An explanation of the *Financial Report of the US Government* for fiscal year 2015

Prepared on behalf of the Peter G. Peterson Foundation

November 2016

Building a better working world

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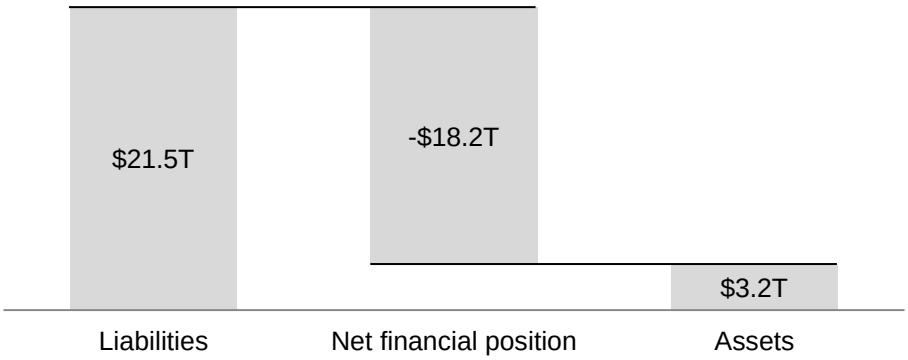
Executive summary

The financial outlook of the US Government is unsustainable, according to the most recent *Financial Report of the US Government*.

Net Financial Position: The net financial position of the US Government was negative $18.2 trillion (see Figure ES-1) at the end of fiscal year 2015 – and had deteriorated by $521 billion since 2014. The net financial position measures the extent to which the government's liabilities exceed its assets.

- **Assets.** The US Government reported assets of more than $3.2 trillion at the end of fiscal year 2015 – approximately $10,000 per person. Loans receivable accounted for 38% of this amount ($1.2 trillion) and consisted mostly of student loans receivable. Other assets included buildings and equipment, supplies, and cash.
- **Liabilities.** The US Government reported liabilities of nearly $21.5 trillion at the end of fiscal year 2015 – approximately $66,700 per person. Federal debt held by the public and accrued interest totaled nearly $13.2 trillion – approximately $41,000 per person. Other liabilities included federal employee and veterans' benefits (other than Social Security and Medicare), loan guarantees, and amounts owed to government contractors.

Figure ES-1. Liabilities, assets, and net financial position of the US Government, as of September 30, 2015
Trillions of dollars



Note: The net financial position is the residual difference between assets and liabilities, representing the cumulative results of government operations since inception. Figures may not sum due to rounding.
Source: US Department of the Treasury.

Net operating cost: The net operating costs of the US Government totaled $520 billion in 2015, which is the amount by which spending on government operations exceeds revenues. It was $81 billion larger than the unified budget deficit of $439 billion in 2015. That difference stems primarily from the accrued costs associated with increases in estimated federal employee and veteran benefits liabilities.

- **Revenue.** The US Government reported revenues totaling more than $3.7 trillion in fiscal year 2015 – or $11,541 per person.
- **Costs.** The US Government spent nearly $4.3 trillion, approximately $13,200 per person, on operating costs, transfer payments, and other spending.

Unfunded liabilities of social insurance programs. The US Government's net operating cost and net financial position do not include the unfunded liabilities of social insurance programs — such as Social Security and Medicare. The unfunded liabilities of those programs are considered separately from the financial statements.

- Medicare's cumulative funding shortfall at the end of 2015 was $27.9 trillion — approximately $86,900 per person.
- Social Security's cumulative funding shortfall at the end of 2015 was $13.4 trillion – nearly $41,800 per person.

Why look at the *Financial Report?*

As an audited and publicly available consolidation of financial statements of the US Government's entities, the *Financial Report* serves as a source of transparency and accountability for how the US Government uses financial resources. The US Treasury Department publishes the report following each fiscal year. And unlike the federal budget, which is mostly prepared using cash-basis accounting, the financial statements in the *Financial Report* are largely prepared using accrual accounting under US Generally Accepted Accounting Principles (GAAP) - the same principles used by most American businesses. This allows the report to provide a more comprehensive view of the government's fiscal operations and financial position.

Contents

An explanation of the *Financial Report of the US Government* for fiscal year 2015

I. Introduction

The *Financial Report of the US Government* (the "*Financial Report")* is a detailed statement of the US Government's costs and revenues, assets and liabilities, and other financial information.[1] The intent of the *Financial Report* is to provide a comprehensive overview of the US Government's current financial position.

The *Financial Report* is similar in many respects to a corporate financial accounting statement that provides a comprehensive picture of a business's financial position. Because the *Financial Report* is subject to audit and is publicly available, it is also a source of transparency and accountability for the use of the US Government's financial resources. Readers should note that the *Financial Report* has not been audited by EY.

Components of the *Financial Report*

The Treasury consolidates financial statements from individual federal entities to issue a government-wide financial statement following the end of each fiscal year[2] in the *Financial Report*. Like the financial reports of private companies, this consolidation of financial statements includes a: (1) balance sheet and, (2) statement of government operations (net operating cost) and the change in net financial position.

The balance sheet summarizes the government's assets, liabilities, and net financial position. (The government's net financial position is equal to its assets less its liabilities.) The statement of operations and change in net financial position summarizes government revenues, expenses, and net operating cost. (Net operating cost is calculated as the excess of the gross cost of the US Government over taxes and other revenues.) The *Financial Report* also includes notes and supplemental information on long-term projections for social insurance programs, which are excluded from the calculation of both net operating cost and net financial position.

The financial statements of federal entities are required to follow the standards established by the Federal Accounting Standards Advisory Board and are subject to audit by the Government Accountability Office (GAO). Although the requirement that the GAO audit the consolidated financial statements of the US Government was put in place in 1997, the GAO has not yet provided an audit opinion on the *Financial Report* because of a number of deficiencies it has noted in the US Government's accounting practices. Many of these deficiencies result from inadequacies in the way in which financial information is obtained. A more detailed discussion of some of the specific deficiencies noted by the GAO is provided in the Appendix.

Accrual-basis accounting of the *Financial Report* versus cash-basis accounting of the federal budget

The *Financial Report* is supplementary to the Budget of the US Government (the "US Budget" or "federal budget"). The budget serves as a planning and control document that identifies government cash receipts and cash disbursements (payments to the public). The *Financial Report* discusses the US Government's financial position at the end of the fiscal year, explains how and why the financial position changed during the year, and provides insight into potential future changes in the US Government's financial condition.

Whereas the US Budget is mostly presented on a cash basis, the financial statements in the *Financial Report* are largely presented on an accrual basis. As such, a key difference between the US Budget and the *Financial Report* is when revenues and outlays are recognized. The accounting treatment of various financial statement items in the *Financial Report* relative to the US Budget is summarized in Table 1.

Table 1. Accounting treatment of various financial items in the Financial Report of the US Government relative to the US Budget

Financial statement item	*Financial Report* (Accrual-basis accounting*)	US Budget (Cash-basis accounting)
Tax collections	Recognized when received*	Recognized when received
Revenue earned in exchange for goods and services	Recognized when earned through provision of a good or service	Recognized when received
Expenses	Recognized when incurred	Recognized as outlay when paid
Property, plant, and equipment	Capitalized as long-term assets at cost when purchased; depreciated and expensed during useful life	Recognized as outlay when paid
Federal employee and veteran benefits	Recognized as liability as employees earn future benefits during their careers; expensed in the month the benefit is due to be paid	Recognized as outlay when paid
Future Social Security and Medicare benefits and contributions	Not recognized on financial statements, but presented separately in statement of social insurance	Recognized as receipts and outlays, respectively
Investments in Government-Sponsored Enterprises (GSEs)	Recognized at current fair market value	Not included in the US Budget

* The *Financial Report* recognizes tax collections as revenue in the same manner as the US Budget: upon receipt of cash in payment of taxes. As such, tax revenue shown in the government's statement of operations and changes in net financial position for fiscal year 2015 includes tax collections that were received during fiscal year 2015. These tax collections relate to, for example, taxes owed on income earned in tax year 2015, tax year 2014, and prior tax years. As such, the financial statements presented in the *Financial Report* are presented under the accrual basis of accounting with certain modifications that are similar in character to the cash basis of accounting.
Note: "Recognition" denotes the process of formally recording an element into the financial statements of an entity.
Source: US Department of the Treasury; Federal Accounting Standards Advisory Board.

The US budget, for example, reports pension outlays to retired federal workers when the payment is made. By contrast, the financial statements record the expense when the benefit is earned. Accrual accounting thus provides a forward-looking assessment of pension costs.

Unified budget deficit versus net operating cost

The unified budget deficit is the most frequently discussed component of the US Budget. The unified budget deficit is largely measured based on cash inflows and outflows, while the net operating cost of the government in the *Financial Report* is reported on an accrual basis. These metrics differ due to the different accounting standards upon which they are based. For example, the purchase of a $2 billion warship is recorded as an outlay in the unified budget deficit, while it is recorded as an asset in the financial statements. This asset is then depreciated over time based on its useful life – and recorded as a cost in the *Financial Report*. The same practice is used for nearly all capital investments by the US Government, such as a grant for infrastructure (e.g., bridge, highway, school, wastewater treatment plant, etc.) to state or local governments, even though such investments may be accounted for differently by those recipient governments.

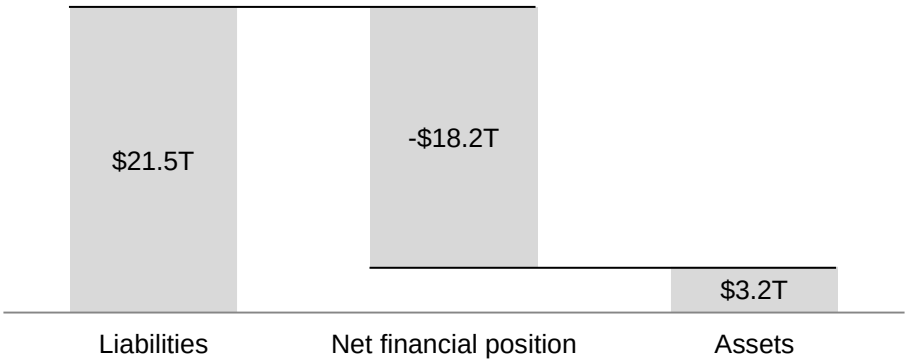
While the unified budget deficit receives significant attention by the Congress, other policymakers, and the media, the accrual-basis financial statements of the US Government offer a different view of the US Government's financial condition.

II. Net financial position of the US Government

Key takeaways:

- Liabilities mostly consisted of federal debt held by the public and accrued interest ($13.2 trillion). The government has also recognized a large liability for pension, health care, and life insurance benefits to be paid to federal employees and veterans ($6.7 trillion).
- U.S. government liabilities exceeded its assets by $18.2 trillion at the end of fiscal year 2015.
- The largest single asset category was loans receivable ($1.2 trillion), 80% of which is student loans.
- The unfunded liabilities of Social Security, Medicare, and other major social insurance programs are not included in the net financial position of the US Government. These unfunded liabilities totaled nearly $41.8 trillion at the end of fiscal year 2015.

Figure 1. Liabilities, assets, and net financial position of the US Government, as of September 30, 2015
Trillions of dollars



Note: The net financial position is the residual difference between assets and liabilities, representing the cumulative results of government operations since inception. Figures may not sum due to rounding.
Source: US Department of the Treasury.

The net financial position of the US Government, as demonstrated in Figure 1, does not include the future unfunded liabilities of social insurance programs. These unfunded liabilities – calculated as the present value of expected future expenditures on social insurance programs less the present value of expected future revenue to these programs – totaled nearly $41.8 trillion at the end of fiscal year 2015, more than double the *Financial Report* net financial position. Adding these liabilities to the US Government's balance sheet would result in a combined net financial position of negative $60 trillion in present value.

Table 2. Major net financial position items of the US Government, fiscal year 2015
Billions of dollars; Dollars per person

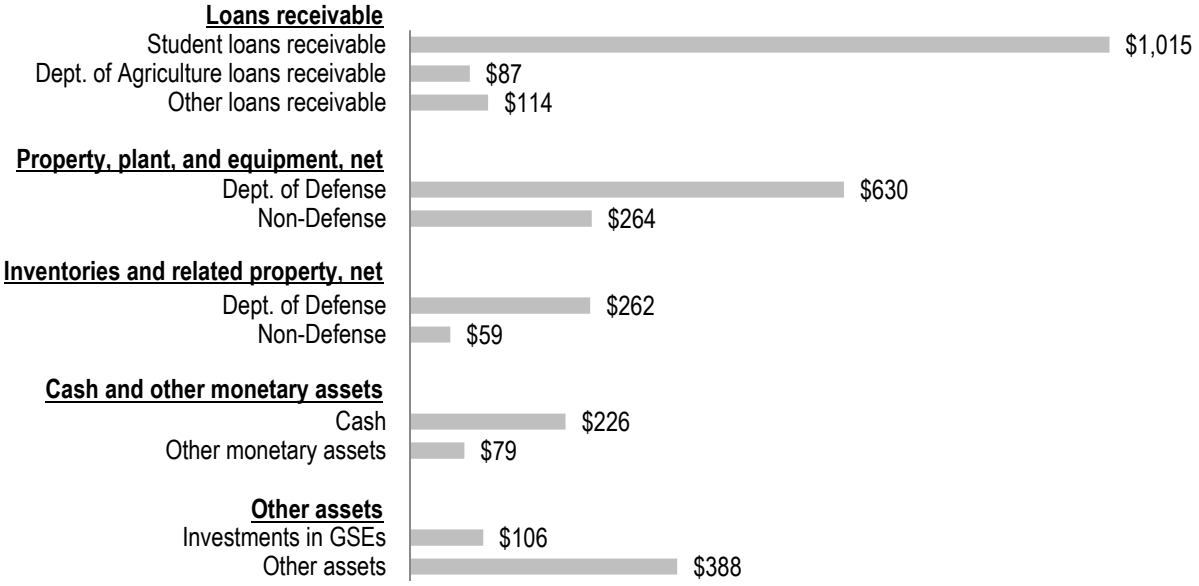
	Amount	Per person	% of total
Assets	**$3,230**	**$10,049**	**100%**
Loans receivable, net^	$1,216	$3,783	38%
Property, plant and equipment, net	$894	$2,781	28%
Inventories and related property, net	$321	$997	10%
Cash and other monetary assets	$305	$949	9%
Investments in GSEs	$106	$331	3%
Other assets	$388	$1,207	12%
Liabilities	**$21,452**	**$66,741**	**100%**
Federal debt held by the public and accrued interest	$13,173	$40,982	61%
Federal employee and veteran benefits payable	$6,719	$20,905	31%
Other liabilities	$1,560	$4,853	7%
Of which: Liabilities for social insurance payments currently due			
Medicare	$66	$206	<1%
Social Security	$71	$222	<1%
Net financial position	**-$18,222**	**-$56,692**	
Unfunded liabilities of social insurance programs*	**-$41,790**	**-$35,689**	**100%**
Medicare	-$27,940	-$29,899	67%
Social Security	-$13,440	-$5,704	32%
Railroad Retirement and Black Lung benefits	-$108	-$86	<1%
Grand Total (Net Financial Position + Unfunded)	**-$60,012**	**-$92,381**	

^ More than 80% of "loans receivable, net asset" is student loans.
*Not included in calculation of net financial position.
Note: The net financial position is the residual difference between assets and liabilities, representing the cumulative results of government operations since inception. The unfunded liabilities of social insurance programs are reported as the present value of future revenue less the present value of future expenditures for the 75-year period from 2015 through 2089. "GSEs" refers to the Government-Sponsored Enterprises Fannie Mae and Freddie Mac. Figures may not sum due to rounding.
Source: US Department of the Treasury; US Bureau of the Census; EY analysis.

Assets

Assets are resources available to meet future needs. The US Government reported assets of nearly $3.2 trillion at the end of fiscal year 2015 – more than $10,000 per person. The different categories of government assets are summarized in Figure 2. Loans receivable accounted for $1.2 trillion (38%) of total US Government assets. More than $1.0 trillion of government loans receivable relate to student loans, including direct student loans and family education loans.

Figure 2. US Government assets as of the end of fiscal year 2015
Billions of dollars



Note: "GSEs" refers to the Government-Sponsored Enterprises Fannie Mae and Freddie Mac.
Source: US Department of the Treasury; EY analysis.

After loans receivable, three categories of tangible assets comprised more than $1.5 trillion (47%) of government assets at the end of fiscal year 2015: property, plant, and equipment; inventories; and cash and other monetary assets. Property, plant, and equipment is reported on the balance sheet net of depreciation and amortization; that is, it reflects the depreciated value of various assets under accrual accounting rules.[3] Department of Defense buildings, equipment, and other fixed assets account for more than 70% (or $630 billion) of all of the US Government's property, plant, and equipment.

Inventories and related property include assets purchased by various federal entities for resale, use, or repair. Other assets included in this category are stockpile materials such as the strategic petroleum reserve and assets acquired through forfeitures to satisfy, for example, a tax liability. Department of Defense assets, such as spare parts and materiel, comprise 82% ($262 billion) of the government's total $321 billion of inventories and related property. The US Government reported holdings of cash and other monetary assets valued at $305 billion at the end of fiscal year 2015. Of this amount, $226 billion was cash and the remaining $79 billion included international monetary assets such as International Monetary Fund Special Drawing Rights, gold and silver, and foreign currency. Most cash is held by the Treasury to finance government operations. This cash is received from tax collections, earned revenue, and federal debt receipts.

The government valued its investments in Fannie Mae and Freddie Mac at $106 billion. This amount includes $92 billion of senior preferred stock and $14 billion of warrants for common stock across the two GSEs. Other assets totaling $388 billion (12% of total assets) include

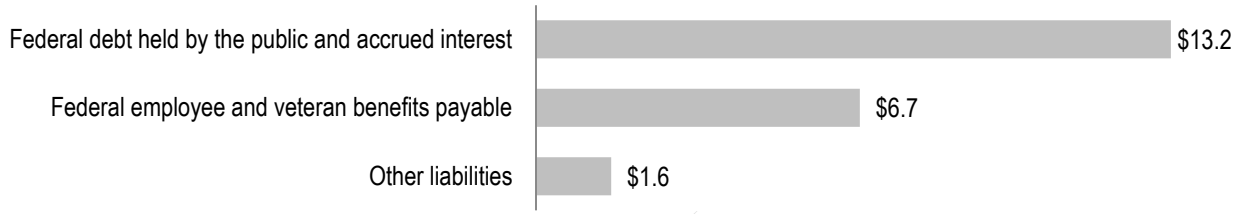
advance payments to contractors and suppliers, FDIC receivables from resolving failed institutions, and assets arising from the actions of energy regulators such as government power marketing authorities and the Tennessee Valley Authority.

Liabilities

Liabilities are obligations of financial resources resulting from prior actions or events. As shown in Figure 3, the US Government reported liabilities totaling nearly $21.5 trillion at the end of fiscal year 2015 – more than $66,700 per person. A majority of this amount, $13.2 trillion, represents federal debt held by the public and accrued interest on that debt. This debt is primarily issued by the Treasury and includes marketable securities such as bills, notes, inflation-protected securities, and bonds, and nonmarketable securities such as savings bonds and state and local government series.

Figure 3. US Government liabilities as of the end of fiscal year 2015

Trillions of dollars



Source: US Department of the Treasury; EY analysis.

Liabilities for federal employee and veteran benefits payable total $6.7 trillion. As explained in Section II, these liabilities are accrued each year as employees earn more benefits through continued employment. They are valued at the estimated present value of future benefits, less the estimated present value of future contributions. These benefits include pensions, post-retirement health benefits, veterans' burial benefits, and life insurance.

Finally, the US Government reported other liabilities of nearly $1.6 trillion. These liabilities include outstanding loan guarantees, fees for nuclear waste disposal that have not yet been earned, postal service income for prepaid postage and post office box rentals, accrued federal employees' wages and benefits, and amounts owed to recipients of subsidies and grants.

Social insurance programs

The US Government recognizes liabilities for the amounts of social insurance benefits due in September of each fiscal year that have not yet been paid. These liabilities totaled $138 billion at the end of fiscal year 2015. However, social insurance benefits owed in the future are not recognized in the US Government's financial statements.

These unrecognized liabilities are measured by the excess of the present value of estimated future expenditures of social insurance programs over the present value of estimated future revenue. They represent the programs' funding shortfall, given current law, over the next 75 years. Medicare had the largest shortfall at the end of fiscal year 2015, amounting to $27.9

trillion, or more than $29,899 per person. The Social Security shortfall totaled more than $13.4 trillion, or $5,704 per person. In total, funding shortfalls for Medicare, Social Security, and other benefit programs totaled almost $41.8 trillion at the end of fiscal year 2015 – nearly $35,689 per person. Over time, these amounts will be gradually reflected on the US Government's financial statements as recipients claim benefits.

Table 3 shows changes in unfunded liabilities between 2014 and 2015. These changes in the unfunded liabilities of social insurance programs from 2014 to 2015 reflect, in large part, simply moving the 75-year window evaluated from 2014-2088 to 2015-2089. Differences in the US Government's social insurance spending in 2089 versus 2014, on a present value basis, result in changes to the programs' unfunded liabilities.

Table 3. Changes in the unfunded liabilities of US social insurance programs, fiscal year 2015

Billions of dollars; Dollars per person

	Amount	Per person
Changes in the unfunded liabilities of social insurance programs*	**$429**	**$1,335**
Medicare	$543	$1,689
Social Security	-$110	-$342
Railroad Retirement and Black Lung benefits	-$5	-$16

*Not included in calculation of net operating cost
Note: The unfunded liabilities of social insurance programs are reported as the present value of future revenue less the present value of future expenditures for the 75-year period from 2015 through 2089. Figures may not sum due to rounding.
Source: US Department of the Treasury; US Bureau of the Census; EY analysis.

Net financial position

Net financial position reflects the value position of the US Government, based on the difference between the valuation of liabilities and the valuation of assets. It does not include the US Government's unfunded liabilities for social insurance.

At the end of fiscal year 2015, the US Government's net financial position was negative $18.2 trillion, or approximately negative $56,700 per person. By comparison, real GDP per person was $ 55,837 in 2015.[4]

Change in net financial position over time

The net financial position of the US Government deteriorated by more than $520 billion from the end of fiscal year 2014 to the end of fiscal year 2015. Much of this change can be attributed to the $339 billion increase in the government's liability for federal debt securities held by the public and accrued interest. This increase reflects new borrowing to support the government's net operating cost.

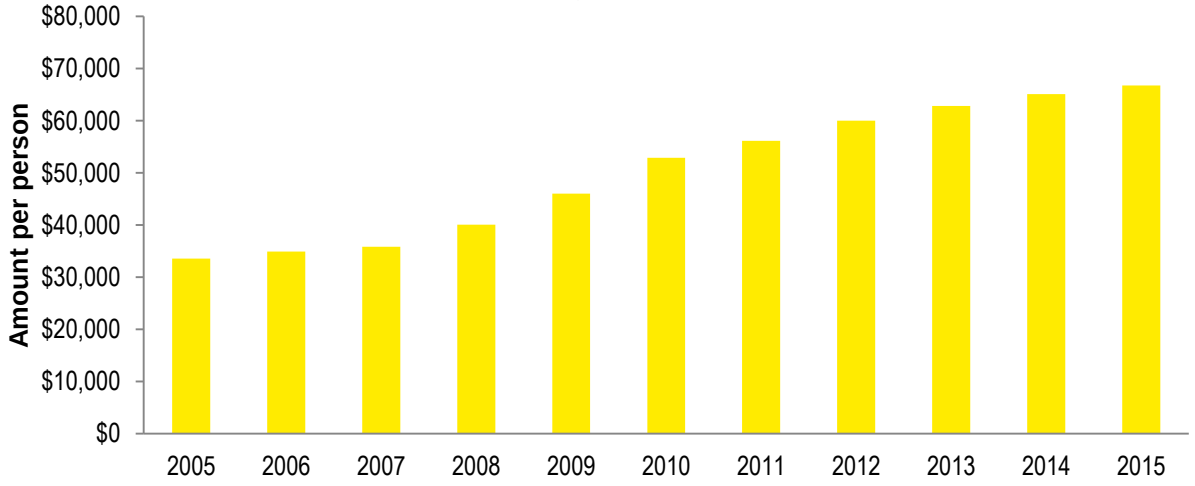
"Other liabilities" increased by $300 billion, led by a temporary $205 billion liability that accounted for federal debt securities that were owed to the Thrift Savings Plan. As part of its extraordinary measures to avoid reaching the federal debt limit, the Treasury Department disinvested and delayed issuing government securities to the Thrift Savings Plan.

Cash and other monetary assets increased by $40 billion, reflecting a corresponding $40 billion increase in operating cash held by the Treasury. The Treasury attributed this change to investment borrowing decisions to manage the balance and timing of the government's cash position. Another notable change from the end of fiscal year 2014 was the $11 billion increase in the estimated fair value of the government's investments in the GSEs Fannie Mae and Freddie Mac.

Figure 4 displays the liabilities of the US Government on a per-person basis from the end of fiscal year 2005 to the end of fiscal year 2015. Liabilities per person accelerated beginning in fiscal year 2008, reflecting changes in fiscal policy in response to the financial crisis and changes in tax collections and mandatory spending as a result of reduced economic activity. The net financial position per person worsened by $28,100 during this period, as shown in Figure 5.[5] Much of this change in the net financial position per person can be attributed to the increase in federal debt and accrued interest, which grew by approximately $25,300 per person. Benefits payable to federal employees and veterans also increased significantly, by more than $5,700 per person. Nearly 60% of the nearly $5,100 change in assets per person can be attributed to an increase in loans receivable.

Figure 4. US net liabilities per person, fiscal years ended 2005-2015

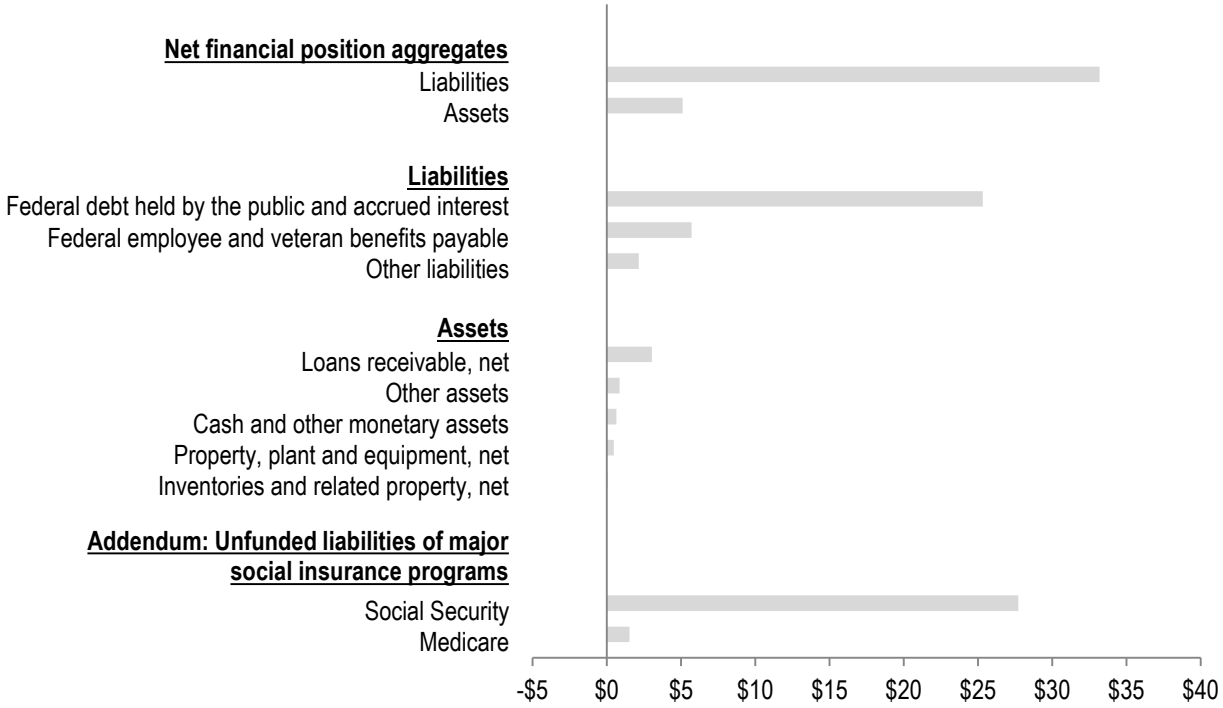
Nominal dollars per person



Source: US Department of the Treasury; US Bureau of Economic Analysis; US Census Bureau; EY analysis.

Figure 5. 10-year change in net financial position per person, by major component

Thousands of dollars per person



Note: The total 10-year change in net financial position is an approximately $28,100 increase per person. This reflects an increase in liabilities of approximately $33,200 per person and an increase in assets of approximately $5,100 per person. The change in the unfunded liabilities of Medicare and Social Security is not included in the calculation of the change in government liabilities and assets. Dollars are nominal.

Source: US Department of the Treasury; US Bureau of the Census; EY analysis.

III. Net operating cost of the US Government

Key takeaways:

- The net operating cost of the US Government for fiscal year 2015 was $520 billion, representing the amount by which the cost of government operations exceeded taxes and other revenue.
- Spending on Medicare, Medicaid, and Social Security, and other major social insurance programs accounted for more than $2.0 trillion of the gross cost of the US Government in fiscal year 2015, or 49% of total costs.
- The US Government's $520 billion net operating cost differs from the unified budget deficit for fiscal year 2015, which was $439 billion. Accrual-based accounting reflected in the net operating cost provides a more comprehensive picture of the value of assets and liabilities (affecting the accounting for resource flows) while also accounting for expenses when incurred rather than when paid.

The *Financial Report* indicates that the net operating cost of the US Government for fiscal year 2015 was $520 billion (see Table 4).[6] The US Government's net operating cost represents the difference between the government's costs and revenue on an accrual-accounting basis.

Table 4. Major net operating cost items of the US Government, fiscal year 2015
Billions of dollars; Dollars per person

	Amount	Per person
Taxes and other revenue	$3,710	$11,541
Less: Gross cost	$4,254	$13,234
Less: (Gain) / loss from changes in assumptions & unmatched items	-$24	$76
Net operating cost	**$520**	**$1,617**

Note: Gross cost is defined as the cost of goods produced and services rendered by the government. Figures may not sum due to rounding.
Source: US Department of the Treasury; US Bureau of the Census; EY analysis.

Taxes and other US Government revenue

The US Government reported taxes and other revenue totaling nearly $3.7 trillion in fiscal year 2015, as summarized in Table 5. More than $3.0 trillion of US Government revenue consisted of taxes, duties, fines, and penalties (88% of total revenue). Of this amount, $1.5 trillion was individual income tax and tax withholdings revenue – approximately $4,732 per person. This tax is paid on individuals' wages, salaries, and tips; business income from proprietorships, partnerships, and S corporations; social insurance benefits; and other types of income. Revenue from payroll tax and self-employment tax totaled $1.0 trillion – $3,186 per person.

Table 5. Taxes and other revenue collected by the US Government, fiscal year 2015
Billions of dollars; Dollars per person

	Amount	Per person	% of total
Taxes and other revenue	**$3,710**	**$11,541**	**100%**
Individual income tax and tax withholdings	**$2,545**	**$7,919**	**69%**
Individual income tax	$1,521	$4,732	41%
Payroll tax and self-employment tax	$1,024	$3,186	28%
Funds are dedicated as follows:			
Social Security	$672	$2,091	18%
Medicare Part A (Hospital Insurance)	$238	$740	6%
Disability Insurance	$114	$355	3%
Earned revenue^	**$376**	**$1,169**	**10%**
Corporate income taxes	**$340**	**$1,057**	**9%**
Other taxes and revenue	**$449**	**$1,397**	**12%**
Excise taxes	$95	$296	3%
Unemployment taxes	$53	$165	1%
Customs duties	$33	$103	1%
Estate and gift taxes	$19	$59	1%
Miscellaneous earned revenues	$19	$59	1%
Other taxes and receipts	$177	$551	5%

^Earned revenue is revenue "earned" by the government in exchange for goods and services provided to the public for a price (e.g., Medicare premiums, national park entry fees, and postal service fees).
Note: Figures may not sum due to rounding.
Source: US Department of the Treasury; US Bureau of the Census; EY analysis.

Corporate income tax revenue totaled $340 billion in fiscal year 2015. Excise tax revenue represented the largest share of the $449 billion in other taxes and revenue collected in fiscal year 2015. Excise taxes include taxes on airline tickets, gasoline, alcoholic beverages, tobacco, and firearms. Other taxes include customs duties, estate and gift taxes, and fines and penalties.

Separate from tax collections, $376 billion of revenue is "earned" by the US Government in exchange for goods and services provided to the public. "Earned revenue" includes Medicare premiums, national park entry fees, and postal service fees.[7] Earned revenue was approximately $1,169 per person in fiscal year 2015.

For the purposes of the *Financial Report*, the US Government recognizes taxes, duties, fines, and penalties when they are collected, not necessarily when the taxpayer's associated income is earned. As such, this revenue is recognized on a cash basis rather than an accrual basis.[8] Earned revenue is recognized on an accrual basis, when the government provides goods and services to the public for a price.

Gross cost of the US Government

The gross cost incurred by the US Government during fiscal year 2015 was nearly $4.3 trillion. Gross cost is the cost of all government departments and entities and includes, for example, salaries, wages, and benefits; transfer payments to the public; operating input expenditures such as rent and utilities; interest costs; and the depreciation of fixed assets such as buildings and vehicles. Under its "cause-and-effect" cost allocation approach, the government allocates cost to the department or entity that "drove" the cost. This approach is used to reasonably assign costs to the appropriate source. Because of the importance of interest on treasury securities, it is reported as a separate category.

Approximately 81% of the gross cost in 2015 was incurred by seven government departments and entities, and nearly 50% of gross costs were incurred by the Department of Health and Human Services (DHHS) and the Social Security Agency (see Table 4). DHHS which administers Medicare, federal responsibilities related to Medicaid, and the Temporary Assistance for Needy Families (TANF) program, accounted for 27% of total US Government gross cost. The Social Security Administration accounted for 22% of gross cost[9]. The Department of Defense accounted for 15% of gross cost.

In total, the US Government spent more than $13,200 per person on operating costs, services, transfer payments, and other forms of spending in 2015 (see Table 6). By comparison, GDP per person in the United States in 2015 was $55,837.[10]

Table 6. Gross cost of the US Government, fiscal year 2015
Billions of dollars; Dollars per person

	Amount	Per person	% of total
Gross cost	**$4,254**	**$13,234**	**100%**
Department of Health and Human Services	$1,131	$3,518	27%
Social Security Administration	$945	$2,940	22%
Department of Defense	$647	$2,012	15%
Interest on Treasury Securities Held by the Public	$251	$780	6%
Department of Veterans Affairs	$187	$581	4%
Department of Agriculture	$148	$460	3%
Department of the Treasury	$146	$454	3%
All other gross costs^	$800	$2,488	19%

Note: Gross cost is defined as the cost of goods produced and services rendered by the government.
Figures may not sum due to rounding.
Source: US Department of the Treasury; US Bureau of the Census; EY analysis.

Net operating cost

Subtracting the US Government's gross cost from taxes and other revenue indicates that the net operating cost of the US Government in fiscal year 2015 was $520 billion – or $1,617 per person. It is difficult to evaluate the net operating cost of particular government departments and entities because taxes and other revenue are not allocated to specific departments and entities (other than earned revenue). However, a few entities were credited with earned revenue which exceeded costs. These entities include the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Small Business Administration, the Tennessee Valley Authority, the Security and Exchange Commission, the Overseas Private Investments Corporation and the Farm Credit System Insurance Corporation.

Reconciling the US Government's net operating cost and unified budget deficit

In fiscal year 2015, the unified budget deficit was $439 billion – approximately $81 billion less than the $520 billion net operating cost. In general, net operating cost is determined on the accrual basis of accounting, while the unified budget deficit generally reflects the cash basis. The fiscal year 2015 net operating cost and unified budget deficit of the US Government are reconciled in Table 7.

For 2015, $119 billion associated with the components of net operating costs are not included in the US Budget. The largest such component is the $55 billion of "book" depreciation on property, plant, and equipment during the course of fiscal year 2015. For example, when the government purchases a fixed asset such as a building, the expenditure is recorded in its entirety as an outlay in the budget. However, it is capitalized as an asset under accrual-basis accounting and only reflected in net operating cost as it is depreciated over its useful life (that is, it is recorded as a cost to the degree that its value is depleted on an annual basis under accounting rules).[11]

The second-largest component of net operating cost not included in the US Budget is the $47 billion increase in pension, health, and other benefits liabilities for federal employees and veterans in fiscal year 2015. This amount is recorded on the government's balance sheet in the *Financial Report*. As these liabilities become payable – for instance, in the form of a payment to a retired federal worker – the associated liability is reduced and the amount payable is recorded as an expense on the government's statement of operations. By contrast, the unified budget includes only the amounts paid to retired federal workers and veterans during the fiscal year.

The accounting treatment of retirement benefits in the *Financial Report* differs from the accounting treatment of social insurance obligations.

Table 7. Reconciliation of the net operating cost and unified budget deficit of the US Government, fiscal year 2015
Billions of dollars

Net operating cost	**$520**
Components of net operating cost that are not part of the unified budget deficit	
Property, plant, and equipment depreciation expense	-$55
Increase in pension, health, and other benefits liabilities	-$47
Increase in environmental and disposal liabilities	-$43
Increase in insurance and guarantee program liabilities	-$9
Unrealized gain on investments in government-sponsored enterprises (GSEs)	$11
Other components	$24
Subtotal	**-$119**
Components of the unified budget deficit that are not part of net operating cost	
Capitalized property, plant, and equipment	$55
Other activities and adjustments	-$17
Unified budget deficit	**$439**

Note: Figures may not sum due to rounding.
Source: US Department of the Treasury.

Pension, health, and other benefit liabilities for federal employees and veterans are reflected in the *Financial Report's* net operating cost as the estimated present value of additional future benefits earned in 2015. To illustrate, consider a federal employee who, as of the end of fiscal year 2015, has earned future benefits with an estimated present value of $100,000 based on his five years of employment with the government. The employee may continue as a federal worker for many more years, during which time the employee would qualify for a greater amount of future benefits. Nonetheless, only those benefits the employee has earned through the employee's five years of service as of the end of fiscal year 2015 would be recorded as a liability on the government's balance sheet in that year. These benefits increment annually adding to annual net operating cost.

Another item is the $11 billion increase in the estimated fair value of the US Government's investments in Fannie Mae and Freddie Mac.[12] The government's estimate of the value of these government-sponsored enterprises (GSEs) increased from nearly $96 billion to more than $106 billion in 2014. This increase reflects higher forecasted GSE earnings, lower forecasted mortgage loan losses, and lower volatility and risk in the mortgage lending industry. The increase in value is reported as a gain in the year in which it occurred. Changes in the value of GSEs and results of GSE operations are not included in determining the unified budget deficit. As stated by the Office of Management and Budget, "[t]hey are not included in the Federal Budget because they are private companies, and their securities are not backed by the full faith and credit of the US Government."[13]

Understanding the difference between net operating cost and the unified budget deficit also requires understanding of the difference in the treatment of expenditures on capital assets. The $55 billion of property, plant, and equipment that was capitalized or recorded as a long term

asset in the US Government's accrual-basis financial statements, was recorded as an expenditure in the US Budget.

Finally, $17 billion of adjustments reflect changes in the valuation of inventory, debt and equity securities, and other assets, and revisions to credit reform subsidy estimates.

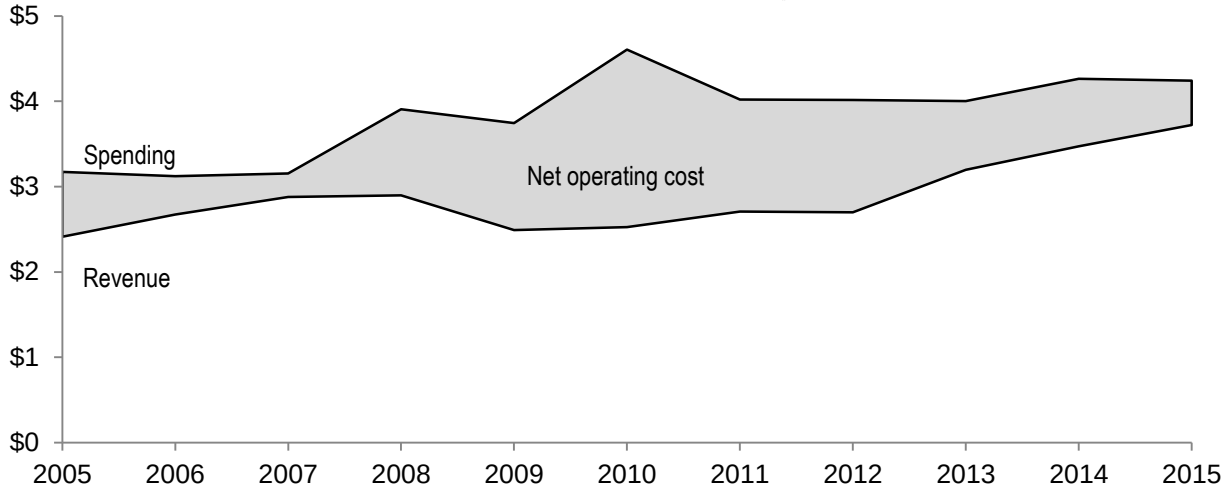
While the unified budget deficit receives significant attention among policymakers and the media, the accrual-basis financial statements of the US Government offer a view of the country's fiscal condition that, from an accounting perspective, more accurately represents economic realities such as the value of real assets and the costs of government operations.

Change in net operating cost over time

Figure 6 displays the change in gross cost, taxes and other revenue, and net operating cost over the 2005-2015 period. Over this period, the US Government's net operating cost was at its lowest point during the period at $0.3 trillion in 2007, after which it increased to a high of $2.1 trillion in 2010. Since 2010, net operating cost has trended downward.

Figure 6. Net operating cost, fiscal years 2005-2015

Billions of dollars



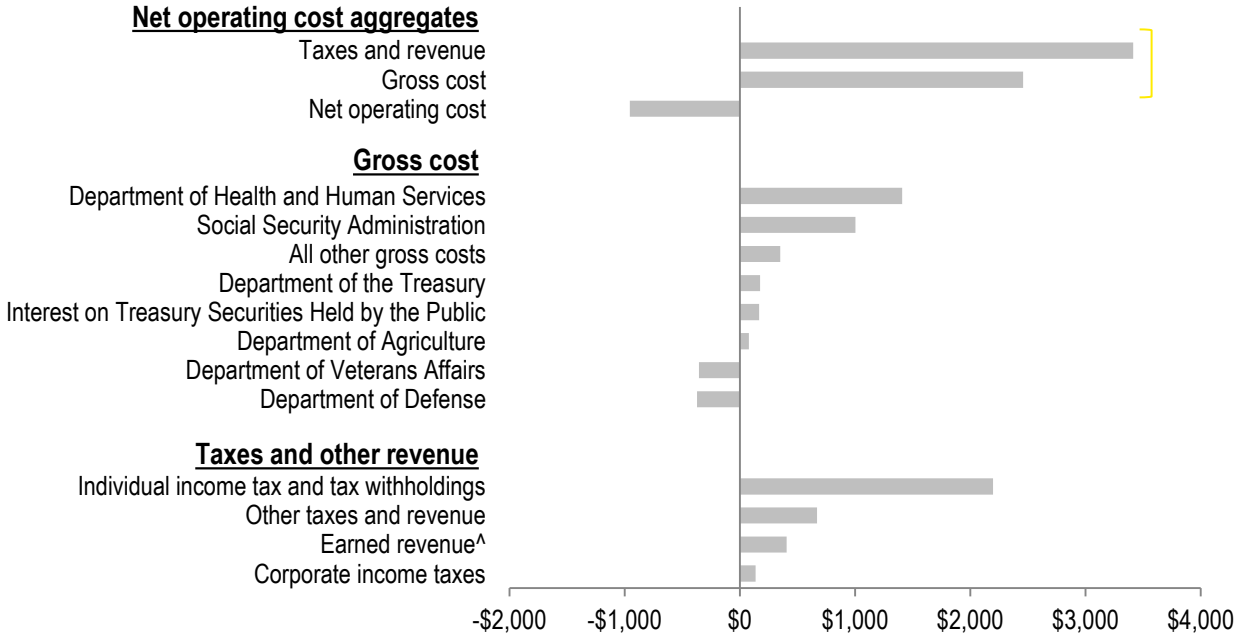
Note: Gross cost is the sum of net operating cost and taxes and revenue. For the purpose of this figure, half of the changes in assumptions / unmatched items category is allocated to all other gross costs and half is allocated to other taxes and revenue. The changes in assumptions reflect changes in the actuarial assumptions used to estimate liabilities (e.g., interest rates and disability claims rates). Unmatched items reflect unreconciled intragovernmental activity and balances between departments and entities. The average annual magnitude of this item is approximately $57 billion.
Source: US Department of the Treasury; EY analysis.

The changes in the components of gross cost, taxes and other revenue, and net operating cost per person between 2005 and 2015 are displayed in Figure 7. Approximately three-quarters of the increase in gross cost per person was due to increased costs from the Department of Health and Human Services ($1,409 per person) and Social Security Administration ($1,044 per person). This reflects the increasing costs related to Medicare and Medicaid (Department of Health and Human Services), as well as Social Security (Social Security Administration) largely due to the aging of the population, the rise in per capita health care costs, and increasing

number of individuals using Medicaid. Two gross cost components declined on a per person basis, namely the Department of Defense ($370 per person decrease) and Department of Veterans Affairs ($355 per person decrease).

The changes in the components of taxes and other revenue are also displayed in Figure 7. Nearly two-thirds of the approximately $3,400 per person increase was a result of increased individual income tax and withholding ($2,200 per person). The remainder of the change resulted from increases in other taxes and revenue ($671 per person), earned revenue ($408 per person), and corporate income tax ($137 per person).

Figure 7. 10-year change in net operating cost per person, by major component
Dollars per person



Note: The 10-year change in net operating cost is an approximately $955 decrease per person. This reflects an increase in gross cost of nearly $2,500 per person and an increase in taxes and revenue of more than $3,400 per person. Dollars are nominal. Earned revenue is revenue associated with a particular gross costs, namely revenue earned for goods and services provided (e.g., Medicare premiums, national park entry fees, and postal service fees). The sum of gross cost and earned revenue is referred to as net cost. Gross costs are defined as the costs of goods produced and services rendered by the government. Net operating cost is computed as (Taxes and revenue) less (Gross cost) plus (Changes in assumptions / unmatched items). For the purpose of this figure, half of the changes in assumptions / unmatched items category is allocated to all other gross costs and half is allocated to other taxes and revenue.
Source: US Department of the Treasury; US Bureau of the Census; EY analysis.

IV. Caveats and limitations

The explanations of the operations and fiscal positions of the US Government in this report rely on the *Financial Report of the US Government* for fiscal year 2015. Readers should be aware of the following caveats and limitations:

- **Financial statements and notes to the financial statements that were presented in the *Financial Report* were not audited by EY.** Information from the *Financial Report* is presented with some adjustments to the aggregation of data to improve understanding. While the *Financial Report* largely presents the financial statements of the US Government in accordance with GAAP, the General Accountability Office (GAO) has noted a number of deficiencies in applying GAAP. These deficiencies are described in the Appendix.

- **Certain financial data presented in the *Financial Report* and described above are based on estimates.** These estimates relate to accounting for pension, Social Security, Medicare, and other future benefit payments; fixed asset depreciation; investment valuation; loans, taxes, and other amounts receivable; and other items. These items are subject to change if the underlying assumptions used to determine the estimates change.

V. Summary

In order to more fully understand the real financial position of the US Government, both the *Financial Report* and the US Budget must be considered. The *Financial Report* for fiscal year 2015 includes accrual-basis financial statements that summarize the fiscal operations and net financial position of the US Government. The accrual-accounting basis offers a different representation of the US Government's finances than the US Budget, which is largely prepared on the cash basis of accounting.

The *Financial Report* indicates that the gross cost of operating the US Government exceeded tax collections and other revenue by $520 billion. This net operating cost was more than $1,600 per person in fiscal year 2015, compared with nearly $2,600 per person in fiscal year 2005. The net financial position of the US Government at the end of fiscal year 2015 was negative $18.2 trillion – negative $56,700 per person – representing the amount by which its liabilities exceeded its assets.

Not included in the US Government's net operating cost or net financial position are the unfunded liabilities of social insurance programs, which totaled nearly $41.8 trillion at the end of fiscal year 2015 (in present value terms for the period 2015 – 2089).

The financing of US Government operations is as difficult and diverse as the many functions and roles that the US Government performs. However, as an audited and publicly available consolidation of financial statements of the US Government's entities, the *Financial Report* serves as a source of transparency and accountability for the use of the US Government's financial resources.

Appendix. The GAO auditor's report regarding the *Financial Report*

The GAO's Independent Auditor's Report outlines several key findings that significantly affect the reliability of government estimates used in arriving at the net operating cost of the government, as contained in the *Financial Report*.[14] These findings are described in Table A-1. These findings largely relate to "continuing" material weaknesses that are key drivers of the GAO's decision to not offer an opinion on whether the US Government's financial statements are presented in accordance with GAAP in all material respects (a "disclaimer of opinion").[15]

Three of the Chief Financial Officers (CFO) Act agencies that received disclaimers of opinion on their fiscal year 2015 report or had not issued their audited fiscal year 2015 financial report represent 32% of the US Government's reported total assets and 19% of the US Government's net costs for 2015.[16]

The fact that these material discrepancies are largely a result of inadequate financial management makes estimating their full potential impact difficult. Focusing on the notes that pertain most specifically to the government's net operating cost would represent 19% of the reported net operating cost (i.e., 19% of $791 billion). Even under the assumption that a small portion of this was inaccurate, the correction of these discrepancies would result in a significant change to the financial position. Within Table A-1, the following items have the most impact on the net operating cost:

- Net costs of government operations
- Disbursement reconciliations
- Improper payments
- Statements of social insurance

The material discrepancies in the net cost of government operations are largely attributable to the Department of Defense (DOD). This is a result of material weaknesses in reporting assets and liabilities. The second issue is the lack of disbursement reconciliation, specifically within the DoD as well as the lack of reconciliations between agencies and the Treasury.

For the first two items, it is difficult to determine whether they have a positive or negative effect on the net financial position of the government. Improper payments are statutorily defined as including overpayments and underpayments. Excluding the DFAS Commercial Pay program, improper payments were estimated to total $124.7 billion in 2014, an increase from $105.8 billion the previous year.[17] The three programs with the highest error rates were the Department of Health and Human Services (HHS) Medicare Fee-for-Service, HHS Medicaid, and the Department of the Treasury's Earned Income Tax Credit. Because this amount is inclusive of over- and under-payments, it is also difficult to have a clear understanding of the direction and magnitude associated with improper payments.

Beyond the accuracy and reliability of the estimates themselves, another issue is the lack of ability to "control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required or authorized," as suggested by the GAO report.[18] The full effects

of this inefficiency are likely greater in magnitude or of more significance than the estimates themselves.

The following items in Table A-1 are most directly attributable to the net financial position:

- Plant, property, and equipment
- Environmental and disposal liabilities
- Military postretirement health benefit liabilities
- Intra-government activity and balances
- Transactions between the general fund and federal entities
- Balancing the financial statements
- Equity investments associated with stabilization

One of the key weaknesses noted was the DOD's inability to adequately account for plant, property, and equipment and inventories and related property. This shortcoming was also noted in the reports of several other agencies. Deficiencies in internal controls are consistent with an inability to know what assets are owned, as well as their specific location and condition. While the former is most relevant to an accurate description of the net financial position, there are secondary effects of this deficiency that also likely reduce the efficiency of government operations. They include the inability to:

- Safeguard from physical deterioration, theft, and loss
- Account for acquisition or disposal
- Assure availability for use when needed
- Prevent unnecessary storage or maintenance costs or the purchase of items already on hand
- Determine full costs of programs that use these assets

An inability to adequately support the amounts allocated to various types of liabilities was also noted across agencies. Essentially, the amount of liabilities is poorly documented. Again, the DOD is considered a key contributor. This includes environmental and disposal liabilities, but perhaps more significantly the inability to document the liabilities associated with both federal employees broadly, and veterans benefits more specifically. This includes the costs associated with direct healthcare care provided by DOD managed military treatment facilities.

Another problematic liability issue is the inability of the US Government to account for potential costs that are or would be associated with treaties or international agreements. Although it is sometimes difficult to understand the effect of these issues, as indicated in Table A-1, many of these liabilities appear to be understated and therefore make the government's financial position appear better than it would if accounting practices were more reliable and costs were effectively captured.

In general, this lack of accountability in reporting liabilities undermines the reliability and accuracy of the financial statements and suggests a more systemic issue in accounting for the full costs of government operations. If liabilities are overstated, then the cost of government operations will be overstated; if liabilities are understated then the full cost of government

services will not be captured. If the costs of providing services cannot be fully and accurately accounted for, it becomes very difficult to hold agencies accountable for their costs as changes from year to year are likely to be as reflective of changes in transparency of accounting as they are in improvements through increased agency efficiency.

Reconciliation of intragovernmental activity and balances is a broad category that encompasses several of the categories previously discussed in Table A-1. Part of this is associated with the deficiencies previously noted that relate to the net costs. This is largely related to the DOD's issues associated with improperly controlling deficiencies in disbursement. To the extent that these disbursements are not fully accounted for there will be subsequent issues with the net financial position and the balance sheet.

Intragovernmental transactions should be clear and transparent. A reduction from one agency should be directly traceable as an addition to another. The lack of transparency in intragovernmental transactions is both a symptom and a consequence of inadequate financial controls and ineffective financial management practices. These include irreconcilable differences between agencies and the Treasury as well as transactions with the General Fund.[19] These differences in the General Fund represent hundreds of billions of dollars on an absolute basis, while inaccuracies at the Treasury represent tens of billions of dollars.

The final area is in regards to the actions taken by the US Government to stabilize financial markets and promote economic recovery. Most of these issues are directly related to the valuation of equity investments made by Fannie Mae and Freddie Mac that, as of September 2014, totaled approximately $96 billion. These estimates are based upon assumptions associated with the economy, potential regulatory changes, market conditions, and the uniqueness of the investment itself. Each of these factors has considerable uncertainty and is therefore subject to change in a way that could either improve or diminish the financial position of the US Government. This uncertainty further challenges the accuracy of the net financial position of the US Government.

Table A-1 summarizes the items that are not properly accounted for in the accrual-based consolidated financial statements. Each row identifies the item, by broad category followed by a brief description and the effect. The last three columns categorize whether the effect of the item, as it is currently recorded in the financial statements, would improve, or diminish the financial position of the US Government (in some cases, the effect is unclear). For example, if assets are overstated, the effect would be to improve the position whereas if liabilities are overstated, this would diminish the financial position (effectively making the statements appear worse).

Table A-1. Items that are not properly recorded in the accrual-based consolidated financial statements of the US Government

			Effect of current presentation on net financial position of the US Government		
Item	**Description**	**Effect**	**Improve**	**Unclear**	**Diminish**
Property, plant, & equipment (PP&E)	Could not determine that PP&E--concentrated in DoD--were properly recorded	Generally, on net, overstates asset balances	✓		
Environmental & disposal liabilities	DoD could not reliably estimate such liabilities	Based on auditor's description, tends to understate liabilities	✓		
Commitments & contingencies	Could not determine whether commitments and contingencies were complete and properly recorded	Based on auditor's description, would tend to understate liabilities	✓		
Disbursement reconciliations	Control deficiencies exist in reconciling disbursement activity	Unclear whether disbursements are understated or overstated, but auditor notes that unreliable cost information makes it difficult to control and reduce costs; assume that costs are overstated as a result of deficiencies	✓		
Improper payments	Government cannot determine full extent of improper payments	Assuming improper payments are understated (estimates indicate $124.6and 136.9 billion of improper payments in FY2014 and 2015 respectively), then costs are understated	✓		
Military postretirement health benefit liabilities	DoD could not support a significant amount of its estimates	Unclear whether estimates understate or overstate actual liabilities		✓	
Net costs of government operations	Significant portions--mainly related to DoD--of net costs could not be supported	Unclear whether net costs are understated or overstated		✓	

Item	Description	Effect	Effect of current presentation on net financial position of the US Government		
			Improve	Unclear	Diminish
Intragovernment activity and balances	Intragovernment activity and balances reported by various federal entities cannot be reconciled	Unclear how net financial position is affected		✓	
Equity investments related to the government's actions to stabilize financial markets and to promote economic recovery	The accrual-based financial statements include significant equity investments in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). As of September 30, 2015, the US Government continued to report approximately $106 billion of investment in the GSEs, which is net of about $88 billion in valuation losses.	Many factors affecting the assumptions and estimates used in valuing these equity investments are inherently subject to substantial uncertainty arising from the uniqueness of the transactions and the likelihood of future changes in general economic, regulatory, and market conditions. As such, there will be differences between the estimated values and the actual results, and such differences may be material. Further, the financial statements do not include the assets, liabilities, or results of operations of entities in which Treasury holds either a direct, indirect, or beneficial equity interest. Treasury and OMB have determined that none of the entities meet the criteria for a federal entity.		✓	
Transactions between the General Fund and federal entities	Transactions between General Fund and federal entities could not be reconciled--on an absolute basis, such transactions "amount to hundreds of billions of dollars"	Unclear how net financial position is affected		✓	
Balancing the financial statements	Treasury Department is unable to properly balance the accrual-based consolidated financial statements	Auditor states that Treasury recorded a net decrease to net financial position to compensate			✓

Item	Description	Effect	Effect of current presentation on net financial position of the US Government		
			Improve	Unclear	Diminish
Statements of social insurance	The 2014 statement of social insurance reflected a change from the assumption regarding scheduled reductions in Medicare payment rates for physician services that was used in the 2013, 2012, 2011, and 2010 statements of social insurance. Specifically, the 2014 statement of social insurance reflects a projected baseline that assumes that the physician payment rate reductions will not occur and that physician payment rates will annually increase at a rate equal to the average sustainable growth rate (SGR) override that occurred over the 10-year period ending on March 31, 2015. This revised assumption is based on a similar change in assumption in the 2014 Medicare Trustees Report, which noted that since the scheduled reductions under the SGR formula for updating the physician fee schedule have been overridden by lawmakers each year beginning with 2003, it is a virtual certainty that lawmakers will override this reduction.	As discussed in Note 24, of the 2014 report, the projected baseline included in the 2014 statement of social insurance exceeded management's projection based on current law, which included the reductions in payment rates for physician services, by about $1.8 trillion. The basis for the projections has changed since last year due to the enactment of the Medicare Access and Children's Health Insurance Program (CHIP) Reauthorization Act (MACRA) of 2015. This law repealed the sustainable growth rate (SGR) formula that set physician fee schedule payments, and replaced it with specified payment updates for physicians. In last year's report, the income, expenditures, and assets for Medicare Part B reflected the projected baseline scenario, which assumed an override of the SGR payment provisions and an increase in the physician fee schedule equal to the average of the most recent 10 years of SGR overrides (through March 2015) or 0.6 percent.			✓

Source: US Department of the Treasury; EY analysis.

Endnotes

[1] *Financial Report of the US Government for Fiscal Year 2015*, US Department of the Treasury, February 25, 2015, https://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/15frusg/02242016_FR(Final).pdf.
[2] Unless otherwise specified, all years are expressed in fiscal years.
[3] Accounting depreciation concepts seek to assign the value of an asset to those periods in which it is "used up." Determining the useful life of an asset is inescapably based on assumptions and estimates and so is imperfect. On the other hand, the concept of economic depreciation considers the use and resulting value of an asset from period to period and seeks to accurately capture the asset's residual value at a point in time. Accounting depreciation and economic depreciation are separate concepts.
[4] "Distribution of Household Wealth in the US: 2000 to 2011," US Census Bureau, http://www.census.gov/people/wealth/files/Wealth%20distribution%202000%20to%202011.pdf.
[5] "Historical Income Tables: People," US Bureau of the Census, https://www.census.gov/hhes/www/income/data/historical/people/. 2015 is the most recent year for which data are available.
[6] The US Government's fiscal year begins October 1 and ends September 30.
[7] While "off-budget" for purposes of deficit control legislation, Postal Service revenues and expenses are included in the unified federal budget, which seeks to "include all of the government's fiscal transaction with the public." Further, unlike GSEs, Postal Service operations, like those of the Social Security Administration, are "indisputably in the public sector," according to a 2009 report from the Postal Service Office of Inspector General. See *Federal Budget Treatment of the Postal Service*, US Postal Service Office of the Inspector General, August 27, 2009.
[8] The *Financial Report* does not detail the reasons for the cash-basis recognition of non-exchange revenue. It notes that the revenue recognition principles used are in accordance with the Statement of Federal Financial Accounting Standards, which is part of US Generally Accepted Accounting Principles.
[9] The gross cost incurred by the Department of Health and Human Services and the Social Security Administration does not include the annual change in unfunded future liabilities for social insurance programs administered by these entities.
[10] Carmen DeNavas-Walt and Bernadette D. Proctor, "Income and Poverty in the United States: 2014," US Census Bureau, September 2015.
[11] Depreciation under accounting rules is different than economic depreciation. Buildings and land, in an economic sense, may actually gain value over time. Their true movement towards economic depletion or obsolescence may be very gradual. In this sense, capital assets such as buildings can be fully depreciated even while retaining an economic market value that may be greater than their acquisition price.
[12] As noted above, "book" or "accounting" depreciation should be understood as distinct from "economic" depreciation.
[13] *The Budget for Fiscal Year 2014*, Office of Management and Budget, April 10, 2013, https://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/budget.pdf.
[14] GAO-15-341R US Government's 2014 and 2013 Consolidated Financial Statements.
[15] A material weakness as defined by the CBO is a deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, detected and corrected, on a timely basis. A deficiency in internal controls exists when the design and or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.
[16] Department of Defense, US Agency for International Development, and Department of Housing and Urban Development.
[17] Defense Finance and Accounting Service Commercial Pay System.
[18] See page 243 of the *Financial Report*.
[19] The General Fund is the central reporting entity that tracks activities fundamental to funding the federal government (i.e., issued budget authority, operating cash, and debt financing activity).