

Chapter 4 Issues the US Federal Government Controls

Test your fiscal perceptions by answering the following questions. By the end of this section, you will discover where the truth lies.

- True False Tax increases are not necessary to finance the U.S. Government's current level of annual expenditures.
- True False The Public Debt is increasing today because Bush decided to engage war in Iraq and the federal government is rebuilding the physical damage from Hurricane Katrina.
- True False When Bush was sworn in as President in 2000, the U.S. had no national debt; there was actually a surplus when Clinton left office.
- True False Terrorism is a more direct threat to my personal well-being than the current fiscal decisions of the U.S. Government.
- True False Foreign currency exchange rates don't affect me because I live in the United States.

How to "Follow the Money"

"The most exciting phrase to hear in science, the one that heralds new discoveries, is not 'Eureka!' (I found it!) but, 'That's funny....'" Isaac Asimov

Rules of the Road

Read this section if you are not familiar with reading numbers on financial statements. Otherwise you can fast-forward to the next section, "Deficits."

Accounting is really very simple. If you can add and subtract, you can read a financial statement. It also helps to be able to divide, which allows you to rank the numbers using

percentages. But that's it. With those mathematical skills, you can read, analyze, and understand financial statements.

Actually when you interface with others in the modern world, you deal with numbers everyday! This chapter reviews federal financial statements to identify significant financial issues. After you follow my thought process a couple of times, you will gain not only the perspective which each financial statement provides, but also the methodology to analyze data for yourself in the future.

Financial reports are called "statements" and sometimes "schedules." You will discover that accountants and financial wizards have a "lingo" all their own which is easy to understand after a little practice. To become familiar with these concepts, use the Glossary if you see a word or phrase that you have forgotten.

Financial statements are reported for a specific time "period," normally a year. The year can either be a "calendar" year, i.e. January 1st through December 31st, which is each U.S. taxpayers' year or a "fiscal" year which is simply another arbitrary set of 365 days. The U.S. Government uses a fiscal year of October 1st to September 30th. Sometimes amounts are listed and subtotaled by "current" or short-term (due or receivable in less than one year) items versus long-term (due or receivable in more than one year) items so the reader can focus on issues facing the entity within the next fiscal period.

So how does this all really work?

First of all, the federal government requires that a budget be approved by Congress to authorize expenditures for the next future period. The executive branch prepares the budget and then Congress debates and appropriates funds or money for expenditures. *Note that Congress has total power over the approval of government expenditures.* This is important. When actually spending money, whether or not the government departments meet or exceed these appropriations is called being "on-budget" or "off-budget." Accounting allows us to score and compare the budget and the results of the actual operations.

Accounting is the language of financial transactions. Internal accountants post individual financial transactions to a journal and then summarize them in a ledger, together called the "books." At the end of a period of time, most often a month, internal accountants prepare at minimum of two financial statements, most commonly called a "Balance Sheet" and an "Income Statement," which taken together reflect the financial status of the entity at the end of the time

period. The U.S. Treasury Department which was headed by John Snow during 2005 provides this internal accounting function for the federal government. You may find it interesting that the U.S. Government has only provided audited financial statements to the public *since 1996*. Amazing. Even after ten years, their effort is still a work-in-progress.

Financial statements tell the story of the activities for an entity during a specific period of time. An entity is a financial operation: a corporation, bank, non-profit organization, government body, etc. Even you, an individual, are an “entity” and need a financial statement whenever you want to interface financially with another “entity.” Examples include preparing your annual tax return when the government wants to see the “Revenues” section of your “Income Statement” or applying to a bank for a home equity loan when the bank asks you for your “Balance Sheet” or “Statement of Net Worth.”

When a specific financial statement will be used by the public to make financial decisions, at the end of an annual fiscal period our federal government requires external accountants, “auditors,” to verify the work of the internal accountants to insure that the reader of a public financial statement can rely on the report. Auditors then add their “opinion” to the Balance Sheet to express their evaluation as to the accuracy of the internal accountant’s efforts. There are several degrees of opinion but all you need to know is that the best is called an “Unqualified Opinion,” the worst is called an “Adverse Opinion,” and that there are several levels between the two. Auditors can also issue opinions on accounting operations within the entity. Generally astute public users of financial statements, especially potential investors, will not accept an “un-audited statement,” and when auditors don’t do their job correctly, they often meet the same fate as their clients, notably Arthur Andersen in the recent Enron scandal. The Government Accounting Office, or GAO, headed by David Walker in 2005 fulfills the external auditing function for the federal government.

The “Income Statement” is a report on the entity’s financial activities during the specific time period reported and the “Balance Sheet” reflects cumulative, continuing balances rolled forward into the next time period. Each account is listed as a “line item” on the statement. Accounts on the “Income Statement” are cleared or zeroed out before the next period and the net result for the time period added to the “Net Position” account on the “Balance Sheet.”

The federal government calls their “Income Statement” the “Statement of Operations,” but it’s exactly the same thing. Since the more general term is “Income Statement,” we will use that term.

The next rule is that everything balances, just like your bank statement. Period, no exceptions. The hierarchy of reports starts with The “Balance Sheet” and the “Income Statement” which are often read together. Amounts from these statements can then be tracked to subsequent reports to further detail specific amounts. In accounting lingo, this is called “drilling down.” But the numbers must also match, i.e. the *line item* amount for “Net Cost” on the highest level statement, the “Income Statement,” must match the *total* amount on the secondary statement called “Statement of Net Costs.” Numbers always balance, if not within one financial statement, then between multiple financial statements.

When the total amount computed from two amounts is positive, it is called a “gain” or “surplus.” When the total amount computed from two amounts is negative, it is called a “loss” or “deficit.” These terms are used exclusively to describe the direction of the flow of money in one period of time.

When there are subsequent statements available to support the amount presented for one line item or if there is more descriptive information concerning the composition of the line item itself, the author of the financial statement will add a Note number to identify a footnote for that line item. This allows the reader to access more detail about the single amount than would otherwise be possible. Interestingly sometimes the amounts that we discover in the federal government’s Notes to Financial Statements provide the bulk of information about our financial problems.

As mentioned earlier, “flow” account totals appear on the “Income Statement” and cumulative totals appear on the “Balance Sheet” which is a snapshot in time of the financial health of an entity. In your personal environment, this is the statement that the bank loan officer requests from you when you request a loan from him. He wants to know what you own (assets), what you owe (liabilities), and the difference between the two (net worth). If your net worth is sufficient to cover what you need, you’ll probably receive that bank loan you requested!

May your total liabilities be zero and your net worth equal to your total assets.

Deficits

Keeping all this in mind, let's take a look at the US Federal Government's Financial Statements for the time period October 1, 2004, through September 30, 2005, as issued by the U.S. Treasury Department. The financial statements in this publication, and many more, are available on the US Treasury web site¹ and provide raw "data". To transform this data into "information," you must relate it to the numbers reported in previous years as a percent gain or loss of the prior periods. This is the historical presentation of private sector of personal and corporate financial statements.

When I found the "Balance Sheet" and "Income Statement" in the US Treasury's 2005 Report, I was surprised to discover that line item amounts were neither compared to the total they generated nor to their amount for the previous period. After I transferred the raw data to a spreadsheet, I added columns to calculate the change between 2004 and 2005 as well as percentage columns where appropriate. The source web site, document, and page number provided in each figure's title will allow you to access the information yourself. All amounts are expressed in billions, unless otherwise noted. My additions to these statements are typed in italics so that you can identify the original raw data and my calculations.

Now let's follow the numbers and see where they lead us! Do not be overwhelmed by the size of these numbers. Although their size is important, the *relationships* between them are more important to us. The first step is to simply read and ponder the statement. Transform the data into information. Then read the analysis to see how it differs from what you see. As we progress, you will begin to analyze financial data independently!

Ready to plunge into the wonderful world of governmental finance to unearth the result of 230 years of democracy?

¹ <http://www.fms.treas.gov/annualreport/index.html> as of May 20, 2006