

A True Portrait of America's Finances

Analyzing the Federal Government's Fiscal Year 2018 Financial Statements

By Bill Bergman

In late March, the U.S. Department of the Treasury issued the fiscal year 2018 financial report for the U.S. government. The report had some bad news, and was notable for its timing, reported results, fiscal projections, accounting for liabilities, auditor opinion, and rhetoric. The public reaction raised perhaps the biggest red flag, however—the report was delivered to deafening silence. This does not bode well for ensuring the integrity of the public purse.

The recognition void also provides an opportunity for CPAs to advance their profession as well as the public interest. This article reviews the report and asks readers to help build public awareness and advocate better government finan-

cial reporting in the United States. A follow-up article will review recent developments in financial reporting by state and local governments.

The Timing

The Treasury Department released the report on March 28, 2019. In 2018, the annual financial report arrived on February 15. The reason for the delay this year was the longest federal government shutdown in the history of the United States. It lasted more than 30 days, ending in late January.

The shutdown started after the federal government failed to pass necessary funding legislation, leading to furloughs for an estimated 800,000 “nonessential” federal workers, as required under the Anti-Deficiency Act. How workers are determined to be “essential” or “nonessential” matters for the timeliness and quality of financial reporting; the Anti-Deficiency Act specifies “emergencies involving the safety of human life or the protection of property” as exceptions allowing for continued government services during required shutdowns.

Government financial reporting certainly provides protection for property. As the Statement and Account clause of the U.S. Constitution recognized and intended, financial reporting should help secure accountability for a taxpayer-funded public purse. But the Anti-Deficiency Act states that the protection of property does not include exceptions for service shutdowns that do “not imminently threaten” safety or property.

This is why many government workers who matter to the annual financial report were legally barred from doing their work while the shutdown lasted. The implication is that government financial reporting is not an essential government service.



The Reported Results

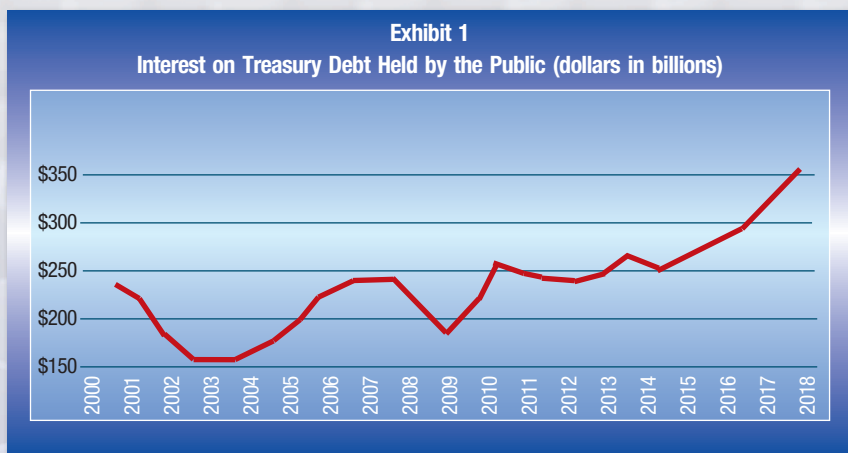
Significant uncertainty shrouds the government's reported financial results, given some important accounting issues and the Government Accountability Office's (GAO) disclaimer opinion on the financial statements. But a close read indicates that the federal government's financial condition continued to deteriorate significantly in FY2018. Bad news arrived in the income statement, the balance sheet, and the government's discussion of its own affairs.

The income statement is called the "Statement of Operations and Changes in Net Position." In 2018, total revenue came to \$3.4 trillion, with individual income tax and tax withholdings accounting for more than 80% of total revenue. But total revenue fell far short of total net cost, leading to net operating cost—a negative bottom line—of approximately \$1 trillion.

The federal government's net operating cost ballooned 10 years ago amidst the Great Recession. It recovered from more than \$2 trillion in 2009 to approximately \$800 billion (still a negative result) in 2014. But results have deteriorated anew in the waning years of the Obama Administration and the early years of the Trump Administration, despite favorable economic and financial market trends.

Another warning signal comes within the income statement. Interest on Treasury securities held by the public has been on a long-term uptrend in the last two decades, despite falling interest rates (see *Exhibit 1*). Interest expense growth accelerated in the last two years, and the report's projections for future borrowing and interest expense growth under current law and policy raise questions about the sustainability of U.S. fiscal policy.

The report also includes a measure called the "fiscal gap." This represents the combination of spending cuts or tax increases deemed necessary to keep the debt/GDP ratio from projected rapid (and unsustainable) increases in future decades. As shown in *Exhibit 2*, the fiscal gap doubled in 2018. Note that the fiscal gap is expressed as a percentage of GDP, and GDP tends to

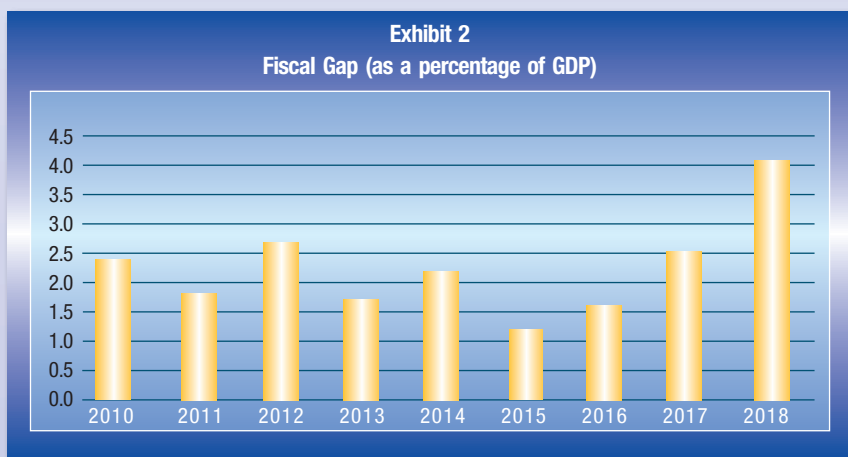


grow over time, at least in the recent past.

Assets have long fallen short of reported liabilities in the federal government's balance sheet, which showed roughly \$4 trillion in assets against \$25 trillion in liabilities in fiscal year 2018. The total net position (assets less liabilities) fell from negative \$20.4 trillion in 2017 to negative \$21.5 trillion in 2018, a more than \$1 trillion decline, consistent with the result for net operating cost. From 2009 to 2018, a period that included an economic recovery from the worst recession since the Great Depression,

grew from \$50 billion in 2000 to their current amount, with most of the growth occurring after the onset of the economic and financial crisis in 2007–2009.

The risk of these assets deserves scrutiny. The accelerating growth in reported loan assets began amidst transformation from loan guarantees to direct government lending—contemporaneous with massive government bailouts of the banking system and reduced employment prospects for young people. On the federal government's balance sheet, student loans are reported net



the federal government's negative net position effectively doubled downward.

The largest and fastest growing assets underlying the reported net position—student loans—also deserve attention. In 2018, student loan assets were reported (gross) at nearly \$1.2 trillion, amounting to nearly one-third of total reported assets (*Exhibit 3*). Student and related education loans

of estimated long-term income (cost). Some observers question the government's accounting for these loans, as well as the assumptions for future loan repayments. This asset may have a rocky road ahead.

The 2018 report began, as it always does, with an introductory summary message from the Secretary of the Treasury. Faced with the challenging task of present-

ing financial results he could be pleased with, Treasury Secretary Steven Mnuchin's discussion then turned to favorable economic conditions. He asserted that government policy could build greater prosperity and, in turn, higher government revenues and a stronger fiscal outlook in the years ahead. From there, he concluded with a commitment to transparency and to "facilitate open and productive dialogue so that all Americans can work together towards a more secure and prosperous future."

Unfortunately, there has not been much of a dialogue. The 250+ page report arrived

This analysis underlies the above-noted discussion of the fiscal gap. But the report also emphasizes the cost of delay in addressing these issues. The longer the government waits to reform law and policy to keep the debt-to-GDP ratio from rising in the future, the more costly the required tax increases or spending cuts will be. The government has now been delaying since the cost-of-delay discussion first entered the report in 2010.

Accounting for Liabilities

The federal government's balance sheet

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to deafening silence. It was not covered anywhere in traditional media, including the *Wall Street Journal*, *New York Times*, or *Washington Post*.

Fiscal Projections

The report's executive summary followed the message from the Treasury Secretary. It covered recent results in a little more depth in a summary titled "Where We Are Now," then moved to a section that used to be titled "Where We Are Headed." This year, however, the section was called, bluntly, "An Unsustainable Fiscal Path."

The section showed a chart with current projections for noninterest spending, net interest, and total spending, all expressed as a share of GDP. Demographic trends loom over Social Security and Medicare projections: under current law and policy, debt and interest spending are implied to mushroom as a share of GDP, becoming so high as to be effectively unsustainable.

delivers almost \$4 trillion in reported assets, compared to more than \$25 trillion in reported liabilities. As bad as that looks, it isn't nearly as bad as the reality. That's because the federal government makes its own accounting standards, under which it chooses not to count the massive holes in Social Security and Medicare as liabilities on its balance sheet.

The annual "Analytical Perspectives" document prepared for the President's budget holds some clues on how the government justifies this treatment. Chapter 4, "Federal Borrowing and Debt," identifies debt as "the largest legally and contractually binding obligation of the Federal Government." It then says this debt includes debt "held by the public" and debt owed to government accounts. The latter includes securities issued to the Social Security and Medicare Trust Funds.

Those funds, however, are not to be trusted. The discussion in the President's budget squares the circle, as in recent years, with the following reasoning:

Issuing debt to Government accounts does not have any of the credit market effects of borrowing from the public. It is an internal transaction of the Government, made between two accounts that are both within the Government itself.

That helps explain why the government does not include debt obligations to the trust funds on its balance sheet: the government says those debts are owed to itself.

The federal government does prepare "Statements of Social Insurance," including Social Security and Medicare present value calculations. But the massive (tens of trillions of dollars) negative net present values in those programs are not included as liabilities on the consolidated balance sheet either. In a summary of his testimony to the Federal Accounting Standards Advisory Board hearing on the issue in 2007 (<http://bit.ly/2W51AF7>), Stephen Goss, chief actuary of the Social Security Administration, provided the following reasoning:

An overriding uncertainty exists under the Social Security (and all Federal Social Insurance) programs. This is the Government's right and ability to alter potential future benefits. Until benefits become due and payable, there is no binding commitment over which a worker has control and so no liability can be recognized. ... Because the Federal Government retains the right to alter benefits up to the time they are due, there can be no liability until benefits become both due and payable.

Truth in Accounting has recast the federal government's balance sheet to include the negative net present values of Social Security and Medicare as liabilities. Using this approach, the balance sheet arrives at a negative net position of more than \$100 trillion. This approach is based on a "closed group" perspective, as the federal government itself once used, and does not count on future participants in its calculations.

These adjusted "Statements of Social Insurance" show a negative net present value for Social Security of more than \$16

trillion in 2018. This total results after calculating 75-year present values for three classes of participants: current participants who have reached eligibility age, current participants who are not yet eligible for benefits, and future participants (i.e., the young and the unborn). That \$16 trillion hole has deepened by approximately \$3 trillion in the last five years, despite a huge (and growing) *positive* position for the program in the future participant category.

In 2017, the Social Security Administration launched a new website section to help people sign in and view their estimated benefits for Social Security. The front page of that section included the messages “set yourself free” and “rest easy, knowing that you’re in control of your future.” How does that square with the government’s reasons for not including those obligations as liabilities in its balance sheet?

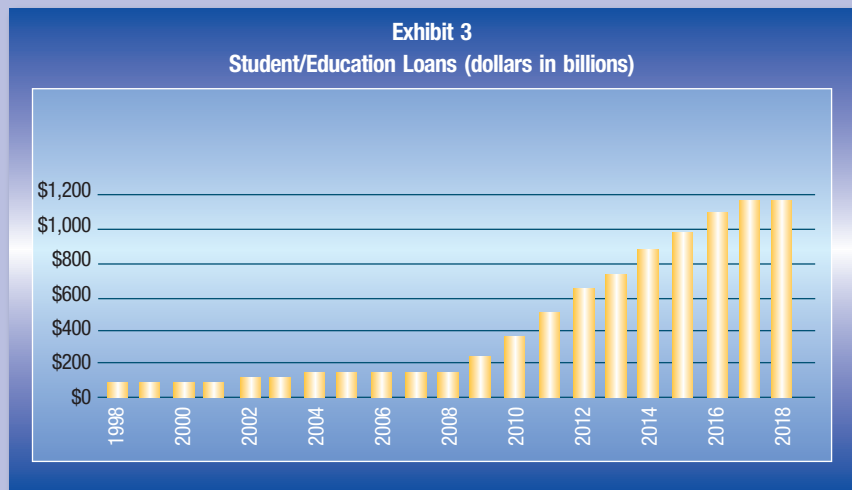
In 2004, the annual financial report included an “overall perspective” section in the discussion and analysis. It showed a balance sheet including Social Security and Medicare among the liabilities, leading to a negative balance of \$46 trillion, right next to the net position on the balance sheet (negative \$8 trillion). That table was introduced with the following sentence:

The schedule below reveals a more complete picture of the Government’s financial responsibilities—its liabilities and responsibilities on the balance sheet as well as its responsibilities that are tracked off the balance sheet.

Truth in Accounting believes the federal government’s balance sheet should include those obligations on its balance sheet. On that basis, the negative net position of the federal government has been deteriorating even faster than the reported position in the last five years. The change in net position has been running more than four times as high as the reported net operating cost.

Auditor Opinion

The news here remains basically bad, but things appear to be moving in the right direction. The federal government’s finan-



cial statements are audited, among other reasons, to secure an opinion on whether the statements are presented consistent with GAAP. For the federal government, GAAP is developed under the Federal Accounting Standards Advisory Board (FASAB). The independence asserted for this body should not be assumed, nor are its standards necessarily truthful and complete. But how many Americans are aware that the government has basically flunked its audit every year for the last 20 years?

In 2018, the GAO again issued a disclaimer of opinion on the consolidated financial statements for the federal government, as it has every year since 1998. Disclaimer opinions on the underlying statements for the Department of Defense, the Department of Housing and Urban Development, and the Railroad Retirement Board are the main reasons for this,

because of the size of their collective contribution to the consolidated statements. But the GAO also cited uncertainty in Medicare cost growth assumptions as a factor preventing an opinion on the Statements of Social Insurance.

So what is the good news? The share of total assets and net cost in departments receiving disclaimer opinions has been declining, and the Defense Department and the Treasury Department have made significant progress in developing auditability and addressing internal control weaknesses. There is a long way to go on that front, and there may be more bad news ahead from the Defense Department’s audit findings in particular. If and when the day finally arrives, a clean audit opinion is not necessarily a good thing, given the flaws in government GAAP. But at least things appear to be moving in the right direction

on the audit front. That does not, however, mean the government's finances are moving in the right direction.

The Rhetoric

In a world where complex accounting issues can make the truth seem unclear, simple cues can provide valuable guideposts. Consider the example of American International Group in the year before its implosion. At year-end 2007, one of the largest and most complicated financial institutions in the world issued an annual report

or otherwise, that was a valuable signal of the impending disaster.

The annual report of the U.S. government can also be mined for financial signals. For example, *Exhibit 4* shows how many times the word "sustain" appears in the report since 1998, either in the word "sustain," "sustainability," or "unsustainable." The number of "sustains" has been growing faster than the number of pages, and the frequency of "unsustainables" has been rising even faster (*Exhibit 5*). Perhaps the government simply deems sustainability

should be removed from the 2020 report. The government certainly has the power to tax and set monetary policy. But in the United States, the system is one of limited, popular sovereignty. These are not the financial statements for the United States of America; these are the statements for the U.S. government. The nation and its government are not the same thing.

The Silence Must End

The Treasury Department issued the government's annual financial report on March 28. The following day, the *Wall Street Journal* ran stories about GDP growth, cat allergies, Major League Baseball's opening day, Saudi women activists, Alex Rodriguez, the Lyft initial public offering, swine flu in China, and U.S. pork prices. But there was no coverage of the annual financial report of the U.S. government, nor has there been through the first two weeks of April. The *Wall Street Journal* is not alone, to be sure. But if ever there were a call to action, this report is it.

In 1970, Albert O. Hirschman wrote a book titled *Exit, Voice & Loyalty: Responses to Decline in Firms, Organizations & States*. Hirschman laid out how people faced with deteriorating conditions can decide to either stick around and try to improve things or abandon ship. The third variable in such decisions, loyalty, helps determine how productive voice and leadership can be in moving things in the right direction.

The responsibilities and public interest principles introducing the AICPA Code of Professional Conduct lay a foundation for CPAs to help inspire public understanding and engagement with financial reporting by the government. The NYSSCPA has a long tradition of leaders working in that spirit. CPAs and their colleagues can play leading roles in educating citizens and developing more relevant accounting standards. □

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with a balance sheet containing \$96 billion in (positive) shareholder equity. On September 30, 2008, the quarterly report had a balance sheet still showing more than \$70 billion in shareholder equity, even after the stock lost almost 100% of its value from April 1 to September 30.

Analyzing AIG's reported financials was a challenging task before, during, and after the implosion. Complex insurance, derivative, and other relationships undermined book value per share as a relevant metric. But a simple clue was available, with lessons for interpreting the financials for the U.S. government.

In AIG's annual reports from 2003 to 2007, the phrase "credit default swap" appeared once in 2003, twice in 2004, twice in 2005, and three times in 2006. Then, in the 2007 report, issued in early 2008 before the stock imploded, the term appeared more than 100 times. In hindsight

a more fashionable thing to show concern about. But these and other trends support a conclusion that the federal government's finances have continued to deteriorate in recent years.

The government claims other tools in its tool chest. The text of the annual report introducing the unbalanced balance sheet continued to include the following:

There are, however, other significant resources available to the government that extend beyond the assets presented in these Balance Sheets. Those resources include Stewardship Land and Heritage Assets in addition to the government's sovereign powers to tax and set monetary policy.

In other words, citizens shouldn't worry about the government's fiscal health; it can always tax them and inflate the value of the nation's money.

In this author's opinion, these sentences

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