



A MESSAGE FROM THE SECRETARY OF THE TREASURY

It is my privilege to issue the 2006 *Financial Report of the U.S. Government*. The objective of this report is to provide to the Congress and the American people timely, useful data on the operating costs and financial condition of the government and a discussion of the nation's long-term fiscal outlook. To make this information available early enough to inform the budget process, Treasury has issued this report on December 15 in each of the past three years rather than on the statutory deadline of March 31.

As announced in October, a strong economy and the recent surge in tax revenues has driven the budget deficit down to \$248 billion, achieving the President's 2009 target of cutting the deficit in half as a percent of GDP well ahead of schedule. Consistent with the improved budget results, this report shows a lower accrual-based net operating cost of \$450 billion. The improvement over 2005 results primarily from lower actuarial costs in certain agencies. There is a difference in the amounts reported for the budget deficit and the net operating cost because of the distinct methods of accounting used. The actuarial costs also account for most of the difference between the budget deficit and the net operating cost reported here.

In addition to reporting the progress in reducing the deficit, this report highlights the biggest long-term economic issue facing our country--the future claim on spending for our major entitlement programs: Medicare and Social Security. Without fundamental reform to ensure the sustainability of these programs, by the year 2080, the cost to the federal government of Social Security and Medicare together will nearly triple as a percentage of the U.S. economy, growing to 17 percent. The present value cost of net expenditures for current participants in these two programs over the next 75 years amounts to \$44 trillion. These long-term challenges do not lend themselves to quick fixes, but given our expanding economy, we can approach these issues from a position of strength, and now is the time.

Treasury is committed to resolving the financial management challenges that have led to the Comptroller General of the United States being unable to express an opinion on the financial statements. These include long-standing problems at particular agencies and unique issues related to the preparation of governmentwide statements. As noted in the audit letter, progress continues to be made, but there is still much to be done to meet the highest standards of transparent, reliable financial reporting.

Through this report, we hope to inform and support the decision making so critical to the nation's fiscal future.

Henry M. Paulson, Jr.

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EXECUTIVE SUMMARY

"We might hope to see the finances of the Union as clear and intelligible as a merchant's books, so that every member of Congress and every man of any mind in the Union should be able to comprehend them, to investigate abuses, and consequently to control them."
 President Thomas Jefferson to Treasury Secretary Albert Gallatin, 1802

Financial Condition of the U.S. Government: An Overview

The *Fiscal Year 2006 Financial Report of the United States Government (Report)* provides the President, Congress, and the American people a comprehensive view of the Federal Government's finances, i.e., its financial position and condition, its revenues and costs, assets and liabilities, and other obligations and commitments. The *Report* also discusses important financial issues and significant conditions that may affect future operations.

For the tenth consecutive year, GAO has issued a disclaimer of opinion on the consolidated financial statements. A disclaimer of opinion is not an indication of the validity or accuracy of the Government's financial information; it means that sufficient information was not available for the auditors to determine whether the information was reliable. Material weaknesses in internal control and other limitations on the scope of its work resulted in conditions that prevented GAO from forming and expressing an opinion on the Government's consolidated financial statements for the fiscal years ended September 30, 2006 and 2005. Eighteen of 24 CFO Act agencies and 24 of 31 major agencies earned unqualified opinions on their individual audits on their fiscal year 2006 financial statements.

Table 1 below provides an overview of several key indicators of the U.S. Government's financial health.

Table 1: Key Financial Indicators: FY 2004 - FY 2006					
billions of dollars	2004		2005		2006
Gross Costs	\$	2,732.0	\$	3,174.6	\$ 3,127.7
Less: Earned (Program) Revenue	\$	207.1	\$	224.8	\$ 226.4
Less: Taxes & Other Revenues:	\$	1,912.7	\$	2,185.5	\$ 2,440.8
Individual Income Tax		\$ 1,512.3		\$ 1,690.1	\$ 1,846.1
Corporate Income Tax		\$ 183.8		\$ 271.8	\$ 350.0
Other		\$ 216.6		\$ 223.6	\$ 244.7
Net Operating Cost¹	\$	(615.6)	\$	(760.2)	\$ (449.5)
Assets					
Less: Liabilities, comprised of:	\$	9,107.1	\$	9,914.8	\$ 10,412.9
Debt to the Public		\$ 4,329.3		\$ 4,624.2	\$ 4,867.5
Federal Employee & Veterans Benefits		\$ 4,062.1		\$ 4,491.8	\$ 4,679.0
Other Liabilities		\$ 715.7		\$ 798.8	\$ 866.4
Net Position (Assets Net of Liabilities)	\$	(7,709.8)	\$	(8,466.9)	\$ (8,916.4)
Social Insurance Responsibilities (off-balance sheet):²					
Closed Group (current participants) ³		\$ 37,279.0		\$ 40,038.0	\$ 44,147.0
Open Group (current + future participants) ⁴		\$ 33,363.0		\$ 35,689.0	\$ 38,851.0
Budget Results					
Budget Deficit (net of):	\$	(412.3)	\$	(318.6)	\$ (247.7)
Receipts		\$ 1,879.8		\$ 2,153.4	\$ 2,406.7
Outlays		\$ 2,292.1		\$ 2,472.1	\$ 2,654.4

¹Total Net Operating Cost includes 'Unmatched Transactions and Balances' not shown in this table.

² present value of 75-year actuarial projections of benefit payments under current law for Social Security, Medicare, and other social insurance programs in excess of their scheduled contributions and earmarked taxes. Not considered liabilities on the balance sheet.

³ includes current participants (i.e., receiving and/or are eligible to receive benefits) ages 15 and over at the start of the period.

⁴ includes all current and future projected participants (i.e., individuals receiving and/or are eligible to receive benefits ages 15 and over at the start of the period, PLUS participants estimated to receive and/or be eligible to receive benefits over the 75-year horizon).

Two Sets of Books? - - Absolutely Not - - Comparing the Financial Report to the Budget Deficit

Each year, the Administration issues two reports that detail financial results for the Federal Government:

- o the *President's Budget*, the Government's primary financial planning and control tool, reports "actual" budget results to inform that public that the government spent taxpayer money in accordance with applicable laws;
- o the *Financial Report of the United States Government* provides the President, Congress, and the American people a broad, comprehensive overview of the cost of the Government's operations, the sources used to finance them, its balance sheet, and the outlook for its social insurance programs.

The following illustrates how the two reports complement each other.

President's Budget	Financial Report of the U.S. Government
<u>Prepared on a 'cash basis'</u>	<u>Prepared on an 'accrual basis'</u>
<ul style="list-style-type: none"> • Initiative-based: focus on current and future initiatives planned and how resources <i>will be used</i> to fund them. • Receipts ('cash in'), e.g., federal income tax received, National Park fees collected. • Outlays ('cash out'), e.g., defense spending, benefit checks sent. 	<ul style="list-style-type: none"> • Retrospective: focus on how resources <i>have been used</i> to implement initiatives. • Revenue: recognized when earned, but not necessarily received.¹ • Costs: recognized when owed, but not necessarily paid.

The Financial Report has as its base ALL the transactions that form the budget results. Adjustments to convert costs and revenues from the cash basis to the accrual basis are shown in the *Statement of Reconciliations of Net Operating Cost and Unified Budget Deficit* in this report. The amounts itemized on this statement are intended to represent the difference between the two bases for reporting. There is no magic, no sleight of hand; just cost accruals to adjust for the timing of the cash outlay versus the portion of non cash-based cost attributable to the current period.

In 2006, for the first time, the *Statement of Social Insurance* has been reported and audited as a principal financial statement. The statement provides a perspective on the Government's long-term responsibilities and costs. It should be noted, however, that even with this addition, the financial statements do not reflect future costs implied by current policy, such as national defense, the global war on terrorism, and hurricane cleanup efforts.

Outstanding Revenue Growth Narrows the Gap between Costs and Revenues

As shown in Table 2, 2006 marked the third consecutive fiscal year of substantial revenue growth. A combination of solid economic growth and improved corporate tax yields have contributed to revenue growth of over 35% since 2003. In 2006, revenues grew to \$2,440.8 billion establishing a new record high. Nearly \$600

billions of dollars	Total Revenue	Change from Prior Year	% Increase	Change from 2003	% Increase from 2003
2003	\$ 1,796.0	\$ (81.7)	-4.4%		
2004	\$ 1,912.7	\$ 116.7	6.5%	\$ 116.7	6.5%
2005	\$ 2,185.5	\$ 272.8	14.3%	\$ 389.5	21.7%
2006	\$ 2,440.8	\$ 255.3	11.7%	\$ 644.8	35.9%

billion in increased cash was collected over the last three years over the \$1.8 trillion base level of 2003 (an average of nearly \$200 billion per year). This has contributed to a reduction of both the budget deficit and net operating cost.

Costs Decline Slightly

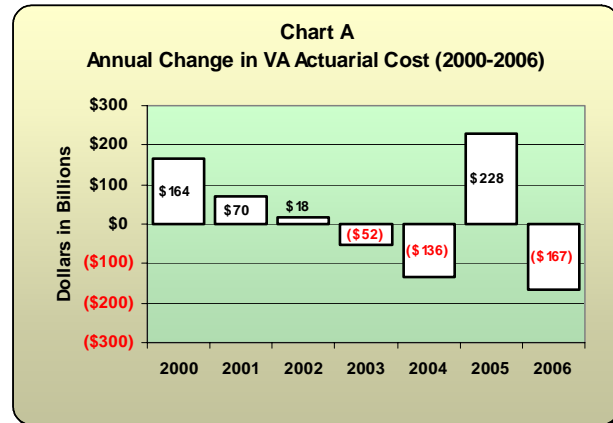
Costs decreased to \$3,127.7 billion from 2005's level of \$3,174.6 billion. This is mostly made up of two contrasting items: (1) an inflationary and programmatic increase in outlays of \$182 billion; and (2) a \$242.5 billion reduction in actuarial costs from last year's record level of \$429.7 billion to \$187.2 billion in 2006, offsetting the spending increase. This unusual result stems from the methodology used to calculate the liabilities for post-

¹ Under GAAP, U.S. Government revenues are recognized on a 'modified cash' basis, or when they become measurable. Exchange revenue is recognized at the time the government provides goods or services to the public or to another Government entity. Nonexchange revenue (e.g., taxes, fines, donations) is recognized to the extent that the collection is probable and the amount is measurable.

employment benefit programs such as employee pensions, health, and veteran's compensation. Actuarial calculations of future outlays by year for these programs are made; then all years are discounted back to the present. Interest rate levels are among the most significant assumptions about the future that can impact these estimates.

Chart A shows the fluctuation in VA's actuarial costs over the past several years. Interest rate changes have a significant role in these variations. VA reported a substantial decrease in actuarial costs (calculated as the annual change in actuarial liabilities) of \$166.6 billion. This followed both significant actuarial cost increases and decreases in 2005 and 2004, respectively. These fluctuations stem mainly from the use of interest rates at year-end to discount future benefits and estimate a current liability amount. Most federal actuarial liabilities are calculated through the use of average future interest rates, not spot rates as

of September 30th of the current period. Because a small change in interest rate assumptions produces the large actuarial cost fluctuations shown in Chart A, reported annual VA actuarial costs are not useful in predicting future annual costs. The change in VA's actuarial costs from year to year accounts for the majority of the change in the Government's net cost in most years (54 percent in 2006). Moreover, in 2006, the change in these and other actuarial (e.g., pension) costs accounted for nearly 80 percent of the \$310 billion decrease in total net operating cost. Finally, total actuarial costs in 2006 of \$187.2 billion, as in most recent years, account for most of the annual differences (93 percent in 2006) between the Government's budget deficit and net cost, and ostensibly, between the cash and accrual bases of accounting in the Federal Government.



Assets & Liabilities – What We Own and What We Owe

The Government's year-end net position can be derived by netting its assets against its liabilities on the *Balance Sheet*. It is important to note that the balance sheet excludes the financial impact of the Government's sovereign powers to tax, regulate commerce, and set monetary policy. It also excludes its control over nonoperational resources, including national and natural resources, for which the Government is a steward. Moreover, the Government's responsibilities are broader than the liabilities presented on the balance sheet, including its future social insurance responsibilities (e.g., Social Security and Medicare), as well as other programs and contingencies.

The Government's largest liability has been the Federal debt held by the public and accrued interest, which increased \$243.3 billion to \$4,867.5 billion in fiscal year 2006 from \$4,624.2 billion in 2005. The sharp increase in tax revenues enabled the Government to borrow a smaller amount of cash from the public this year as compared to the previous year to finance its operations. The Government increased its net borrowings from the public by a combined \$529.5 billion since fiscal year 2005 to help finance more than 90 percent of budget deficits in both 2005 and 2006. However, the Government's debt operations are much more complex than this would imply. Each year, trillions of dollars of debt matures and new debt takes its place. For example, in fiscal year 2006, new borrowings were \$4.5 trillion and maturing debts were \$4.2 trillion.

Federal employee and veteran benefits payable, 45% of the Government's total reported liabilities, have increased dramatically in recent years, from \$2,600.7 billion at fiscal year-end 1999, to \$4,679.0 billion as of September 30, 2006.

Social Insurance and Other Responsibilities

Information reported on social insurance programs addresses fundamental questions about their current and future financial sustainability, i.e., the extent to which the Government could meet future program demands under current laws and conditions. For the programs listed as social insurance (e.g., Old Age, Survivors' and Disability Insurance (OASDI) or Social Security, Medicare (Parts A, B, and D)), the Statement of Social Insurance (SOSI) shows the estimated future excess of scheduled benefit expenses over contributions, premiums, and tax income (excluding interest), based on each program's actuarial trust fund report (see Table 3).

In concert with other financial statements and reports, this information gives both a short- and long-term view of significant financial issues facing the Government. For financial reporting purposes, the *Balance Sheet* presents

a 'snapshot' at a point in time of the Government's *current* financial condition, emphasizing how current and prior actions and events have impacted its assets and liabilities.

By contrast, the *SOSI* presents an assessment of the extent to which the programs are unfunded under current financing arrangements relative to scheduled benefit obligations, based on the calculated net present value of future estimated revenues and expenditures over an extended period.

Since these estimates are not liabilities, and therefore do not impact either an entity's current assets or liabilities, they are considered 'off-balance sheet' items; according to Federal accounting standards. This distinction substantially limits the comparability of the Government's current net liabilities to future net social insurance responsibilities. Their significance can, however, be measured in other contexts. Table 4 shows how the two compare. Fiscal year 2006 total assets of \$1,496.5 billion and total liabilities of \$10,412.9 billion combine to derive the Government's current net liability of \$8,916.4 billion. By comparison, *SOSI* reports net present value expenditures of \$44,147 billion in net social insurance responsibilities.² The net social insurance responsibilities (scheduled benefits in excess of estimated revenues) indicate that those programs are on an unsustainable fiscal path and difficult choices will be necessary in order to address their large and growing long-term fiscal imbalance. Delay is costly and choices will be more difficult as the retirement of the 'baby boom' gets closer to becoming a reality with the first wave of boomers eligible for retirement under Social Security in 2008

billions of dollars	2002	2003	2004	2005	2006
This table shows the present value of 75-year actuarial projections of the benefit payments under current law for Social Security, Medicare, and other social insurance programs in excess of their scheduled contributions and earmarked taxes for current participants ages 15 and over at the start of the period.					
Social Insurance Responsibilities, Net (closed group)¹					
Social Security (OASDI)	\$ (11,216)	\$ (11,742)	\$ (12,552)	\$ (13,583)	\$ (14,976)
Medicare	\$ (12,896)	\$ (15,007)	\$ (24,615)	\$ (26,339)	\$ (29,040)
Other ²	\$ (107)	\$ (109)	\$ (112)	\$ (116)	\$ (131)
Total Social Insurance Responsibilities, Net, (closed group)	\$ (24,219)	\$ (26,858)	\$ (37,279)	\$ (40,038)	\$ (44,147)
Total Social Insurance, Net (open group)²	\$ (17,887)	\$ (20,825)	\$ (33,363)	\$ (35,689)	\$ (38,851)
¹ The 'closed group' includes current participants (i.e., receiving and/or are eligible to receive benefits) ages 15 and over at the start of the period. The 'open' group' (shown below for comparative purposes), includes all current and future projected participants (i.e., individuals receiving and/or are eligible to receive benefits ages 15 and over at the start of the period, PLUS participants estimated to receive and/or be eligible to receive benefits in the future over the 75-year horizon).					
² For the 'closed' group, 'Other Social Insurance Programs' = Railroad Retirement Program. The 'open' group includes both the Railroad Retirement and Black Lung Programs. The <i>SOSI</i> presents only 'open group' totals for Black Lung (i.e., does not identify 'closed' group amounts separately). Therefore, Black Lung is only reflected in the 'open' group amounts above.					

billions of dollars	2002	2003	2004	2005	2006
Liabilities Net of Assets (balance sheet)	\$ (6,820)	\$ (7,094)	\$ (7,710)	\$ (8,467)	\$ (8,916)
The balance sheet presents a 'snapshot' of an entity's current financial position (net of assets and liabilities as of the end of the current fiscal year.					
Social Insurance Responsibilities, Net (closed group - - off-balance sheet)	\$ (24,219)	\$ (26,858)	\$ (37,279)	\$ (40,038)	\$ (44,147)
The Statement of Social Insurance presents the present value of estimated future revenues and expenditures under current law.					
Combined Net Liabilities (current) and Social Insurance Responsibilities (future)	\$ (31,039)	\$ (33,952)	\$ (44,989)	\$ (48,505)	\$ (53,063)

Looking Ahead – The President's Management Agenda

Fiscal responsibility requires the sound stewardship of taxpayer money. Once the Congress and the President decide on overall spending levels, taxpayer dollars should be managed to maximize results. The President's Management Agenda (PMA) is creating a results-oriented Government where agencies and programs are managed professionally and efficiently to achieve the results expected by the Congress and the American people.

The PMA's broad goal is to make the Government more results-oriented with a focus on achievement, efficiency, and accountability. It emphasizes improving Government operations by setting clear goals and action plans, and then following through on those plans. Agencies continue to manage to achieve better results. PMA standards for success are used to measure agencies' progress and achievement in meeting overall goals. The chart above summarizes Federal agencies' current status as of September 30, 2006. Agencies are also rated on their progress. These ratings and other related information are discussed later in this report and are available at:

www.whitehouse.gov/results/agenda/standards.pdf

² Tables 3 and 4 both focus on closed-group obligations, equal to the present value of net payments (benefits less taxes) expected during the projection period on behalf of program participants over age 15 at the start of the projection period. While a true accrual measure would count only benefits already earned (and taxes already paid) by current workers, the closed-group liability includes future benefit accruals and future taxes of current workers, making the closed-group numbers more forward-looking than a strict accrual-based calculation.