STATEMENT

of

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FINANCIAL REPORT OF THE U.S. GOVERNMENT, 1999:
Implications for FASAB

The latest *Financial Report*, the third annual version of the document formerly known as the *Consolidated Financial Statements of the U.S. Government*, is a significant but disappointing milestone. It is the first volume issued since FASAB standards were designated as generally accepted accounting principles for the federal government. However, it serves as a reminder of the board's need to evaluate its work agenda in terms of the progress the government has made toward FASAB's reporting goals.

FASAB's *Objectives of Federal Financial Reporting* (July 1993) provide clear guidance as to the desired end. They intend for the federal government to demonstrate accountability, provide useful information, and improve the management of government by making required disclosures that address four concerns: budgetary integrity, operating performance, stewardship, and systems and controls.

Accordingly, the *Financial Report* should enable the user to monitor various aspects of the federal government:

- the source and use of budgetary resources,
- the costs of operations,
- the effectiveness and efficiency of programs,
- the adequacy of future resources for sustaining services and meeting commitments,
- the benefits of programs and their implications for national well-being,
- changes in the government's financial position,
- its performance in safeguarding assets, and
- the consistency of the budget with other sources of information.

On the basis of the 1999 report, I conclude that the federal government has not succeeded in meeting FASAB's objectives. To make significant progress, the Treasury needs to allocate more time and resources to preparing the report, and FASAB needs to provide more and different direction.

I summarize my assessment of FASAB standards with three observations about the report.

First, the report emphasizes the government's inability to report its financial performance or position using audited accounting information and implicitly exaggerates the importance of the audit. More important, the report fails to address the reporting objectives.

Second, the 1999 report is not significantly better than the 1998 version. It is largely unchanged in message and structure, and the differences in the latest version are an equal mix of forward and backward steps.

Third, the report lacks a unified focus. It is a parade of components rather than a report on overall financial performance and position. As a direct consequence, it fails to provide a critical stewardship message.

I will elaborate on each of those observations and then point out some implications for FASAB standard setting.

THE AUDIT, THE WHOLE AUDIT, AND NOTHING BUT THE AUDIT

The single theme of the 1999 report is that the government is unable to report its financial performance or position using audited accounting information. Beyond that, no consistent message is offered. The failure to achieve an audit opinion appears to have robbed the preparers of their authority, ability, and willingness to say anything important. Whatever the reason, the result is a *mea culpa* accompanied by text and tables that the reader is cautioned not to rely on.

For example:

- The Secretary's opening transmittal letter observes, "significant progress continues to be made. . . . The quality of data continues to improve. The successful Year 2000 remediation process has resulted in better systems. . . . Despite this progress, we have much yet to achieve."

- The Management's Discussion and Analysis (MD&A) section repeats exactly the accomplishments noted in the Secretary's letter and declares, "Nonetheless, we have more to achieve." The section continues not with substantive information about financial performance or position but with a discourse on the government's lack of reliable, historical financial information, the work of FASAB, the accrual basis of accounting, and the reporting entity. Those topics are not irrelevant, but they are at best a placeholder for information about performance and condition.

- Finally, the MD&A falls on its sword: "despite progress over the past year, GAO again was unable to render an opinion on the reliability of the Government-wide financial statements."

- The audit letter and audit report account for 25 percent of the pages in the report. Those condemn with sustained confidence, mostly repeating the 1998 letter and report. The wordy style and enumeration of insignificant detail add nothing to the primary message or readability of the report.

Now consider what the report contributes to our reporting objectives:

Source and Use of Budgetary Resources. The MD&A has a pie chart showing the components of federal revenue (e.g., 72.3 percent from individual income taxes and withholding) that replicates the chart in the first chapter of the President's budget. The supplemental information section has a table on unexpended budget authority. There may be a reader of the report who could explain the significance of that information to the government or the nation. I cannot, and the accompanying text in the report does nothing to enlighten me.

Costs of Operations. The Statement of Net Cost is meaningless at such a high level of aggregation (health, commerce and housing credit, etc.) and without standards of comparison. (Is $140 billion a lot or a little for health?) With few exceptions, the net cost detail provided in the supplemental section also stops well short of a definable activity (health care services, health care research). Where the information reported is at a meaningful level (postal service, deposit insurance), net cost cries out for explanation and reconciliation with other reported information. How did the "self-supporting" Postal Service and deposit insurance programs have net costs of $18 billion and $3 billion, respectively?

Effectiveness and Efficiency of Programs / Benefits and Welfare. Without performance measures, the report makes no claim to inform the reader about these objectives.

Sustainability of Policies. This topic is so critical to the objectives of FASAB that I discuss it separately below as a weakness of the underlying reporting model.

Changes in Financial Position. The MD&A dismisses the balance sheet, including the unremarked negative net position, with: "the U.S. government's most important financial resource, its ability to tax and regulate commerce, cannot be quantified and is not reflected. Natural resources, stewardship land, . . . national defense assets, and heritage assets are other examples of resources that are not included in the $883.0 billion of federal assets reported on the Balance Sheet at the end of fiscal 1999. As can be seen, significant assets of the Federal Government are not reflected on the Balance Sheet."

Then, after a cursory discussion of current year revenues and expenses ["the excess of revenue over net cost figure (accrual basis) contained in these financial statements for fiscal 1999 is $76.9 billion"], net cost ["$1756.0 billion in 1999"], and the long-term budget outlook ["favorable–even more so than only a few years ago"], the MD&A returns to the theme of improving government management, including the successfully addressed Y2K problem, modernization of student aid

delivery, reengineering of the naturalization process, the census, and the "daunting problems" of modernizing systems and controls. Except for the reference to the budget surplus, the report has nothing to say about changes in financial position.

Safeguarding Assets. Weaknesses in systems and controls are emphasized repeatedly, and the report acknowledges important missing elements, such as mission support equipment from the Stewardship Report on national defense assets. But the report makes no effort to interpret those weaknesses. Is the government suffering significant losses of valuable or dangerous assets? How serious is the problem? Is this merely a failure to do accounting for accounting's sake?

Consistency of Budget Data. The absence of any attempt to reconcile budget and accounting cost for specific programs has been noted. The reconciliation of excess revenue over net cost ($76.9 billion) with the unified budget surplus ($124.4 billion) includes a $30.5 billion net adjustment for "unidentified difference."

In sum, a cover-to-cover reading of the report finds little that is consistent with the FASAB reporting objectives.

THE GLACIAL PACE OF IMPROVEMENT

The failure of the 1999 report to accomplish FASAB's reporting objectives would be less cause for concern if that report were a significant improvement over the 1998 version. It is not. The small changes that have been made seem equally divided between gains and losses.

On the gain side, the MD&A in 1999 reads less like a political document and more like the work of objective professionals. It is less apt to claim grand achievements for the current Administration and more apt to credit the rest of the government with contributions. That is a step toward accuracy and enhanced credibility.

The 1999 version is 17 pages longer, which provides increased opportunity for informative disclosure. The new pages are allocated as follows:

- The auditor's section, which already occupied one-fourth of the report, adds a page to chastise the government for using Social Security projections as of January 1, 1999, and Medicare projections as of September 30, 1999, rather than those of January 1, 2000.

- The Stewardship section adds three pages to report investments in nonfederal physical property, human capital, and research and development.

- The Notes section is increased by seven pages to add information on deferred maintenance, accounts receivable, subsidy expense for direct loans and guarantees, and collections and refunds of federal revenue.

- The remaining additional pages are taken up by reformatting and page breaks.

The 1999 audit opinion seems slightly less harsh than before. Specifically, the 1998 Disclaimer of Opinion is modified as shown by the terms in brackets:

> Because of the serious deficiencies in the government's systems, recordkeeping, documentation, financial reporting, and controls, [readers are cautioned that] amounts reported in the financial statements and related notes do [may] not provide [be] a reliable source of information for decision-making by the government or the public.

Thus, in 1999, the auditor softened the declaration that the amounts reported do not provide a reliable source of information to a "caution" that the amounts

reported “may not be a reliable source.” Is this intended to signal that the auditor thinks things are better? If so, it is a very subtle way of saying so.

Yet the 1999 report is no closer to an audit opinion than the previous year’s version. The massive material deficiencies are unchanged: property, plant, equipment, and inventory controls; loans receivable and guarantee liabilities; environmental and disposal liabilities; military postretirement health benefits; cost of government operations; improper payments (moved to the section on ineffective internal controls); cash disbursement; preparation of financial statements; and ineffective internal controls.

The latest version corrects some errors in the 1998 report, including the mislabeling of the chart showing Social Security Estimated Trust Fund Balances. But production quality is lower in 1999, as indicated by incomplete headings (pp. 43, 102), typos in a heading (p. 7), missing bullets (pp. 51-52), inconsistent use of shading to indicate higher- and lower-order headings (pp. 7-11), repeated lines of text (top of p. 36), reversal of labels on chart lines (p. 61), and misnamed federal departments (p.12). While each of those errors is a minor matter by itself, the cumulative effect is to predispose the reader to assume that any eye-catching anomaly is merely a report error.

ALL TREES, NO FOREST

The current approach to preparing the *Financial Report* is to compile short versions of the reports of individual departments and agencies and to eliminate some intragovernmental transactions and balances. The missing element is a sustained focus on the sum of the parts. Instead, the report adopts an agency perspective. That results in extended and misleading discussions of the "solvency" of individual programs and trust funds rather than the overall financial position of the government. Such an orientation prevents the government from adequately communicating the foreseeable and dramatic consequences of the baby boomers' retirement in combination with current Social Security and Medicare policy.

The security of commitments made by the federal government cannot be assessed by the financial condition of individual programs. The government's ability to discharge specific obligations depends on its overall financial position. For example, measured by its fund balances and long-term commitments, the Civil Service Retirement System for federal employees is in a much stronger financial condition than Social Security. But it would be wrong to conclude from the status of the trust funds that CSRS benefits are more secure. Obligations of the U.S. government are obligations of the U.S. government, not of the Social Security Administration or the Office of Personnel Management.

The Forest View. In fact, the U.S. government–not any of its individual programs–needs to review its overall spending and revenue plans because current policies, taken as a whole, cannot be sustained without adverse economic consequences. In simplest terms, the nation has saved too little to support the future consumption that the government has promised and that people expect to enjoy. The most visible cause of that imbalance is the imminent planned retirement of the large generation born just after World War II.[1] For earlier generations, retirement consumption has been financed from private savings and, since the advent of Social Security in 1935, by payroll tax transfers from the employed to the retired. The same sources will finance benefits in the future, but the large generation nearing retirement age has been promised Social Security and Medicare benefits that must be paid for by a proportionately smaller workforce. Over the next 30 years, the number of covered workers per Social Security beneficiary will drop from 3.4 to 2.1. Under current law, social insurance revenues will be about 7 percent of GDP by 2030, while social insurance expenditures will exceed 12 percent of GDP. In addition, the government will need to continue to provide for the national defense, administer justice, and carry out all its other major duties. Paying for projected spending under current policy will require raising taxes or borrowing.

1. For a more complete analysis, see Congressional Budget Office, *Long-Term Budgetary Pressures and Policy Options*, May 1998.

There are only two things we can do to make the situation easier for succeeding generations: we can choose to save now (both as individuals and as a government) to increase the productive capacity of the economy in the future, or we can accept lower benefits.[2]

That fiscal condition of the government seems ideal for disclosure in the *Financial Report.* It is foreseeable; it is sufficiently big that the absence of audited accounting reports does not obscure it; and much of the worst harm can be mitigated by changing expectations and behavior now. It is hard to imagine a case in which financial disclosure of the need for change could be offered with more confidence or benefit. But it is a condition that can be identified and disclosed only through a consolidated view of federal finances.

Into the Trees. The agency perspective embodied in the *Financial Report*, however, allows the government to avoid adequately communicating the needed readjustment of expectations and policies. Worse yet, the report contributes to complacency and the likelihood that policy and behavior will not be changed until the opportunity to mitigate the harm has passed.

The 1999 report first broaches this issue in the MD&A under the heading Long-term Budgetary Outlook. That section opens by saying:

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2. Dan Crippen, "Social Security Mirage," *Washington Post*, May 18, 2000.

> The longer term economic and budget outlook is favorable–even more so than only a few years ago. With prudent fiscal policy the budget could remain in surplus for many decades.

Then, referring to the baby boomers and the pressure they will put on the budget through Medicare and Social Security, the text advises:

> Fiscal discipline–paying down the debt and reducing or eliminating interest payments–improves the long-run budget balance. Additional reforms such as the Administration proposals described below, will be needed to strengthen Social Security and Medicare.

That statement is less than a fiscal fire alarm. Indeed, the future squeeze on disposable income is treated as though it were a technical legislative matter for the Administration and the Congress to work out. If the Administration already has a plan that pays full benefits for 50 years (p. 11), then a longer-term solution is not likely to cause the current generation of readers much worry.

In notes intended to explain the financial statements, the government appears to wash its hands of the long-term outlook:

> The magnitude and complexity of social insurance programs, coupled with the extreme sensitivity of projections relating to the many assumptions of the programs, produce a large range of possible results. The Stewardship Responsibilities section describes the social insurance programs, reports long-range estimates that can be used to assess the financial conditions of the programs, and explains some of the factors that impact the various programs. Using this information, readers can apply their own judgement as to the solvency and sustainability of the individual programs.

The Stewardship Responsibilities section includes charts showing trust fund balances for each social insurance program. Here the 1999 report continues the program view and thus errs in depicting trust fund assets as factors reducing the Social Security and Medicare deficits. Assets of trust funds are intragovernmental claims, not assets of the government as a whole. Accordingly, they disappear on consolidation. That change from 1998 is all the more anomolous in light of the fact that FASAB adopted SFFAS 17, "Accounting for Social Insurance," in 1999. In adopting that standard, the board rejected as misleading any suggestion that the "assets" held by a social insurance trust fund reduce the resources that the government will need to pay benefits.[3]

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3. Letter of Dan L. Crippen, Director, Congressional Budget Office, to the Honorable Lawrence H. Summers, Secretary of the Treasury, April 11, 2000.

According to the Stewardship section, the combined balance of the OASI and DI trust funds reaches zero in 2034 and then continues falling for the rest of the 75-year projection period. Trust fund balances for Medicare Part A are exhausted in 2015. That section also has tables showing the present value of additional resources needed (over and above projected earmarked receipts) to make payments for Social Security and Medicare under current law: $3.7 trillion for OASDI and $3.1 trillion for Medicare Part A.

Those charts and tables and the accompanying text do not disclose the nature or extent of the choices facing the country. One reason is that lines showing trust fund balances falling through a region of negative numbers do not suggest that anything troubling is happening. Throughout the 75-year projection period, current benefits are assumed to be paid in full and on time. No complementary chart shows the rising tax burden and cuts in other services that will be necessary to make those payments.

To change the focus and produce a meaningful, government-wide financial report will require a more comprehensive approach to reporting. Given time and resources, the preparers can do much to improve the report on their own, but FASAB also needs to act.

IMPLICATIONS FOR FASAB

First, we need to impose a government-wide perspective on the *Financial Report*. For starters, we might revert to the former name: *consolidated* financial statements. But the real objective is to shift the focus of the report from the trees to the forest. The board has appropriately rejected the balance sheet as a central unifying statement. But we have not put anything that could serve the same function in its place. One promising alternative is a modified version of the Current Services Assessment (CSA). The CSA projection now extends only through fiscal year 2005, but if it was replaced by a long-term budget projection of 75 years or more, it would contribute to shifting the focus from programs to the overall financial position. It would also constitute a major step toward meeting the stewardship objective of disclosing the sustainability of current policies under expected economic conditions. Another advantage of including a long-term budget projection as a prominent statement is that it would recognize both future tax revenues and future social insurance payments, without the necessity of putting either on the balance sheet.

Second, we need to help the preparers overcome the professional reticence that an adverse audit opinion seems to have created. The importance that is currently attached to the audit is grossly overblown. We cannot wait for the auditor's approval before the government will provide the public and policymakers with a

useful report. One option is to require the Administration to provide its best assessment of the overall financial performance of the government, now and over the long term. In that case, the accounting standards should not permit a "clean opinion" on a report that does not provide a clear and comprehensive assessment of financial condition. Another option is to require the government to explain its GPRA objectives and provide measurable performance indicators that would permit the public to gauge annual progress toward their achievement.

Third, we need to expand the reporting of net costs substantially. Net cost should be reported at a meaningful level of disaggregation, such as postal service and deposit insurance rather than health care services and other income security, to take four examples from the current report. We also need to add meaningful explanations of those costs in relation to outputs, as well as other sources of information, including the budget and press accounts. Where appropriate, we need to encourage cost comparisons between federal and private producers (such as for electricity production, pilot training, and hospital services). To avoid trying to do too much, the *Financial Report* could list the Web site addresses for component entity reports and for the performance reports of the U.S. government and its component agencies.

Fourth, we need to ensure that the report is made more inviting and readable. That could be accomplished in several ways:

- Severely restricting the number of pages that the audit letter and report take up. That portion of the report is verbose, repetitive, and obscure. If it was limited to a few pages, the interruption in flow would be reduced and the focus on important issues would be enhanced. Of course, nothing would prevent the auditor from publishing a detailed audit report of any length and referring readers to that report.

- Increasing the amount of time devoted to producing the report. The MD&A needs to be written in a more concise, readable style. Doing that well takes time. Moreover, proofreading and editing have clearly been sacrificed under the extreme time pressures of the current production schedule. I, for one, would be willing to trade a delay in production for more substance, more clearly presented. Another possibility is to abandon the hope that the required financial report can serve as a vehicle for communicating useful information to a wide audience. If so, FASAB should try to identify an alternative report or reports that could serve that function.

- Ensuring that the report has a message relevant to our objectives, stated plainly and directly.