



United States Government Accountability Office

Understanding the
Primary Components
of the

Annual Financial Report of the United States Government

Preface

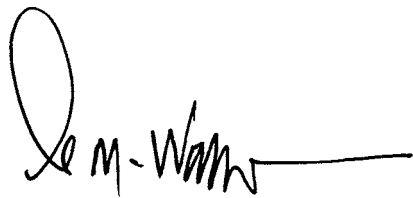
The U.S. government is the largest, most diverse, most complex, and arguably the most important entity on earth today. Useful, timely, and reliable financial and performance information is needed to make sound decisions on the current results and future direction of vital federal programs and polices. The Department of the Treasury, in coordination with the Office of Management and Budget, annually prepares the Financial Report of the United States Government, hereafter referred to as the Consolidated Financial Report (CFR). The CFR is a general-purpose report of accountability intended internally for members of Congress, federal executives and federal program managers, and externally primarily for citizens and citizen intermediaries who are interested in and have a reasonable understanding of federal government activities and are willing to study the information with reasonable diligence. Citizen intermediaries include members of the news media, analysts, and others who analyze and interpret for the general public the more complex and detailed information in the CFR.

The goal of the CFR, and the subject of this guide, is to make available to every American a comprehensive overview of the federal government's finances. As described in the CFR, significant issues regarding the reliability and presentation of the federal government's financial information still need to be addressed. For example, the Department of Defense's current financial management problems present a significant impediment to our being able to express any opinion on the federal government's consolidated financial statements. Also, additional transparency is needed in connection with intragovernmental debt, on-budget deficits, and the large and growing per capita and intergenerational burden associated with the federal government's growing liabilities and unfunded commitments. At the same time, in its current form, the CFR offers certain valuable insights into the overall financial operations, condition, and financial outlook of the federal government. This information is becoming increasingly more useful as the nation's accounting and reporting issues are resolved.

GAO prepared this guide to the CFR to help those who seek to gain a baseline understanding of the significant information provided in the primary components that make up the CFR, especially the financial statements. This guide explains the purpose of each CFR component and provides illustrative financial information using actual fiscal year 2004 and 2003 data to focus readers on the kinds of significant information found in the various parts of the CFR. Because the illustrative financial information contained in this guide minimizes detail in order to highlight significant line items, it does not show all of the items included in the federal government's actual CFR or explain the less significant ones. Changes to accounting standards and reporting requirements may affect the applicability of certain portions of this guide to future CFRs. Also, this guide is not intended to help people who are interested in understanding the financial statements of individual federal agencies, most of which publish their own financial statements.

The annual financial reports of the United States Government, for which this guide was prepared, are available through Treasury's Web site at www.fms.treas.gov/fr/index.html.

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A handwritten signature in black ink, appearing to read "D. M. Walker", followed by a horizontal line extending to the right.

David M. Walker
Comptroller General of the United States

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The Consolidated Financial Report

Similar to a corporation's annual report, the Consolidated Financial Report (CFR) is the federal government's general-purpose report of accountability to the American public on its finances. It is intended to

- provide an overall view of the annual financial results of operations and the financial position of the federal government, including long-term commitments and obligations;
- demonstrate accountability for the money the federal government raises through taxes and for spending money according to the laws and regulations that govern the federal government's budgets and financial operations;
- report on the federal government's operating performance, accounting systems, and internal control; and
- demonstrate the federal government's stewardship over its resources.

The consolidated financial statements (CFS) in the CFR, submitted by the Department of the Treasury in coordination with the Office of Management and Budget, present consolidated and summarized financial information from the various federal government agencies and departments. The federal government is responsible for

- preparing the annual CFS in conformity with U.S. generally accepted accounting principles;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the control objectives of the Federal Managers' Financial Integrity Act, 31 U.S.C. 3512 (c), (d) are met; and
- complying with applicable laws and regulations.

The Federal Accounting Standards Advisory Board (FASAB), after considering the financial and budgetary information needs of citizens, congressional oversight groups, executive agencies, and other users, promulgates the accounting and reporting standards essential for public accountability.

GAO conducts the audit of the federal government's financial information contained in the financial statements in the CFR, along with the accompanying notes to the financial statements, with the objective being to provide an opinion on the fairness of the financial statements taken as a whole.

The Consolidated Financial Report

The CFR is organized into six major sections

Management's
Discussion and
Analysis

Government
Accountability
Office Report

Financial
Statements

Stewardship
Information

Notes to the
Financial
Statements

Supplemental
Information

- **Management's Discussion and Analysis** provides management's insights into the information presented in the federal government's financial statements and the Statement of Social Insurance.
- **Government Accountability Office Report** presents the results of GAO's audit of the financial statements.
- **Financial Statements** consolidate financial information from federal entities to provide an overall view of the federal government's financial operations and condition.
- **Stewardship Information** provides information about the federal government's resources and responsibilities that are not included on the federal government's Balance Sheet, the largest of which relate to social insurance programs such as Social Security and Medicare.
- **Notes to the Financial Statements** provide important disclosures and details related to information reported on the statements, and
- **Supplemental Information** provides additional information about selected financial operations of the federal government.

This guide discusses the significant content of each section in the CFR, with a primary emphasis on the federal government's financial statements.

Management's Discussion and Analysis

The Management's Discussion and Analysis (MD&A) section of the CFR provides important insights into the information presented in the federal government's financial statements and the Statement of Social Insurance. It presents management's perspective on the financial information and overall operations of the federal government.

The MD&A is intended to provide readers with a narrative overview and analysis of the federal government's performance, financial position, and financial operations. It is also intended to address the federal government's performance measures, financial statements, systems and controls, compliance with laws and regulations, and actions taken or planned to address problems. For example, the fiscal year 2004 MD&A

- includes a table under the heading Additional Responsibilities that shows the federal government's summary of the nation's total liabilities and responsibilities, including the projected continuing significant claims that Social Security and Medicare programs have on the nation's budgetary resources;
- highlights the significant reporting items identified for the year, such as the estimated long-term (75-year) cost and financial impact of the new Medicare prescription drug plan and the increased debt ceiling;
- discusses the federal government's financial results for the year, including trends in net costs, assets, and liabilities, providing management's explanations for significant changes; and
- discusses the nation's economic and budget results, the federal government's organization, and operating performance measures.

Government Accountability Office Report

GAO's report tells readers whether or not, or to what extent, they can rely on the information provided in the CFS. GAO conducts its audit of the CFS in accordance with U.S. generally accepted government auditing standards, obtains and evaluates evidence, and provides a formal written conclusion on whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. The MD&A, stewardship, and supplemental information in the CFR are not required to be audited.

The auditor may express an **unqualified opinion**, a **qualified opinion**, or an **adverse opinion**, or **disclaim an opinion** on the fairness of the financial statements taken as a whole. In an **unqualified opinion**, the auditor states that the information in the financial statements and accompanying notes is presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. A **qualified opinion** discloses exceptions to an unqualified opinion, such as inadequate disclosures or selected nonconformities with U.S. generally accepted accounting principles. However, in a qualified opinion, the exceptions are not considered material enough to affect the fairness of the statements taken as a whole. Exceptions considered too serious or pervasive to justify a qualified opinion result in an **adverse opinion**, which states that the financial statements taken as a whole are not presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. The circumstances related to such exceptions are also disclosed in the auditor's report. A **disclaimer of opinion** may result when the auditor is unable to obtain sufficient information upon which to base an opinion. The circumstances related to a disclaimer are described in the auditor's report. For example, GAO disclaimed an opinion on the fiscal year 2004 CFS because of the effects of persistent material weaknesses in the federal government's internal control and certain accounting and reporting practices that limited the scope of work that could be performed, a major element of which relates to the Department of Defense's continued inability to undergo an audit of its financial statements.

GAO's report also includes an opinion on whether the federal government had effective internal control over financial reporting and over compliance with laws and regulations. It also reports on any identified significant matters of noncompliance with selected provisions of applicable laws and regulations.

Financial Statements

Some Important Financial Statement Concepts

Before considering the purpose and content of each of the federal government's consolidated financial statements, it is important to understand certain concepts about the nature of the federal government's financial statements, especially the federal government's (1) use of cash and accrual accounting and (2) treatment of transactions between federal entities.

Cash and Accrual Accounting

The federal government generally uses accrual accounting to record and report financial information contained in its financial statements. Accrual accounting, which is also used by private business enterprises, is the basis for U.S. generally accepted accounting principles for federal government entities. It is intended to provide a complete picture of the federal government's financial operations and financial position. The federal government primarily uses the cash basis of accounting for its budget, which is the federal government's primary financial planning and control tool. The budget helps establish national spending priorities and helps ensure that the federal government spends taxpayers' money in accordance with applicable appropriations laws. Differences between the federal government's operating results and its budget results are shown in the statement called the Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit). Accordingly, understanding the basic concepts of the cash basis and accrual basis of accounting is important to understanding the information included in the federal government's financial statements.

Cash-Based Accounting

Because it is similar to keeping a checkbook, the cash basis of accounting (used to account for and report budget results) is perhaps the easier of the two bases of accounting to understand. The cash basis focus is on cash receipts, cash disbursements, and the difference between the two amounts. With relatively few exceptions, budget receipts are recorded when cash is received and budget outlays are recorded when cash is disbursed. The difference between cash receipts and cash disbursements at the end of the fiscal year is reported as the annual budget surplus or budget deficit. For example, for fiscal year 2004 the federal government reported a unified budget deficit of about \$412 billion (explained in more detail later in the guide). This deficit was based on reported cash outlays of about \$2,292 billion compared with reported cash receipts of about \$1,880 billion. It is important to note here that the federal government's cash receipts used in determining the unified budget deficit include surplus funds earmarked for the Social Security trust funds and certain other trust funds.

Accrual-Based Accounting

The accrual basis of accounting recognizes revenue when it is earned and recognizes expenses in the period incurred, without regard to when cash is received or disbursed. The federal government, which receives most of its revenue from taxes, nevertheless recognizes tax revenue when it is collected, under an accepted modified cash basis of accounting.

Expenses are recognized during the period in which they are incurred. Accrual accounting, for example, recognizes that while the employee is working, the employee earns not only a salary but also health, pension, and other benefits that will be paid in the future during the employee's retirement. Accordingly, each year, on the basis of actuarial calculations of benefits earned, the federal government records as an expense (operating cost) an estimated amount for these earned benefits and increases the related liability—Federal Employee and Veteran Benefits Payable—for the amount owed to its employees, both civilian and military. Thus, the accrual basis of accounting is intended to provide a complete financial picture for the CFR reader of the federal government's annual employee-related costs.

Also under accrual accounting, the federal government reports physical assets when they are acquired and records the related expenses only when the assets are sold or when the federal government benefits from their use or consumption. Physical assets consist of inventories of goods held for sale or for future consumption, and long-lived or “fixed” assets such as land, buildings, and equipment. In the case of assets such as buildings and equipment, the measure of benefit consumption is known as depreciation.

Treatment of Transactions between Federal Entities

In the normal course of federal government operations, federal agencies and departments purchase and sell goods and services among themselves. These types of activities between federal agencies and departments are called intragovernmental transactions. They also include amounts the federal government borrows from the Social Security trust funds. Intragovernmental transactions are recorded in federal agencies' and departments' accounts and financial statements along with transactions conducted with outside entities. These intragovernmental transactions are to be eliminated from the federal government's consolidated accounts and financial statements so that the totals for the affected accounts, when summarized for all federal government agencies and departments, are not overstated for the federal government as a whole.

Financial Statements

Composition of the Financial Statements

The federal government's consolidated financial statements consist of five financial statements that are related and a Statement of Social Insurance (page 27 provides discussion and a simplified overview of how these five financial statements are related). Each of the five financial statements presents 2 years of financial data so that readers can compare the federal government's financial information for the current and prior years. The financial statements are introduced below in the order in which they appear in the CFR.

Statement of Net Cost	Statement of Operations and Changes in Net Position	Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit)	Statement of Changes in Cash Balance from Unified Budget and Other Activities	Balance Sheet	Statement of Social Insurance
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- The first statement shows how much it costs on the accrual basis of accounting to operate the federal government in total, and by major department and agency. This statement is called the **Statement of Net Cost**.
- The second statement shows the accrual-based results of the federal government's operations—the extent to which the federal government's tax revenue covers the net cost. It also shows how these results (called the net operating revenue or net operating cost) affect the federal government's net financial position—the difference between its assets (what it owns) and its liabilities (what it owes). This statement is called the **Statement of Operations and Changes in Net Position**.
- The third statement shows the relationship between the accrual-based operating results and the cash-based budget results. It begins with the net operating result (revenue or cost) from the Statement of Operations and Changes in Net Position and shows the items that explain the difference between that amount and the federal government's annual cash-based budget surplus or deficit. This statement is called the **Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit)**.
- The fourth statement shows the relationship between the cash-based budget surplus or deficit and the change in the federal government's operating cash balance. It begins with the cash-based budget surplus or deficit and shows the items that explain either how the federal government used a budget surplus or financed a budget deficit. This statement is called the **Statement of Changes in Cash Balance from Unified Budget and Other Activities**.

Financial Statements

- The fifth statement is the federal government's **Balance Sheet**. It shows the nature and amount of the federal government's assets (what it owns) and liabilities (what it owes) and the difference between the two, called the net position. This net position amount is the same as the net position amount reported in the Statement of Operations and Changes in Net Position. Under current federal accounting standards, the federal government's powers to tax, certain natural resources not used in operations, and certain long-range commitments such as Social Security and Medicare are not included on the federal government's Balance Sheet. These types of resources and responsibilities are discussed in the stewardship section of the CFR.

The additional statement, titled the **Statement of Social Insurance**, shows how much money the federal government estimates it would need today to cover the projected long-term commitments of its major social insurance programs, such as Social Security and Medicare. For fiscal year 2004, this statement is presented in the stewardship section of the CFR. The federal government will be including a Statement of Social Insurance in the CFR as a sixth financial statement beginning in fiscal year 2006.

Also, beginning with the fiscal year 2006 CFR, additional information will be provided for certain revenue. Currently, federal revenue earmarked for certain funds, such as the Social Security trust funds, is not separately presented on the face of the federal government's consolidated financial statements. To improve the transparency of this important source of revenue, the Federal Accounting Standards Advisory Board (FASAB) has issued a standard for identifying and reporting earmarked funds. According to FASAB, an earmarked fund receives specifically identified revenue and other financing sources that (1) remain available over time, (2) are required by statute to be used for designated activities, benefits, or purposes, and (3) must be accounted for separately from the government's general revenues. At the governmentwide level, earmarked revenue will be shown separately on the Statement of Operations and Changes in Net Position. The Balance Sheet will show separately the portion of net position attributable to earmarked funds. This information is intended to assist users of financial statements in understanding the federal government's results of operations and related commitments.

Statement of Net Cost

The Statement of Net Cost is intended to show how much it cost to operate the federal government by federal agency and department, and in total. It provides costs on an accrual basis of accounting, which recognizes expenses when they are incurred, regardless of when cash is disbursed. Thus, it provides cost information for the accounting period that can be related to the goods produced, services rendered, and the outcomes of the programs of the federal government's agencies and departments for the same period. Since the actuarial calculations for social insurance costs are not reported as liabilities on the Balance Sheet, the corresponding costs also are excluded from the cost of government operations. An important concept of the Statement of Net Cost is that the revenue earned by federal agencies and departments from their operations, such as admissions to national parks and fees paid for postal services and stamps, is subtracted from their cost of operations. The net cost is the amount to be financed from tax revenue and, as needed, borrowing.

Readers can use information from this statement to identify such things as

- how much the federal government's net cost increased or decreased from the prior fiscal year,
- which agencies or departments accounted for most of the federal government's net cost, and
- which agency or department experienced the largest increase and which experienced the largest decrease in net cost from the previous year.

For example, from fiscal year 2003 to fiscal year 2004, the federal government's total net cost increased about \$36.8 billion. Also, the Department of Defense, the Department of Health and Human Services, and the Social Security Administration together accounted for about \$1.7 trillion, or about 68 percent, of the approximately \$2.5 trillion total net cost reported for fiscal year 2004. And, for fiscal year 2004, the Department of Defense reported the largest cost increase, about \$100.1 billion, and the Department of Veterans Affairs reported the largest cost decrease, about \$125.7 billion.

It is important to note that agencies that use actuarial projections in determining their costs and related liabilities may experience large fluctuations in annual costs due to program benefit changes and changes to the actuarial assumptions. The MD&A explains that the primary cause of the Department of Defense's increase was a new law that increased the Military Retirement Fund's actuarial liability by about \$91 billion. The primary cause of the Department of Veterans Affairs' decrease was changes in interest rates and other actuarial assumptions. Also, the agencies' costs shown on the Statement of Net Cost include certain governmentwide allocated costs. The change in the U.S. Postal Service costs resulted primarily from a change in how certain long-range pension costs were allocated to it beginning in fiscal year 2004.

Statement of Net Cost

Illustrative Net Cost Information

(In billions of dollars)	Year ended Sept. 30 2004			Year ended Sept. 30 2003		
	● Gross Cost	■ Earned Revenue	▲ Net Cost	Gross Cost	Earned Revenue	Net Cost
Department of Defense	672.1	22.3	649.8	562.2	12.5	549.7
Department of Health and Human Services	583.9	33.4	550.5	542.3	29.7	512.6
Social Security Administration	534.9	2.6	532.3	512.6	0.3	512.3
Department of Veterans Affairs	51.1	3.2	47.9	175.7	2.1	173.6
Interest on Treasury securities held by the public	158.3	–	158.3	156.8	–	156.8
U.S. Postal Service	54.0	68.0	(14.0)	81.5	67.6	13.9
Other components	<u>677.7</u>	<u>77.6</u>	<u>600.1</u>	<u>621.8</u>	<u>52.6</u>	<u>569.2</u>
Total	<u>2,732.0</u>	<u>207.1</u>	<u>2,524.9</u>	<u>2,652.9</u>	<u>164.8</u>	<u>2,488.1</u>

- **Gross Cost** is the accrual-based total cost of the federal government's operations for the year. The statement presents gross cost by federal agency and department from highest to lowest. Also, it includes the cost of interest on Treasury securities held by the public, which includes foreign investors.
- **Earned Revenue** comes from fees charged for goods and services. The fees charged for postal services such as stamps, is a well-known example of earned revenue. Earned revenue shows how much the federal agencies and departments earn from their operations to cover their gross costs, as opposed to relying on taxes and borrowing to cover the costs.
- ▲ **Net Cost** is the portion of the gross cost left after subtracting earned revenue. The federal government funds the net cost of government from tax revenue and, as needed, by borrowing.

Statement of Operations and Changes in Net Position

Similar to the income statement of a corporation, the Statement of Operations and Changes in Net Position shows the financial results of the federal government's annual operations (tax revenue less net cost). It also shows the effect these results have on the federal government's net position—the difference between its assets and liabilities.

An important concept for this statement is the relationship between the results of operations and the Balance Sheet. The financial results of the federal government's operations should be directly reflected in the values of its assets and liabilities, which determine the federal government's net financial position. For example, a net operating cost of \$500 billion also reduces the federal government's net position by \$500 billion. However, unexplained differences between the net operating cost and the changes in net position have been reported in the CFR. The federal government's Statement of Operations and Changes in Net Position has included these unexplained differences as “Unreconciled transactions affecting the change in net position” (a net amount of \$3.4 billion for fiscal year 2004).

Adjustments to beginning balances, shown as a change in accounting principle and prior period adjustments in the financial statements, may also affect the federal government's net position. Adjustments result from corrections of significant errors in the financial statements of prior years or the effect of using a new or different accounting principle. Such adjustments are reflected in the beginning net position. The note explaining adjustments on the fiscal year 2003 Statement of Operations and Changes in Net Position shows that about \$383 billion of the approximately \$394 billion of adjustments was due to a change in accounting principle that eliminated the category of national defense property, plant, and equipment as stewardship information, and included such assets on the Balance Sheet.

Readers can use information from this statement to identify such things as

- how much tax revenue the federal government generated in total and from its various categories of taxes,
- the extent to which tax revenue covered the federal government's net cost, and
- whether the financial status of the federal government—its net position—has improved or deteriorated from the prior year.

For example, about \$1.5 trillion (approximately 79 percent) of the federal government's 2004 reported tax revenue came from individual taxpayers. Also, the federal government's 2004 reported net cost exceeded its tax revenue, culminating in a net operating cost for 2004 of about \$615.6 billion. Moreover, the reported net operating costs for fiscal years 2004 and 2003—about \$615.6 billion and \$667.6 billion, respectively—together decreased the federal government's net position by almost \$1.3 trillion.

Statement of Operations and Changes in Net Position

Illustrative Information on Operations and Changes in Net Position

(In billions of dollars)	Years ended Sept. 30	
	2004	2003
(Operations)		
■ Revenue		
Individual income tax and tax withholdings	1,512.3	1,481.3
Corporate and other taxes and miscellaneous revenues	<u>400.4</u>	<u>314.7</u>
Total Revenue	1,912.7	1,796.0
▲ Net Cost of Government Operations		
Unreconciled transactions affecting the change in net position	<u>(3.4)</u>	<u>24.5</u>
● Net Operating Cost (Results of Operations)	<u>(615.6)</u>	<u>(667.6)</u>
(Changes in Net Position)		
◆ Net Position, Beginning of Period		
Adjustments to beginning balances	–	393.6
Results of Operations	<u>(615.6)</u>	<u>(667.6)</u>
◆ Net Position, End of Period	<u>(7,709.8)</u>	<u>(7,094.2)</u>

- **Revenue** primarily comes from federal income tax collections, which includes taxes earmarked for Social Security and Medicare.
- ▲ **Net Cost of Government Operations** is the net cost from the Statement of Net Cost.
- **Net Operating Cost** is the financial Results of Operations—the difference between the tax revenue and the net cost of government operations plus the net amount of any unreconciled transactions affecting the change in net position.
- ◆ **Net Position** is the difference between the assets and liabilities reported on the Balance Sheet.

Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit)

This statement is intended to demonstrate the federal government's accountability to the budget by reconciling its accrual-based net operating results to its cash-based "unified budget" results. The term unified budget refers to the budget compilation that includes the full range of federal activities, both "on-budget" and "off-budget" amounts. By law, Social Security's and the Postal Service's activities are considered off-budget. On-budget programs and costs are those not excluded from the budget by law. The approximate \$412 billion fiscal year 2004 unified budget deficit shown on this statement consists of about \$567 billion on-budget deficit and approximately \$155 billion off-budget surplus. The off-budget surplus consists mostly of surplus revenue that the federal government borrowed from the Social Security trust funds (about \$151 billion for fiscal year 2004) to finance the federal government's current operations. Of the Social Security trust funds' \$151 billion fiscal year 2004 surplus, about \$65 billion came from cash receipts and about \$86 billion came from intragovernmental interest.

Readers can use information from this statement to identify such things as

- major differences between the net operating cost and unified budget deficit,
- how much of the federal government's operating cost was attributable to the depreciation of its assets, and
- how much the federal government spent on capitalized fixed assets.

A major difference between the two bases of accounting for fiscal year 2004 is that changes in accrued expenses related to employee and veteran benefits, which totaled about \$182 billion, are included in the net operating cost but not in the budget. In this statement, accrued benefit expenses are shown as an increase in liabilities for employee and veteran benefits. Also, the federal government reported about \$89.9 billion for depreciation expense for fiscal year 2004, which is included in the net operating cost but not in the budget. In addition, the amount identified on this statement for the purchase of capitalized fixed assets for fiscal year 2004 totaled about \$112.1 billion, consisting of approximately \$83.2 billion for the Department of Defense and about \$28.9 billion for civilian agencies.

Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit)

Illustrative Reconciliation of Net Operating Cost and Unified Budget Deficit

(In billions of dollars)	Years ended Sept. 30	
	2004	2003
● Net Operating Cost (Results of Operations)	(615.6)	(667.6)
■ Components of Net Operating Cost Not Part of the Budget Deficit		
Increase in liabilities for employee and veteran benefits	182.1	290.6
Decrease in environmental liabilities	(0.7)	(23.1)
Depreciation expense	89.9	71.2
Other	34.2	47.1
▲ Components of the Budget Deficit Not Part of the Net Operating Cost		
Cash outlays for capitalized fixed assets	(112.1)	(102.0)
Other	9.9	9.0
* The Unified Budget Deficit	<u>(412.3)</u>	<u>(374.8)</u>

- **The Net Operating Cost** comes from the Statement of Operations and Changes in Net Position. It primarily represents the difference between the federal government's tax revenue and expenses.
- **Components of Net Operating Cost Not Part of the Budget Deficit** are mostly current-year expenses under accrual accounting that do not involve current-year cash outlays. Increases in liabilities such as employee and veteran benefits and depreciation expense are recognized as current-year operating expenses under accrual accounting, but not in the budget.
- ▲ **Components of the Budget Deficit Not Part of Net Operating Cost** consist mostly of current-year cash outlays for transactions that do not involve current-year expenses, such as outlays to purchase buildings and equipment that the federal government capitalizes (records on its Balance Sheet as assets) and depreciates (expenses) as they are used in operations. The outlays to purchase these assets increase the unified budget deficit but not the current net operating cost.
- * **The Unified Budget Deficit** represents the difference between cash receipts (primarily from taxes) and cash outlays for the year for all programs, on- and off-budget. As previously noted, it includes the surplus cash receipts earmarked for the Social Security trust funds, about \$65 billion for fiscal year 2004.

Statement
of Net Cost

Statement
of Operations
and Changes
in Net Position

Reconciliation
of Net Operating
Revenue (or Cost)
and Unified Budget
Surplus (or Deficit)

**Statement
of Changes in
Cash Balance
from Unified
Budget and
Other Activities**

Balance Sheet

Statement of
Social Insurance

Statement of Changes in Cash Balance from Unified Budget and Other Activities

Since the federal government operates its budget principally on a cash basis, the primary purpose of the Statement of Changes in Cash Balance from Unified Budget and Other Activities is to report how the annual unified budget surplus or deficit relates to the federal government's borrowing (debt held by the public) and changes in operating cash. It explains why a unified budget surplus or deficit normally would not result in an equal change in the government's operating cash balance.

Readers can use the information provided in this statement to identify

- increases in federal borrowing as a result of the federal government spending more than it collected in taxes,
- decreases in federal borrowing as a result of a budget surplus,
- changes in the government's operating cash balance, and
- how much cash the federal government spent to pay interest on debt held by the public.

For example, for fiscal year 2004, the federal government reported that it increased its net borrowings from the public by about \$379.7 billion to help finance the approximately \$412.3 billion fiscal year 2004 unified budget deficit. It did this by borrowing about \$4,759.2 billion from the public and paying off debts of approximately \$4,379.5 billion. The federal government also reported that it used about \$144.7 billion of its cash to pay interest on debt held by the public.

Statement of Changes in Cash Balance from Unified Budget and Other Activities

Illustrative Information on Changes in Cash Balance from Unified Budget and Other Activities

(In billions of dollars)	Years ended Sept. 30	
	2004	2003
Unified Budget Deficit	(412.3)	(374.8)
Adjustments for Noncash Outlays Included in the Budget		
■ Interest accrued by Treasury on debt held by the public	145.6	143.3
Subsidy expense	<u>(6.6)</u>	<u>(11.8)</u>
Subtotal	139.0	131.5
Items Affecting the Cash Balance Not Included in the Budget		
Net transactions from financing activity		
▲ Borrowings from the public	4,759.2	4,289.1
▲ Repayment of debt held by the public	<u>(4,379.5)</u>	<u>(3,914.7)</u>
Subtotal	379.7	374.4
Net transactions from monetary and other activity		
■ Interest paid by Treasury on debt held by the public	(144.7)	(144.4)
Other	<u>18.5</u>	<u>3.2</u>
Subtotal	(126.2)	(141.2)
Decrease in Operating Cash Balance	<u>(19.8)</u>	<u>(10.1)</u>
Operating Cash Balance, Beginning of Period	<u>50.8</u>	<u>60.9</u>
Operating Cash Balance, End of Period	<u>31.0</u>	<u>50.8</u>

- An exception to the cash-based budget is the reporting of accrued interest on debt held by the public. To calculate the change in operating cash balance, interest for the unified budget results is adjusted to include only the cash outlays. Specifically, the amount reported for **interest accrued by Treasury on debt held by the public** is added to the unified budget results and the amount reported for **interest paid by Treasury on debt held by the public** is subtracted from the unified budget results.
- ▲ The major financing activities include **borrowings from the public** and **repayment of debt held by the public**. Net borrowings provide operating cash needed to finance the budget deficit.

Statement of Net Cost	Statement of Operations and Changes in Net Position	Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit)	Statement of Changes in Cash Balance from Unified Budget and Other Activities	Balance Sheet	Statement of Social Insurance
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Balance Sheet

The Balance Sheet shows an end-of-year view of the federal government's overall financial position, its assets (what it owns), its liabilities (what it owes), and the difference between the two (its net position). It is important to note that the Balance Sheet excludes the sovereign powers of the federal government to tax, regulate commerce, and set monetary policy, as well as certain nonoperational resources, including national parks and natural resources, over which the federal government is a steward. In addition, the federal government's responsibilities are much broader than the liabilities reported on the Balance Sheet, including the potential commitments related to and the impact of social insurance programs such as Social Security and Medicare over the long term. These resources and responsibilities are described in the Stewardship section of the CFR.

Readers can use information from this statement to identify such things as

- the makeup of the federal government's assets and liabilities,
- which liabilities increased the most, and
- whether the federal government has a positive net position—more assets than liabilities—or a negative net position—more liabilities than assets.

For example, the two largest liabilities are (1) about \$4.3 trillion of debt held by the public, from whom the federal government borrowed money to pay for past deficits, and (2) about \$4.1 trillion of pension and benefits owed to civilian employees and military personnel. These two items also account for the largest increases in liabilities for fiscal year 2004: federal debt held by the public and accrued interest increased by about \$384.5 billion, and federal employee and veteran benefits payable increased by approximately \$182.1 billion. Also, for fiscal year 2004, the federal government's negative net position was about \$7.7 trillion.

Other Considerations

Certain federal trust funds, such as the Social Security trust funds, have been running surpluses, which are loaned to the Treasury and reduce the current need for the federal government to borrow from the public to finance current operations. The transactions relating to the use of such surpluses are eliminated from the federal government's Balance Sheet because, in effect, they represent loans from one part of the government to another. Importantly, these intragovernmental debt holdings, which are not shown on the Balance Sheet, also constitute future obligations of the Treasury because the Treasury must provide cash to redeem these securities in order for the trust funds to pay benefits or other obligations as they come due.

Balance Sheet

Illustrative Balance Sheet Information

(In billions of dollars)	As of Sept. 30	
	2004	2003
■ Assets		
Cash and other monetary assets	97.0	119.6
Loans receivable, net	220.9	221.1
Inventories and related property, net	261.5	252.7
Property, plant, and equipment, net	652.7	658.2
Other assets	<u>165.2</u>	<u>153.8</u>
Total assets	<u>1,397.3</u>	<u>1,405.4</u>
▲ Liabilities		
Federal debt securities held by the public and accrued interest	4,329.4	3,944.9
Federal employee and veteran benefits payable	4,062.1	3,880.0
Environmental and disposal liabilities	249.2	249.9
Other liabilities	<u>466.4</u>	<u>424.8</u>
Total liabilities	9,107.1	8,499.6
● Commitments and Contingencies		
◆ Net Position	<u>(7,709.8)</u>	<u>(7,094.2)</u>
Total liabilities and net position	<u>1,397.3</u>	<u>1,405.4</u>

- Assets** are the operational resources the federal government has available as of the end of the fiscal year. The largest category—property, plant, and equipment, net—includes land and buildings and the federal government’s military equipment, such as ships, aircraft, and tanks, after subtracting accumulated depreciation.
- ▲ Liabilities** are the financial responsibilities of the federal government as of the end of the fiscal year. In addition to federal debt securities, liabilities include federal employee and veteran benefits payable—the amount the federal government estimates that it owes its military and civilian employees and veterans under its life and health insurance and pension plans.
- Not all **● Commitments and Contingencies** of the federal government require recognition as liabilities on the Balance Sheet. Commitments that require the future use of resources, such as long-term leases, as well as loss contingencies that are assessed to be at least reasonably possible, are disclosed in the notes to the financial statements.
- ◆ Net Position** is the difference between the federal government’s assets and liabilities.

Statement of Net Cost	Statement of Operations and Changes in Net Position	Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit)	Statement of Changes in Cash Balance from Unified Budget and Other Activities	Balance Sheet	Statement of Social Insurance
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Statement of Social Insurance (Stewardship Information)

The Statement of Social Insurance shows how much more money would be needed, in today's dollars, for the federal government's social insurance programs to continue to operate over the long term as they are structured today. The estimates presented in these statements, while unaudited, are based on actuarial projections of persons who are or will be participants in these programs. Also, the estimates exclude related trust fund balances, primarily the special U.S. Treasury securities held by the trust funds. These securities are guaranteed for principal and interest by the full faith and credit of the U.S. government and, as of September 30, 2004, totaled about \$1.9 trillion, of which the Social Security trust funds held about \$1.6 trillion.

Readers can use information from this statement to identify such things as

- the total amount of projected additional resources needed today to fully fund the major social insurance programs over the projected period,
- which social insurance programs project the largest need for additional resources, and
- how much the projected needs for additional resources have changed from prior years.

For example, at the beginning of 2004, the projected amounts needed for the next 75 years, the sum of the lines called the present value of resources needed, totaled about \$33.4 trillion. The largest projected need was about \$11.4 trillion to sustain Federal Supplementary Medical Insurance, Medicare Part B. Also, the present value of the projected long-term resources needed for Social Security and Medicare Parts A and B have almost doubled over the past 5 years from about \$13.0 trillion for 2000 to about \$25.2 trillion for 2004. In addition, the present value of the projected long-term resources needed for the next 75 years for the federal government's new commitments for prescription drug benefits is about \$8.1 trillion.

Estimated amounts shown as needed over an infinite period, while not shown on the Statement of Social Insurance, are also presented in the Stewardship section of the CFR. The present value of the resources needed for programs noted above totaled about \$74 trillion based on an infinite time period.

Statement of Social Insurance (Stewardship Information)

Illustrative Social Insurance Information

Present Value of Long-Range (75 Years, Except Black Lung) Actuarial Projections (In billions of dollars)	As of January 1				
	2004	2003	2002	2001	2000
● Federal Old-Age, Survivors and Disability Insurance (Social Security)					
Contributions and earmarked taxes	27,699	26,148	25,289	23,693	21,689
Benefit payments	<u>32,928</u>	31,075	29,851	27,900	25,534
Present Value of Resources Needed	5,229	4,927	4,562	4,207	3,845
■ Federal Hospital Insurance (Medicare Part A)					
Contributions and earmarked taxes	8,976	8,411	8,286	7,756	7,033
Benefit payments	<u>17,468</u>	14,577	13,412	12,486	9,732
Present Value of Resources Needed	8,492	6,166	5,126	4,730	2,699
▲ Federal Supplementary Medical Insurance (Medicare Part B)					
Premiums	3,889	3,120	2,708	2,696	2,165
Benefit payments	<u>15,329</u>	12,773	10,833	10,780	8,659
Present Value of Resources Needed	11,440	9,653	8,125	8,084	6,494
▲ Federal Supplementary Medical Insurance (Medicare Part D)					
Premiums	2,651	-	-	-	-
Benefit payments	<u>10,770</u>	-	-	-	-
Present Value of Resources Needed	8,119	-	-	-	-
Other - Present Value of Resources Needed	83	79	74	73	(4)
Total	<u>33,363</u>	<u>20,825</u>	<u>17,887</u>	<u>17,094</u>	<u>13,034</u>

- **Social Security** provides **Federal Old-Age and Survivors Insurance and Disability Insurance**. Both programs are financed by taxes on employees and employers, including the self-employed, and are administered by the Social Security Administration.
- **Federal Hospital Insurance (Medicare Part A)** covers inpatient hospital and related care. It is financed primarily by a payroll tax on employers and employees, including the self-employed, and a portion of the income taxes paid on Social Security benefits. Federal Hospital Insurance is administered by the Department of Health and Human Services.
- ▲ **Federal Supplementary Medical Insurance**, which also is administered by the Department of Health and Human Services, consists of two parts, called Medicare Part B and Medicare Part D. Medicare Part B covers hospital outpatient services, physicians' services, and other assorted products and services. Part D covers the federal government's prescription drug program. Both parts are financed primarily by transfers from the general fund of the Treasury and premiums from participants.

Other Stewardship Information

The stewardship section of the CFR also provides the reader with unaudited information about assets that the federal government holds for the benefit of the nation, called stewardship assets. Stewardship assets are not used in federal government operations and, therefore, are not included on the Balance Sheet. These assets include

- natural heritage assets, such as national parks, national forests, and wilderness areas;
- collection-type heritage assets, including museums, archives, and libraries such as the Smithsonian Institution, National Archives, and Library of Congress; and
- cultural heritage assets, including monuments and memorials such as the Washington Monument and Jefferson Memorial in Washington, D.C.

The CFR provides information about these assets in terms of physical quantities, such as millions of acres of land; miles of rivers; numbers of buildings, monuments, memorials, and archeological and historical sites; and items in national library and museum collections.

The stewardship section also describes how much the federal government spent for programs that provide long-term benefits to the public. These programs include grants for construction and major renovation of state and local government property, such as bridges and roads, and grants for education and training. The stewardship section also describes the expenses the federal government has incurred in its basic and applied research and in development programs.

Readers can use information from this section to identify such things as

- how many acres of stewardship land the federal government owns and whether the number of acres has increased or decreased in total and by category;
- how much the federal government spent on nonfederal physical property such as state and local bridges and roads, and whether such spending has increased or decreased; and
- how much the federal government spent on educating and training the public and whether such spending has increased or decreased.

For example, the illustrative table below on stewardship land reports the number of acres of stewardship land held by the federal government in various categories for fiscal years 2003 and 2004. It shows, for instance, that the Bureau of Land Management, with about 261.8 million acres, is responsible for approximately 40 percent of the federal government's stewardship land. The table on stewardship investments reports annual expenditures from fiscal year 2000 through fiscal year 2004. It includes things that the government considers investments in the future of the nation, such as public education and training, under investments in human capital, and various categories of research and development.

Other Stewardship Information

Illustrative Stewardship Information

Stewardship Land as of September 30					
Agency	Predominant use	Millions of Acres		Percentage	
		2004	2003	2004	2003
Bureau of Land Management	Public land	261.8	262.0	40.5	39.9
U.S. Forest Service	National forest system	192.9	192.5	29.8	29.3
U.S. Fish and Wildlife Service	National wildlife refuge system	90.3	95.9	14.0	14.6
National Park Service	National park system	79.0	84.2	12.2	12.8
Department of Defense	Defense facilities	16.7	16.7	2.6	2.5
Bureau of Reclamation	Water, power, and recreation	<u>5.7</u>	<u>5.9</u>	<u>0.9</u>	<u>0.9</u>
Total acres		<u>646.4</u>	<u>657.2</u>	<u>100.0</u>	<u>100.0</u>

Stewardship Investments for the Years Ended September 30					
	Fiscal Year	Restated Fiscal Year	Restated Fiscal Year	Restated Fiscal Year	Restated Fiscal Year
(In billions of dollars)	2004	2003	2002	2001	2000
Investments in nonfederal physical property	45.3	46.8	47.6	37.9	38.9
Investments in human capital	77.1	71.3	54.7	44.3	36.8
Research and development					
Investments in basic research	32.9	24.6	22.8	18.9	18.2
Investments in applied research	23.9	21.5	21.6	17.5	16.3
Investments in development	<u>60.2</u>	<u>48.3</u>	<u>44.4</u>	<u>39.4</u>	<u>38.1</u>
Total investments	<u>239.4</u>	<u>212.5</u>	<u>191.1</u>	<u>158.0</u>	<u>148.3</u>

Notes to the Financial Statements

The notes to the financial statements are an important source of information about the financial operations and condition of the federal government. As stated on the bottom of each of the statements, notes are considered an integral part of the financial statements. Moreover, most of the consolidated financial statements contain references to one or more notes.

The 21 notes to the federal government's fiscal year 2004 consolidated financial statements provided 36 pages of important and required disclosures. The notes addressed the following topics:

1. Significant Accounting Policies	8. Other Assets	15. Collections and Refunds of Federal Revenue
2. Cash	9. Accounts Payable	16. Unreconciled Transactions Affecting the Change in Net Position
3. Accounts Receivable	10. Debt Held by the Public	17. Change in Accounting Principle and Prior Period Adjustments
4. Loans Receivable and Loan Guarantees	11. Federal Employee and Veteran Benefits Payable	18. Contingencies
5. Taxes Receivable	12. Environmental and Disposal Liabilities	19. Commitments
6. Inventories and Related Property	13. Benefits Due and Payable	20. Dedicated Collections
7. Property, Plant, and Equipment	14. Other Liabilities	21. Indian Trust Funds

The first note to the federal government's consolidated statements summarizes the significant accounting policies used in accounting for and reporting on the federal government's consolidated financial information. Other notes provide important disclosures and details about the items on the statements. For example, the Federal Employee and Veteran Benefits Payable note provides details about the composition of benefits payable to federal civilian employees, military personnel, and disabled veterans, which exceeded \$4 trillion for fiscal year 2004. Because this estimated amount is based on actuarial calculations, the note also identifies the significant long-term assumptions used in determining these liabilities and related expenses. In addition, the note discloses that the Department of Veterans Affairs (VA) provides medical care to veterans on an "as available" basis,

Notes to the Financial Statements

subject to the limits of the annual appropriations. VA does not report an accrued long-term actuarial liability for this medical care, but recognizes the medical care expenses in the period the services are provided. For the time period 2000 through 2004, the note states that the average medical cost per year was \$22 billion. Further, the note discloses that VA provides pension benefits to certain veterans and their dependents based on annual eligibility reviews. Although VA does not recognize a long-term actuarial liability for these pension benefits, VA discloses the projected amounts of future payments for pension benefits, \$102.2 billion as of September 30, 2004, and \$102.7 billion as of September 30, 2003. Readers can use this information to learn which benefit programs are primarily responsible for changes in the federal government's liability to its civilian employees, military personnel, and veterans and thus to better understand factors likely to drive future federal disbursements.

The table below is the summary table from the fiscal year 2004 note for Federal Employee and Veteran Benefits Payable, which shows how much the federal government estimates it owes civilian and military employees in various categories of benefits. The full note also provides additional tables depicting the details of the changes in the pension and post-retirement health benefits categories from fiscal year 2003 to fiscal year 2004 for both civilian and military employees, and discusses the various categories.

Illustrative Note Information

Federal Employee and Veteran Benefits Payable as of September 30						
	Civilian		Military		Total	
(In billions of dollars)	2004	2003	2004	2003	2004	2003
Pension and accrued benefits	1,230.2	1,190.4	837.7	739.0	2,067.9	1,929.4
Post-retirement health benefits	266.1	244.4	725.3	683.0	991.4	927.4
Veteran compensation and burial benefits	N/A	N/A	924.8	954.8	924.8	954.8
Liability for other benefits	<u>54.4</u>	<u>47.2</u>	<u>23.6</u>	<u>21.2</u>	<u>78.0</u>	<u>68.4</u>
Total	<u>1,550.7</u>	<u>1,482.0</u>	<u>2,511.4</u>	<u>2,398.0</u>	<u>4,062.1</u>	<u>3,880.0</u>

Supplemental Information

The supplemental information section, the final section of the CFR, is intended to provide additional information about the federal government's finances that may affect future operations or help taxpayers better understand how the federal tax burden is distributed. The supplemental information is not required to be audited.

Readers can use information from this section to identify such things as

- the estimated costs of maintenance needed to bring property owned by the federal government to an acceptable condition, called deferred maintenance (e.g., for fiscal year 2004, the estimated cost of deferred maintenance on such property ranged from about \$13.4 billion to approximately \$25.4 billion);
- the amount of funds authorized by Congress that have not been spent or committed for the year, called unexpended budget authority;
- the estimated amount of income tax refunds that may be paid on taxpayers' claims against the federal government (e.g., the federal government reported for fiscal year 2004, that it estimated \$8.4 billion may be paid on taxpayers' claims); and
- the amount of federal taxes paid by groups of individuals by income level (e.g., individuals with adjusted gross incomes over \$200,000 paid about 40 percent of the individual federal income taxes collected for fiscal year 2002).

The following table is taken from the supplemental information section of the CFR. It is intended to provide additional information about individual taxable income and taxes paid. Although the data are from the 2002 tax year, the information nonetheless helps readers understand how the federal tax burden is distributed based on adjusted gross income.

Supplemental Information

Illustrative Supplemental Information

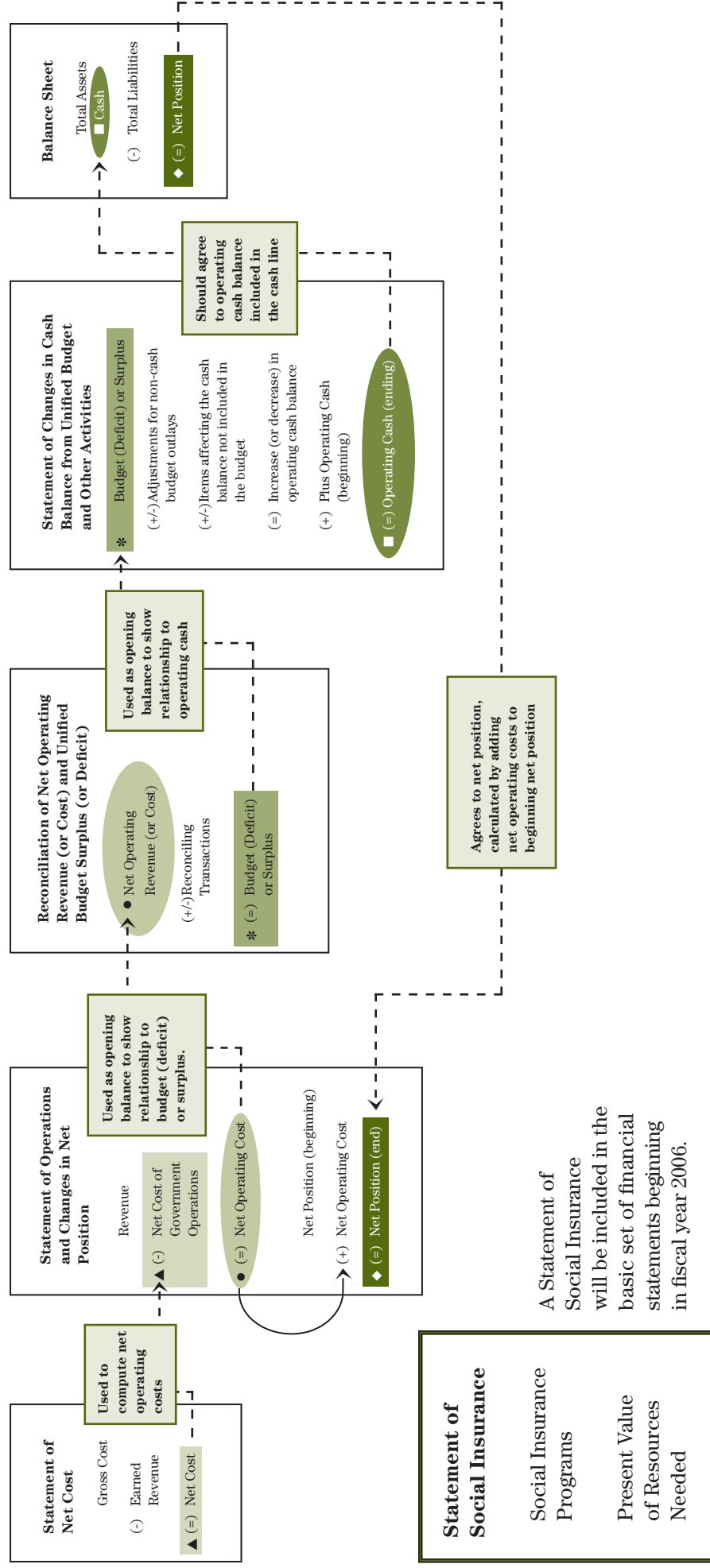
Individual Income Tax Returns for Tax Year 2002						
Adjusted gross income (AGI)	Number of taxable returns	AGI	Total income tax	Average AGI per return	Average income tax per return	Income tax as a percentage of AGI
	(in thousands)	(dollars in millions)	(dollars in millions)	(in whole dollars)	(in whole dollars)	
Under \$15,000	38,133	211,417	3,942	5,544	103	1.9%
\$15,000 to under \$30,000	29,964	657,946	27,621	21,958	922	4.2%
\$30,000 to under \$50,000	24,556	959,677	70,761	39,081	2,882	7.4%
\$50,000 to under \$100,000	26,687	1,864,379	196,005	69,862	7,345	10.5%
\$100,000 to under \$200,000	8,442	1,112,924	175,904	131,834	20,837	15.8%
\$200,000 or more	<u>2,419</u>	<u>1,233,062</u>	<u>323,558</u>	<u>509,695</u>	<u>133,745</u>	<u>26.2%</u>
Total	<u>130,201</u>	<u>6,039,405</u>	<u>797,791</u>	—	—	—

How the Federal Government's Financial Statements Relate to One Another

The federal government's consolidated financial statements consist of five interrelated statements. The chart on the next page provides an overview of the five statements and how selected components of those statements are related.

- ▲ The total operating expense, called Net Cost, presented in the Statement of Net Cost is used in the Statement of Operations and Changes in Net Position to determine whether the federal government's financial operations (revenue less expenses) resulted in net operating cost or net operating revenue for the year.
- The operating result from the Statement of Operations and Changes in Net Position explains the change in the federal government's net position. It is also the beginning balance in the Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit).
- ◆ The Net Position from the Statement of Operations and Changes in Net Position agrees to the Net Position on the Balance Sheet, which is based on the difference between the federal government's reported assets and liabilities.
- * The unified budget result is used in the Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit) and the Statement of Changes in Cash Balance from Unified Budget and Other Activities to show how the federal government's financial operations and changes in operating cash are connected to the unified budget results.
- The federal government's ending operating cash balance from the Statement of Changes in Cash Balance from Unified Budget and Other Activities is the same as the operating cash component of the "Cash and other monetary assets" line on the Balance Sheet. The operating cash amount can be found in the Balance Sheet note for Cash and other monetary assets.

How the Federal Government's Financial Statements Relate to One Another





G A O

Accountability * Integrity * Reliability