +207 | +225 |
| Total (tax) revenue for the fiscal year | +1,913 | +2,185 |
| Total tax and service revenue for the fiscal year | +$2,120 | +$2,410 |
| [Unadjusted] accrual-based deficit for the fiscal year | -$612 | **-$765** |
| | | |
| Unadjusted accrual-based deficit for the fiscal year | -$612 | -$765 |
| Adjustment by effect of unreconciled transactions | -4 | +$5 |
| [Reported] Adjusted accrual-based deficit for the fiscal year | -$616 | **-$760** |

Exhibit 7.9
Explanation of Changes in Reported Net Financial Position

| | Amount |
|---|---|
| Reported net financial position as of end of FY 2004 | -$7,710 |
| Accrual-based deficit for FY 2005 | -765 |
| Overstatement of FY 2005 deficit due to unreconciled transactions | +5 |
| Net financial position as of the end of FY 2005 | -$8,470 |
| Prior period adjustments | +7 |
| Effect of change in accounting principle in FY 2005 | +4 |
| Reported net financial position as of the end of FY 2005 | -$8,459 |

The reconciliation is performed in Exhibit 7.9. The Federal Government's net financial position as of the end of FY 2004 was a negative $7,710 billion. The FY 2005 accrual-based deficit number produced by matching expenses and revenues was $765 billion. This deficit number was reduced to $760 billion to take into account the effects of transactions that the Federal Government's accounting systems could not reconcile.

(In other words, the $765 billion number was overstated by $5 billion.) Therefore the negative net position at the end of FY 2005 should have been negative $8,470 billion.

During FY 2005, the Department of Defense implemented a change in inventory valuation method from Latest Acquisition Cost to Moving Average Cost. This change in accounting policy instantly improved the *reported* net financial position of the Federal Government by $3.6 billion. Here is a dramatic illustration of the importance of accounting policy (and changes thereof). The FY 2005 year-end net position was reduced by $3.6 billion to reflect the transactions and events that had occurred prior to FY 2005.

In summary, the $749 billion reported worsening of the Federal Government's net position was a combination of (a) the effects of substantive transactions and events, the recognition of which produced the reported revenue and expense numbers, (b) the effects of accounting policy changes, and (c) the effect of the flaws in the Federal Government accounting system.

**D. Financial Performance Measured by the Cash Basis**

The Treasury Department keeps track of the Federal Government's cash receipts, outlays and balances throughout the fiscal year. The two reconciliation schedules in the CFS include the actual cash deficit numbers from the "check book" of the Federal Government. This information (see Exhibit 7.10) is available from the Financial Highlights in the Combined Statements of Receipts, Outlays and Balances, available at the website of the Financial Management Service of the U.S. Department of the Treasury.

Exhibit 7.10
United States Government
Total Receipts, Outlays and Deficits
For the Years Ended September 30, 2005 and September 30, 2004

| | 2005 | 2004 |
|---|---|---|
| Total receipts | $2,153 | $1,880 |
| Total outlays | 2,472 | 2,293 |
| Total cash-based deficit (-) | -$319 | -$413 |

To make these numbers more comprehensible, we might convert them to daily averages (Exhibit 7.11). We could then easily see that on a daily basis, the Federal Government spent $1 billion more in cash than it received in revenue. How could it do it? The answer is: by constant borrowing.

Exhibit 7.11
Daily Averages of Cash Flows

| Financial Indicator | FY 2004 | | FY 2005 | |
|---|---|---|---|---|
| | Total for FY | Daily Average | Total for FY | Daily Average |
| Total receipts | $1,880 | $5.15 | $2,153 | $5.90 |
| Total outlays | -$2,293 | -$6.28 | -$2,472 | -$6.77 |
| Cash-based deficit | -$413 | -$1.13 | -$319 | -$0.87 |

**E. Adequacy of Revenues**

By now we know that the Federal Government in FY 2004 and FY 2005 was running a deficit on both the cash basis and the accrual basis. We will reconcile these two numbers in the next section. Before doing so, we ask the question: How many years' worth of revenue would be necessary to pay off the accumulated liabilities?

Let us assume the current fiscal year tax revenue to be the average annual tax revenue in the foreseeable future. We can then relate the estimated annual revenue number into the various liability numbers. As Exhibit 7.12 shows, even if it were possible to ignore current year's expenditure requirements, it would take approximately 2 years to pay off federal debt alone, and another 2 years to liquidate pension and benefit liabilities. It would take 4 to 5 years' worth of tax revenue to pay off all the federal liabilities.

Exhibit 7.12
Future Revenues Needed to Liquidate Liabilities

| Financial Indicator | FY 2004 | FY 2005 |
|---|---|---|
| Annual tax revenue | $1,913 | $2,186 |
| Federal debt securities held by the public & accrued interest<br>Estimated number of years required to pay off this liability | $4,329;<br>2.3 years | $4,624;<br>2.2 years |
| Federal employee and veteran benefits payable<br>Estimated number of years to pay off this liability | $4,062;<br>2.1 years | $4,492;<br>2.1 years |
| Total liabilities<br>Estimated number of years to pay off total liabilities | $9,107;<br>4.8 years | $9,915;<br>4.5 years |

## V. RECONCILING ACCRUAL- AND CASH-BASED DEFICIT NUMBERS

We have seen that the Federal Government's accounting systems measure its financial performance in two ways. The cash accounting system keeps track of the government's actual cash receipts and cash disbursements (outlays) throughout the fiscal year and produces an actual cash-based deficit number for the fiscal year. This number is the "actual" counterpart to the projected cash deficit in the annual budget for the entire Federal Government. The accrual accounting system measures revenues and cost or expenses throughout a fiscal year and produces an actual accrual-based deficit number for the same fiscal year. The statement titled "Reconciliation of Net Operating Cost and Unified Budget Deficit" (Exhibit 7.13) explains how these two cash-based and accrual-based *actual* deficit numbers are related to each other so that their difference of $441 billion could be explained.

The statement "Reconciliation of Net Operating Cost and Unified Budget Deficit" is annotated in Exhibit 7.14 to cross-reference with the explanation in the text. The "Reconciliation" statement begins with the accrual-based deficit of $760 billion as a negative number. Therefore, an adjustment item that will make the deficit look smaller under the cash-basis deficit is a positive number. By the same token, an adjustment number that will make the deficit look larger under the cash-basis is a negative number.

Exhibit 7.13
United States Government
Reconciliations of Net Operating Cost and Unified Budget Deficit
For the Years Ended September 30, 2005, and September 30, 2004

| (in billions of dollars) | **2005** | **2004** |
|---|---|---|
| **Net Operating cost [actual accrued deficit]** | (760) | (615) |
| ***Components of Net Operating Cost Not Part of the Budget Deficit*:** | | |
| **Increase in Liability for Military Employee Benefits**: | | |
| Increase in military pension liabilities | 58 | 99 |
| Increase in military health liabilities | 109 | 42 |
| Increase in other military benefits | 3 | 2 |
| Increase in liability for military employee benefits | 170 | 143 |
| **Increase in Liability for Veterans Compensation and Burial Benefits**: | | |
| Increase/(decrease) in liabilities for veterans | 150 | (40) |
| Increase in liabilities for survivors | 47 | 10 |
| Increase in liabilities for burial benefits | 1 | 0 |
| Increase/(decrease) in liability for veteran's compensation | 198 | (30) |
| **Increase in Liability for Civilian Employee Benefits** | | |
| Increase in civilian pension liabilities | 43 | 40 |
| Increase in civilian health liabilities | 25 | 22 |
| Increase/(decrease) in other civilian benefits | (6) | 7 |
| Increase in liability for civilian employee benefits | 62 | 69 |
| **Decrease in Environmental Liabilities** | | |
| Increase/(decrease) in Energy's environmental liabilities | 8 | (2) |
| Increase in all others' environmental liabilities | 2 | 1 |
| Increase/(decrease) in environmental liabilities | 10 | (1) |
| Depreciation expense | 80 | 90 |
| Property, plant, and equipment disposals and revaluations | 48 | 0 |
| Increase in benefits due and payable | 14 | 3 |
| Increase in insurance programs | 31 | 37 |
| (Increase)/decrease in taxes receivable | (1) | 2 |
| (Increase) in accounts receivable | (9) | (1) |
| Increase in other liabilities | 15 | (5) |
| Seigniorage and sale of gold | (1) | (1) |
| Increase/(decrease) in accounts payable | 8 | (2) |
| ***Components of Budget Deficit Not Part of Net Operating Cost*** | — | — |
| Capitalized Fixed Assets: | | |
| Department of Defense | (110) | (83) |
| Civilian agencies | (37) | (29) |
| Total capitalized fixed assets | (147) | (112) |
| Decrease/(increase) in inventory | (11) | (9) |
| Decrease/(increase) in securities and investments | (18) | - |
| Increase in other assets | (5) | (12) |
| Principal repayments of preceded reform loans | 10 | 9 |
| Net amount of all other differences | (13) | 23 |
| **Unified budget deficit [actual cash deficit]** | (319) | (412) |

Exhibit 7.14
United States Government
Reconciliations of Net Operating Cost and Unified Budget Deficit
For the Year Ended September 30, 2005

| (in billions of dollars) | **2005** | Reference |
|---|---|---|
| **Net Operating cost [actual accrued deficit]** | (760) | |
| ***Components of Net Operating Cost Not Part of the Budget Deficit*:** | | |
| **Increase in Liability for Military Employee Benefits**: | | |
| Increase in military pension liabilities | 58 | |
| Increase in military health liabilities | 109 | |
| Increase in other military benefits | 3 | |
| Increase in liability for military employee benefits | 170 | 1 |
| **Increase in Liability for Veterans Compensation and Burial Benefits**: | | |
| Increase/(decrease) in liabilities for veterans | 150 | |
| Increase in liabilities for survivors | 47 | |
| Increase in liabilities for burial benefits | 1 | |
| Increase/(decrease) in liability for veteran's compensation | 198 | 1 |
| **Increase in Liability for Civilian Employee Benefits** | | |
| Increase in civilian pension liabilities | 43 | |
| Increase in civilian health liabilities | 25 | |
| Increase/(decrease) in other civilian benefits | (6) | |
| Increase in liability for civilian employee benefits | 62 | 1 |
| **Decrease in Environmental Liabilities** | | |
| Increase/(decrease) in Energy's environmental liabilities | 8 | |
| Increase in all others' environmental liabilities | 2 | |
| Increase/(decrease) in environmental liabilities | 10 | 7 |
| Depreciation expense | 80 | 2 |
| Property, plant, and equipment disposals and revaluations | 48 | 2 |
| Increase in benefits due and payable | 14 | 6 |
| Increase in insurance programs | 31 | |
| (Increase)/decrease in taxes receivable | (1) | 8 |
| (Increase) in accounts receivable | (9) | 8 |
| Increase in other liabilities | 15 | 3 |
| Seigniorage and sale of gold | (1) | |
| Increase/(decrease) in accounts payable | 8 | 5 |
| ***Components of Budget Deficit Not Part of Net Operating Cost*** | — | |
| Capitalized Fixed Assets: | | |
| Department of Defense | (110) | |
| Civilian agencies | (37) | |
| Total capitalized fixed assets | (147) | 10 |
| Decrease/(increase) in inventory | (11) | 4 |
| Decrease/(increase) in securities and investments | (18) | 9 |
| Increase in other assets | (5) | |
| Principal repayments of preceded reform loans | 10 | 11 |
| Net amount of all other differences | (13) | |
| **Unified budget deficit [actual cash deficit]** | (319) | |

Each of adjustment items is briefly explained, followed by an analytical journal entry. An analytical journal entry represents the summation of actual journal entries made over the course of the fiscal year. The analytical journal entries are useful for assessing the impact of the transactions or events on results of operations as measured on the accrual basis. For pedagogical purposes, net position is called net assets, gross cost is called expense, and net operating cost is called accrual-based deficit. All dollars in the journal entries are in billions.

1. *Increase in Post-employment Benefits*. Accounting recognition in FY 2005 of the increases in actuarial liabilities for (a) military employee benefits, (b) veterans compensation and burial benefits, and (c) civilian employee benefits raised FY 2005 expenses and therefore the accrual-based deficit. These accounting actions did not require cash outlays and therefore had no impact on cash-based deficit for FY 2005. Other things being equal, due to these three major items, the cash-based deficit would be smaller than the accrual-based deficit by $430 billion, which accounts for virtually all (98%) of the difference between these two deficit numbers.

| Account | Debit | Credit |
|---|---|---|
| NA. Expense – personal services | $430 | |
| L. Military employee benefits | | $170 |
| L. Veterans compensation and burial benefits | | 198 |
| L. Civilian employee benefits | | 62 |

We saw earlier that the Federal Government had to borrow cash constantly to finance cash deficits. It could reduce cash outlays by not paying cash now for the pension and other benefits earned by employees. Under the accrual basis of accounting, the Federal Government recognizes as personnel expenses the additional benefits granted that year to civilian and military employees as well as veterans. Hypothetically, suppose the law required those earned benefits be paid in cash to the employees and veterans, and assume no other changes affecting the cash deficit, the amount of cash deficit in FY 2004 would increase from $412 billion to $594 billion, and the FY 2005 cash deficit would more than double (see Exhibit 7.15). From this analysis, we can see that most of the difference (increase) in accrual-based deficit relative to the cash deficit was induced by seemingly “painless” policy decisions to improve employee and veteran benefits through larger actuarial liabilities.

**Exhibit 7.15**
**Saving Cash by Postponing Payment**

| Financial Indicator | FY 2004 | FY 2005 |
|---|---|---|
| Total increase in liability for military employee benefits | $143 | $170 |
| Total increase/(decrease) in liability for veterans compensation | ($30) | 198 |
| Total increase in liability for civilian employee benefits | $69 | 62 |
| Total increases in liability for employee and veteran benefits | $182 | $430 |
| Actual cash deficit | $412 | $319 |
| Cash deficit if increases in liabilities were all paid in cash | $594 | $749 |

*2. Depreciation Expense and Revaluation of Fixed Assets*. Depreciation expense and the losses associated with the disposals and revaluations of property, plant and equipment (PPE) raised FY 2005 expense and therefore accrual-based deficit. Since these items did not require cash outlays, they also had no impact on the cash-based deficit.

| Account | Debit | Credit |
|---|---|---|
| NA. Depreciation expense | $80 | |
| NA. Losses on PPE disposals and revaluations | 48 | |
| A. Property, plant and equipment | | $128 |

*3. Cash Advance for Service*. The "Reconciliation" shows a $15 billion increase in "other liabilities," which the notes identified as deferred revenue. Cash received in advance of service in reciprocal transactions was recognized under the accrual basis as a liability and not as revenue in FY 2005. In contrast, cash-basis accounting treated the receipts as FY 2005 revenue. Other things being equal, the cash-basis deficit was less than the accrual-based deficit by the $15 billion.

| Account | Debit | Credit |
|---|---|---|
| A. Cash | $15 | |
| L. Deferred revenue | | $15 |

*4. Cost of Goods Used or Sold*. Increase in inventory in FY 2005 was a decrease in expense of that year, thus decreasing FY 2005 accrual-based deficit. But the increase in inventory did not involve cash outlays and had no impact on the FY 2005 cash deficit.

| Account | Debit | Credit |
|---|---|---|
| A. Inventory [e.g. of supplies] | $11 | |
| NA. Expense – cost of goods used or sold | | $11 |

*5. Increase in Accounts Payable*. When the Federal Government received services from suppliers in FY 2005 but did not pay them in cash by year-end, it saved cash outlays in FY 2005 but had to recognize this amount as FY 2005 expense.

| Account | Debit | Credit |
|---|---|---|
| NA. Expense – for services received | $8 | |
| L. Accounts payable | | $8 |

*6. Entitlement Benefits Due and Payable*. Recognition of benefit payments due and payable for social insurance programs (such as Social Security) in FY 2005 resulted in increase in FY 2005 expense and liability as year-end. This accounting action explains another $14 billion of the difference between the accrual-based deficit and cash-base deficit.

| Account | Debit | Credit |
|---|---|---|
| NA. Expense– for benefits under entitlement programs | $14 | |
| L. Benefits due and payable | | $14 |

*7. Increase in Environmental Liabilities.* The Federal Government re-estimates its liability for environmental clean-up every year. Its environmental liabilities increased in FY 2005, thus increasing the difference between the two deficit numbers. Conversely, a decrease in environmental liabilities and in non-cash expense would reduce accrual-based deficit relative to the cash-based deficit.

| Account | Debit | Credit |
|---|---|---|
| NA. Expense – for clean-up the environment | $10 | |
| L. Environmental Liabilities | | $10 |

*8. Increase in Receivable.* Under the accrual basis, taxes receivable and account receivable were recognized as revenue. Recognition of more revenue in FY 2005 reduced the accrual-based deficit in that year.

| Account | Debit | Credit |
|---|---|---|
| A. Taxes receivable | $1 | |
| A. Accounts receivable | 9 | |
| NA. Revenue | | $10 |

*9. Recognition of Gains.* Recognition of FY 2005 gains associated with increases in investments reduce accrual-based deficit that year.

| Account | Debit | Credit |
|---|---|---|
| A. Investments | $18 | |
| NA. Gain | | $18 |

*10. Cash Payments for Capital Assets.* Cash payments for capital asset purchases in FY 2005 increased the cash-based deficit for that year. Since the cash outlays were "capitalized," they had no impact on accrual-based deficit in FY 2005. The $147 billion capitalized fixed asset purchases therefore offset the other adjustments that raised the accrual-based deficit relative to the cash-based deficit.

| Account | Debit | Credit |
|---|---|---|
| A. Property, plant and equipment | $147 | |
| A. Cash | | $147 |

11. *Repayment of Federal Loans.* When the Federal Government makes loans, it recognizes loans receivable when loan proceeds is disbursed. When the loans are repaid, the cash receipts reduce the amount of loans receivable. This is the current accrual accounting method required by a 1990 law, which changed the budgeting and accounting for federal loans. Earlier, federal loan disbursements resulted in cash outlays, and repayments of loan principal resulted in cash receipts. Thus the repayment of pre-1990 loans would reduce cash deficit in FY 2005, but had no impact on accrual-based deficit.

| Account | Debit | Credit |
|---|---|---|
| A. Cash | $10 | |
| A. Loans receivable | | $10 |

In summary, most of the differences between the cash-based and accrual-based deficit numbers are explained by the increases in estimated future cost for services rendered by civilian and military employees either rendered in FY 2005 or rendered in previous years but recognized in FY 2005. The larger amount under the accrual-basis was offset to some extent by the capitalization of cash outlays for fixed asset purchases.

## VI. THE VALUE AND LIMITATIONS OF THE CFS

### A. The Value 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 valuable information to the federal budget 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.

### B. Limitations of the CFS

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 and subsidies. 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) seven years in a role.

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. Since we learned from Chapter 6, the Federal Government has been on a thirty-your journal of perfecting its Consolidated Financial Statements. Judging from the comments of the GAO, it still has a long way to go. The Federal Government does not have the luxury of retreating from its quest for an unqualified audit opinion from the GAO. After all, the Consolidated Financial Statements are the only source of factual financial information about the entire Federal Government.

## VII. SUMMARY

Government has the unique power to tax and to regulate, thus imposing costs on some people or shift costs to others. The national government in particular has responsibility to provide public goods and promote the general welfare. In a democracy, an objective of government accounting systems is to produce and communicate financial information to promote financial accountability and transparency. This objective is achieved by presenting general purpose financial statements in accordance with generally accepted accounting principles (GAAP) and subjecting them to independent audits before they are distributed to the public.

Due to the federal system in the U.S., the American national government (often called the Federal Government) has a separate fiscal system. GAAP for the U.S. Government are set by the Federal Accounting Standards Advisory Board (FASAB) sponsored by its chief budgeting, finance and auditing offices. In compliance with legal requirements and following common practices, FASAB requires organization-wide financial statements for the U.S. Government as a whole and its constituent agencies. The Federal Government's consolidated statements are encompassing in scope and relatively concise, making them easier for the public to understand its financial position and performance. However, their aggregated nature prevent them from adequately showing internal fund transfers, especially the use of surpluses of the dedicated social insurance taxes to finance general government deficits. Furthermore, according to the government's audit agency, its systems and internal control problems were so serious that it could not state whether the financial statements fairly presented the government's financial position and performance. Since GAAP for the Federal Government was the auditor's basis for determining "fair presentation," most of this chapter is concerned with how FASAB standards influenced the form and contents of the financial statements.

The Federal Government's commercial enterprises and business-like activities use similar accounting principles for the private sector. Revenues are recognized to the extent goods are transferred or services are rendered, and expenses are matched against revenues to reveal income or loss. For general government operations, however, the emphasis of financial reporting and analysis is the cost of providing government services. In general, user fees pay for a relatively portion of the gross cost of service, and are deducted from it to arrive at the net cost of services. The net cost is then matched against taxes and other compulsory assessments to see whether the Federal Government's net financial position has improved or worsened during the year. While cost of service is measured with a high degree of accruals, i.e. including depreciation expense of capital assets used and attributable increases in long-term liabilities, tax revenues and compulsory assessments are recognized when cash is received and legally enforceable claims are established by taxpayer agreement or judicial proceedings. The financial statements in the CFS also include a reconciliation between the accrual-based results of operations and the cash-based deficits and cash position.

The Consolidated financial statements (CFS) of the United States are valuable additions to the stream of financial information published by the Federal Government. To the budget document, the CFS adds financial information with three characteristics: (a) the information in the CFS is based largely on actual transactions and events; (b) financial performance is measured on the accrual basis; and (c) the balance sheet presents the cumulative results to date and features liabilities and non-cash assets. To the year-end cash reports, the CFS adds non-cash revenues and expenses, along with liabilities and non-cash assets. The usefulness of the CFS is limited by its high level of aggregation and lack of information about intra-governmental transactions, by the exclusion of Federal Government resources and responsibilities whose recognition is prohibited by current federal accounting standards, and by the unreliability of some numbers due to accounting system and internal control problems. Nevertheless, since the CFS is the only comprehensive year-end financial overview of the Federal Government, they should be used while keeping the limitations in mind.

Due to the size and complexity of the Federal Government's finances, the CFS are correspondingly voluminous and complex. One way to make them bring them within the comprehension of "every member of Congress and every man of any mind" is to extract salient information from them to describe various aspects of the Federal Government's financial conditions. In order to achieve this purpose, this chapter has featured a number of financial indicators and ratios designed to gauge the Federal Government's overall financial position and performance, and to relate actual performance to earlier projections. The financial analysis has confirmed the Federal Government's serious liquidity and solvency problems due to decades' long accumulation of annual cash deficits. These deficits were the results of insufficient revenues to cover cash outflows, principally to pay for military operations and national defense, and senior citizens' public pensions and health care. The accrual method of measuring the cost of government operations makes the Federal Government's financial picture look even worse. Under this method, the Federal Government has to recognize as current expense the deferred compensation for pension and other benefits granted to civilian and military employees (including veterans). In view of the magnitude and growth of the Federal Government's expenses, the unwillingness and/or inability to raise tax revenues will lead to prolonged fiscal imbalance for years to come – on both the cash and accrual bases.

# APPENDIX 1

Financing Cash Deficits
FY 2004 and FY 2005

## United States Governments
## Statements of Changes in Cash Balance
## from Unified Budget and Other Activities
## For the Years Ended September 30, 2005, and September 30, 2004

| (in billions of dollars) | **2005** | **2004** |
|---|---|---|
| Budget receipts---actual | 2,153 | 1,880 |
| Budget outlays---actual | (2,472) | -2,293 |
| Unified budget deficit | (319) | -413 |
| **Adjustments for Noncash Outlays Included in the Budget:** | | |
| Interest accrued by Treasury on debt held by the public | (154) | (146) |
| Subsidy expense | 14 | 7 |
| **Items Affecting the Cash Balance Not Included in the Budget** | | |
| *Net Transactions from Financing Activity*: | | |
| Repayment of debt held by the public | 4,317 | 4,379 |
| Borrowings from the public | (4,614) | (4,759) |
| Total | (297) | (380) |
| *Net Transactions from Monetary Activity:* | | |
| Increase/(decrease) in special drawing rights | (5) | 1 |
| Decrease in other monetary assets | (0) | (1) |
| Decrease in loans to the IMF | (6) | (5) |
| Total | (11) | (5) |
| *Net Transactions from Other Activities:* | | |
| Net direct loan activity | - | 5 |
| Interest paid by Treasury on debt held by the public | 152 | 145 |
| Net guarantee on loan activity | (20) | (17) |
| Decrease in miscellaneous assets | 0 | 0 |
| Increase in allocations of special drawings rights | 0 | 0 |
| Increase in deposit fund balances | (2) | (3) |
| Increase in miscellaneous liabilities | - | (1) |
| Seigniorage and other equity | (1) | (1) |
| Reclassification of aged unreconciled accounts | - | - |
| NRRIT non-Federal securities | 2 | 2 |
| Total | 132 | 131 |
| **Disposition of Deficit** | (316) | (392) |
| Increase/(Decrease) in operating cash balance | (3) | (20) |
| **Operating Cash:** | | |
| Operating cash balance beginning of period | 31 | 51 |
| Operating cash balance end of period | 28 | 31 |

# APPENDIX 2

Consolidated Financial Statements
for FY 2002 and 2003

United States Government
Balance Sheets
As of September 30, 2003, and September 30, 2002

| (in billions of dollars) | 2003 | 2002 |
|---|---|---|
| **Assets** | | |
| Cash and other monetary assets | $120 | $142 |
| Accounts receivable, net | 34 | 32 |
| Loans receivable, net | 221 | 219 |
| Taxes receivable, net | 23 | 21 |
| Inventories and related property, net | 241 | 192 |
| Property, plant and equipment, net | 658 | 325 |
| Other assets | 97 | 65 |
| Total assets | $1,394 | $997 |
| **Liabilities** | | |
| Accounts payable | 62 | 56 |
| Federal debt securities held by the public and accrued interest | 3,945 | 3,573 |
| Federal employee and veteran benefits payable | 3,880 | 3,589 |
| Environmental and disposal liabilities | 250 | 273 |
| Benefits due and payable | 100 | 95 |
| Loan guarantee liabilities | 35 | 28 |
| Other liabilities | 227 | 202 |
| Total Liabilities | $8,499 | $7,817 |
| Contingent liabilities and Commitments | | |
| **Net position** | (7,105) | (6,820) |
| Total liabilities and net position | 1,394 | 997 |

United States Government
Statements of Net Cost
For the Years Ended September 30, 2003, and September 30, 2002

| (in billions of dollars) | Gross Cost | Earned Revenue 2003 | Net Cost | Gross Cost | Earned Revenue 2002 | Net Cost |
|---|---|---|---|---|---|---|
| Department of Agriculture | 96 | 11 | 85 | 81 | 10 | 71 |
| Department of Commerce | 9 | 1 | 8 | 7 | 1 | 6 |
| Department of Defense | 562 | 13 | 550 | 420 | 14 | 407 |
| Department of Education | 59 | 5 | 54 | 50 | 5 | 45 |
| Department of Energy | 2 | 5 | (3) | (3) | 5 | (8) |
| Department of Health and Human Services | 543 | 30 | 513 | 450 | 27 | 473 |
| Department of Homeland Security | 28 | 3 | 25 | * | * | * |
| Department of Housing and Urban Development | 44 | 2 | 42 | 36 | 2 | 34 |
| Department of Interior | 16 | 5 | 11 | 15 | 1 | 14 |
| Department of Justice | 31 | 1 | 29 | 30 | 2 | 27 |
| Department of Labor | 68 | | 68 | 65 | | 65 |
| Department of State | 13 | 1 | 11 | 11 | 1 | 10 |
| Department of Transportation | 64 | 1 | 63 | 65 | 2 | 64 |
| Department of Treasury | 75 | 3 | 72 | 66 | 4 | 62 |
| Interest on Treasury securities held by the public | 157 | — | 157 | 175 | | 175 |
| Department of Veterans Affairs | 176 | 2 | 174 | 218 | 3 | 216 |
| U.S. Agency for International Development | 10 | 0 | 10 | 8 | — | 8 |
| Environmental Protection Agency | 10 | 0 | 9 | 8 | 1 | 8 |
| Federal Emergency Management Agency | 3 | 1 | 2 | 6 | 2 | 4 |
| General Services Administration | 1 | 0 | 1 | 0 | 0 | 0 |
| National Aeronautics & Space Administration | 13 | 0 | 13 | 15 | 0 | 15 |
| National Science Foundation | 5 | — | 5 | 4 | — | 4 |
| U.S. Nuclear Regulatory Commission | 1 | 1 | 0 | 1 | 0 | 0 |
| Office of Personnel Management | 0 | — | 0 | 0 | — | 0 |
| Small Business Administration | 4 | 1 | 3 | 1 | 1 | 1 |
| Social Security Administration | 513 | 0 | 512 | 493 | 0 | 493 |
| Export-Import Bank of the United States | 0 | 0 | 0 | (1) | 0 | (2) |
| Federal Communications Commission | 7 | 1 | 6 | 7 | 1 | 6 |
| Federal Deposit Insurance Corporation | 0 | 0 | 0 | 2 | 1 | 1 |
| National Credit Union Administration | 0 | 1 | 0 | 0 | 0 | 0 |
| Pension Benefit Guaranty Corporation | 12 | 1 | 11 | 13 | 1 | 12 |
| Railroad Retirement Board | 10 | — | 10 | 9 | — | 9 |
| Tennessee Valley Authority | 8 | 7 | 1 | 8 | 7 | 1 |
| United States Postal Service | 82 | 68 | 14 | 83 | 66 | 17 |
| All other Authorities | 32 | 1 | 31 | 23 | 1 | 22 |
| Total | 2,650 | 165 | 2,486 | 2,416 | 157 | 2,260 |

United States Government
Statements of Operations and Changes in Net Position
For the Years Ended September 30, 2003, and September 30, 2002

| (in billions of dollars) | **2003** | **2002** |
|---|---|---|
| Revenue: | | |
| Individual income tax and tax withholdings | 1,481 | 1,539 |
| Corporation income tax | 128 | 14 |
| Unemployment taxes | 31 | 26 |
| Excise taxes | 68 | 68 |
| Estate and gift taxes | 22 | 26 |
| Customs duties | 19 | 18 |
| Other taxes and receipts | 40 | 49 |
| Miscellaneous earned revenues | 7 | 7 |
| Total revenue | 1,796 | 1,878 |
| Less net cost of Government operations | 2,486 | 2,260 |
| Unreconciled transactions affecting the change in net position * | 25 | 17 |
| Net operating cost | (665) | (365) |
| Net position, beginning of period | (6,820) | (6,459) |
| Change in accounting principle # | 383 | |
| Prior period adjustments | (3) | 4 |
| Net operating cost | (665) | (365) |
| Net position, end of period | (7,105) | (6,820) |

United States Government
Reconciliations of Net Operating Cost and Unified Budget Deficit
For the Years Ended September 30, 2003, and September 30, 2002

| (in billions of dollars) | **2003** | **2002** |
|---|---|---|
| **Net Operating cost [actual accrued deficit]** | (665) | (365) |
| ***Components of Net Operating Cost Not Part of the Budget Deficit*:** | | |
| **Increase in Liability for Military Employee Benefits**: | | |
| Increase in military pension liabilities | 9 | 22 |
| Increase in military health liabilities | 91 | 11 |
| Increase/(decrease) in other military benefits | 1 | 0 |
| Increase in liability for military employee benefits | 101 | 32 |
| **Increase in Liability for Veterans Compensation and Burial Benefits**: | | |
| Increase in liability for veterans | 93 | 148 |
| Increase in liability for survivors | 13 | 9 |
| (Decrease)/Increase in liability for burial benefits | 0 | 1 |
| Increase in liability fro veterans compensation | 106 | 157 |
| **Increase in Liability for Civilian Employee Benefits** | | |
| Increase in civilian pension liabilities | 57 | 17 |
| Increase in civilian health liabilities | 23 | 16 |
| Increase in other civilian benefits | 0 | 6 |
| Increase in liability for civilian employee benefits | 80 | 39 |
| **Decrease in Environmental Liabilities** | | |
| (Decrease) in energy's environmental liabilities | (26) | (29) |
| Increase/(Decrease) in all others' environmental liabilities | 3 | (5) |
| (Decrease) in environmental liabilities | (23) | (34) |
| Depreciation expense | 71 | 21 |
| Property, plant, and equipment disposals and revaluations | 13 | — |
| Increase in benefits due and payable | 5 | 9 |
| (Increase) In taxes receivable | (2) | 0 |
| Increase in other liabilities | 25 | 14 |
| Premium on early buyback of public debt | | 4 |
| Seigniorage and sale of gold | (1) | (1) |
| Increase/(decrease) in accounts payable | 6 | 0 |
| ***Components of Budget Deficit Not Part of Net Operating Cost*** | — | |
| Capitalized Fixed Assets: | | |
| Department of Defense | (68) | (18) |
| Civilian agencies | (35) | (23) |
| Total capitalized fixed assets | (102) | (41) |
| (Increase)/decrease in accounts receivable | (2) | 2 |
| Decrease/(increase) in inventory | 18 | (8) |
| Increase in other assets | (12) | (2) |
| Principal repayments of preceded reform loans | 9 | 8 |
| Net amount of all other differences | (4) | 1 |
| **Other:** | | |
| Prior period adjustments | 1 | 7 |
| **Unified budget deficit [actual cash deficit]** | (375) | (158) |

## United States Governments
## Statements of Changes in Cash Balance
## from Unified Budget and Other Activities
## For the Years Ended September 30, 2003, and September 30, 2002

| (in billions of dollars) | **2003** | **2002** |
|---|---|---|
| Budget receipts---actual | 1,782 | 1,853 |
| Budget outlays---actual | (2,157) | (2,011) |
| Unified budget deficit | (375) | (158) |
| **Adjustments for Noncash Outlays Included in the Budget:** | | |
| Interest accrued by Treasury on debt held by the public | (143) | (152) |
| Subsidy expense | 12 | 5 |
| **Items Affecting the Cash Balance Not Included in the Budget** | | |
| *Net Transactions from Financing Activity*: | | |
| Repayment of debt held by the public | 3915 | 3570 |
| Borrowings from the public | (4,289) | (3,791) |
| Total | (374) | (221) |
| *Net Transactions from Monetary Activity:* | | |
| Increase in special drawing rights | 0 | 1 |
| Increase/(decrease) in other monetary assets | (4) | 14 |
| Increase in loans to the IMF | 3 | 2 |
| Total | 1 | 17 |
| *Net Transactions from Other Activities:* | | |
| Net direct loan activity | 1 | 14 |
| Interest paid by Treasury on debt held by the public | 144 | 159 |
| Premium on early buyback of public debt | __ | 4 |
| Net guarantee on loan activity | (6) | (2) |
| Decrease in miscellaneous assets | 0 | (1) |
| Increase in allocations of special drawings rights | (1) | 0 |
| Increase in deposit fund balances | (3) | 0 |
| Decrease in miscellaneous liabilities | 1 | 3 |
| Seigniorage and other equity | (1) | (1) |
| Reclassification of aged unreconciled accounts | 0 | __ |
| NRRIT non-Federal securities | 21 | 2 |
| Total | 158 | 176 |
| **Disposition of Deficit** | (349) | (174) |
| Increase/(Decrease) in operating cash balance | (26) | 17 |
| **Operating Cash:** | | |
| Operating cash balance beginning of period | 61 | 44 |
| Operating cash balance end of period | 35 | 61 |

## KEY TERMS AND CONCEPTS

budgetary integrity operating performance stewardship public money
annual financial report consolidated financial statements
assets stewardship assets liabilities stewardship responsibilities
net position gross cost earned revenue net cost
unearned revenue net operating revenue net operating cost
accrual-based deficit cash-based deficit receipts outlays

## REFERENCES AND FURTHER REDINGS

*U.S. Department of the Treasury:*

U.S. Department of the Treasury, Financial Management Service, Consolidated Financial Statements of the U.S. Government, Fiscal Year 2005.

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GAO, Report on the Consolidated Financial Statements of the U.S. Government, Fiscal Year 2003 -- included in Financial Report of the U.S. Government for FY 2005.

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FASAB, Statement of Federal Financial Accounting Concepts 1 "Objectives of Federal Financial Reporting" (September 1993).

FASAB, Statement of Federal Financial Accounting Concepts 2 "Entity and Display" (June 1995).

FASAB, Statement of Federal Financial Accounting Concepts 4 "Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government" (January 2003).

FASAB, SFFAS 24 "Selected Standards for the Consolidated [Financial] Report of the United States Government (March 2003).

## REVIEW QUESTIONS

1. How did the 1990 Chief Financial Officers Act contributed to the improvement of federal accounting and financial reporting?
2. What does the Constitution of the United States require the Federal Government to do in informing the American people about the government's finances?
3. According to the FASAB, what are the objectives of federal financial reporting?
4. What significant entities are excluded from the Consolidated Financial Statements of the U.S. Government? Why?
5. What are the major sections of the Consolidated Financial Report of the U.S. Government?
6. What are the information contents of each of the Consolidated Financial Statements?
7. How are the Consolidated Financial Statements of the U.S. Government related to each other?

8. What are the main reasons why the accrual-based and cash-based deficit numbers are so different?
9. Why is the "Stewardship Information" section in the Consolidated Financial Report necessary? What information is disclosed there?
10. In relation to other fiscal documents of the Federal Government, what is the valued-added of the Consolidated Financial Statements? What are the limitations of the CFS?

**DISCUSSION QUESTIONS**

1. If Thomas Jefferson were alive today, what grade (A to F) would be give to the Federal Government in bringing its system of finance "within the comprehension of every member of Congress"?
2. Have the Consolidated Financial Statements of the U.S. Government succeeded in finances of the Union [i.e. the United States] as clear and intelligible as a merchant's book, so that every member of Congress, and every man of any mind should be able to comprehend them to investigate abuses, and consequences to control them"?
3. To what extent have the Consolidated Financial Statements met the objectives of financial reporting adopted by the FASAB?
4. On September 23, 2003, the Comptroller General of the United States said: "… the federal government's current measurement and score-keeping approaches leave much to be desired. The result is an incomplete and misleading picture of the federal government's current financial condition and fiscal outlook." Do you agree with the statement? Do the Consolidated Financial Statements present an incomplete and misleading picture of the Federal Government's current financial condition and fiscal outlook?
5. Referring to the Comptroller General's statement quoted above: which financial measurement methods of the Federal Government leave much to be desired, in your opinion?
6. What would be your response to the comment that the Consolidated Financial Statements are unconstitutional because the Constitution of the United States calls for a "regular statement and account of the receipts and expenditures…"?
7. In what respects are the Consolidated Financial Statements different from (a) the Combined Statements of Receipts, Outlays and Balances, and (b) the Budget of the United States?
8. Is there any justification that the Consolidated Financial Statements do not include a statement of budget comparison, with information about: actual revenue vs. projected revenue, actual outlay vs. projected outlay, and actual deficit vs. projected deficit?
9. What are the asymmetries or imbalances in the presentation of the Federal Government's financial position and performance?
10. What are the advantages and disadvantages of consolidating the financial statements of scores of federal agencies into one set of financial statements for the entire U.S. Government?

## EXERCISES

1. Match the special accounting terms used by the Federal Government with their definitions, plain-English meanings or counterparts in financial accounting:

| | | | |
|---|---|---|---|
| 1 | Earned revenue | A | Tax revenue |
| 2 | Net operating cost | B | Accrued surplus |
| 3 | Unified budget | C | Net assets, net financial position |
| 4 | Unearned revenue | D | Cash inflows, cash outflows and cash position |
| 5 | Consolidated financial statements | E | Congressional watchdog |
| 6 | Government Accountability Office | F | Sales revenue |
| 7 | Net operating revenue | G | Budget for the whole government |
| 8 | Receipt, outlays and balances | H | Accrued deficit |
| 9 | Net position | I | Off-the-balance-sheet federal resources and responsibilities |
| 10 | Stewardship assets and liabilities | J | Financial statements for the whole government |

2. Accessing the website of the Financial Management Service of the U.S. Department of the Treasury, and print out the summary annual cash receipts and outlay figures for the most recent fiscal year ended.
3. Access the website of the Financial Management Service of the U.S. Department of the Treasury, and print out the Consolidated Financial Statements for the most recent fiscal year ended.
4. Use the data from Exercises 2 and 3 to update the financial statement analysis in this chapter.
5. Construct analytical journal entries (as illustrated in the text) to explain the reasons for the difference between the cash-based deficit and accrual-based deficit numbers for the most recent fiscal year for which data are available.