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Congress of the United States House of Representatives

Washington, DC 20515

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The Honorable Richard B. Cheney
U.S. Representative
Cannon House Office Building
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Dear Dick:

As requested, I will attempt to summarize the principal reasons why the Federal deficit as determined on the accrual-basis of accounting (as presented in my letter to Howard Baker dated May 28, 1987, copy enclosed) differs with the cash-basis deficit calculation the Federal government now employs. The former is based on generally accepted accounting principles (GAAP) that government already imposes on public companies in the private sector through the S.E.C.; the latter is the "Mickey Mouse" cash accounting system we took New York City off in the mid-seventies as a condition for the Federal bailout, but that the U.S. Government still uses itself!!

Morton Egol, who heads up the public sector industry practice at Arthur Andersen & Co. (AA & Co.), the international accounting firm, said in a March 10, 1987 Wall Street Journal article:

"Cash-basis accounting, which the Federal government uses, is an oxymoron. It is merely a reporting of checkbook entries with virtually no assessment of assets and liabilities and no evaluation of outputs. Unlike accrual-basis accounting, cash-basis accounting ignores such things as accounts receivable and accounts payable. It provides no reserves for uncollectible debts, treats the sale of assets as income and long-term capital investments as current expenses, fails to depreciate capital assets, and disregards the long-term cost of retirement programs."

Since the government does not maintain accrual-basis accounting systems, there can be no precise determination of the accrual-basis Federal deficit. AA & Co. performed a study of U.S. Government accounting practices in 1975 and produced the first set of accrual-basis financial statements for the Federal government as of the fiscal 1974 year-end (see copy of FY 84 statement enclosed). Subsequently, a Commission was formed by U.S. Treasury Secretary Bill Simon that reviewed the results of

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this study and developed a methodology to carry-forward the results of the AA & Co. study so that, for each year since, the U.S. Treasury has prepared prototype accrual-basis financial statements.

As confirmed by a recent update of the 1974 study and AA & Co. publication released in February 1986, "Sound Financial Reporting In the U.S. Government," such financial statements represent the best indication available of the real cost of government and the accumulated deficit after reflecting all known liabilities. (A copy of the AA & Co. booklet is enclosed for your reference.)

The AA & Co. updated study confirmed an accrual-basis deficit for fiscal 1984 of \$333 billion as compared with \$185 billion on a cash-basis, a variance of \$148 billion. The financial statements in the publication include a statement on page 17 which summarizes the differences between accrual-basis and cash-basis accounting for the Federal budget. As shown in that statement, the principal causes of the higher annual-basis deficits are:

	<u>\$ Billions</u>
- Depreciation	30
- Provision for Social Security	133
- Provision for Pensions	61
- Additions to Property & Equipment	(72)
- Miscellaneous, Net	<u>(4)</u>
Excess of Accrual-Basis Deficit Over the Cash-Basis Deficit	148

The following is a brief description of the above items, which are discussed in more detail in the booklet:

Depreciation--The wear and tear on long-lived assets is charged to the period in which the assets are in service.

Social Security Provision--The unfunded liability for government promises to participants in the social security program, net of expected contributions from participants, is reflected in the accrual-basis financial statements and is being amortized over 30 years. This is the method of accounting followed for retirement programs in the private sector. The accrued liability at September 30, 1984 was \$1.9 trillion and represents the amounts promised to present participants that will have to be funded by contributions from future participants. It is a form of borrowing.

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Pensions Provision--As for social security, the government makes no provision for amounts it has promised military or civilian personnel under various pension programs. The above amount represents the true cost of personnel services in excess of the current salary portion of personnel costs. The accrued liability for such programs was \$1.3 trillion at September 30, 1984.

Property--The cash-basis of accounting does not distinguish between operating expenses and long-lived assets. Under GAAP, such assets are capitalized and then depreciated over their estimated useful lives, thereby apportioning the cost over the periods benefitted by the expenditure.

There are many accounting issues that should be resolved to refine the accrual-basis/GAAP financial statements. For example, the government's receivables should be reduced to reflect provisions for bad debt losses on loans to farmers, students, etc., liabilities under various credit guaranty and insurance programs should be recorded, and accounting policies for programs that have grown in significance since 1974, such as medicare, should be re-evaluated. The resolution of such issues would tend to widen the difference in the accrual-basis and cash-basis deficit.

In my letter to Howard Baker I explained that while accrual basis/GAAP deficits are considerably larger than the cash deficits for the reasons outlined above, Jimmy Carter's aggregate accrual basis deficits are even \$55 billion greater than those incurred in Ronald Reagan's first term. The main reason for this is that President Reagan spent proportionately more on capital items whose benefit gets amortized over future fiscal periods under GAAP. Conversely, President Carter spent proportionately more on items which were consumed immediately, providing no benefit to future periods. Furthermore, President Carter's budgets incurred future obligations to spend which were not recorded as Carter deficits under the cash basis. As a result, much of President Reagan's cash basis deficit is actually the accrual basis deficit of Jimmy Carter.

I believe that failure by the government to follow sound financial reporting is not merely an accounting issue, it's governmental as well. It is a crucial question of governance -- a missing link in our constitutional system that allows public officials to commit resources without reporting to the public. This lack of public accountability has resulted in fiscal

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recklessness and an unstable economic environment that threatens the foundations of our society. The lack of public accountability fosters cynicism among the citizenry and can weaken the nation's resolve and its ability to act appropriately when challenges arise.

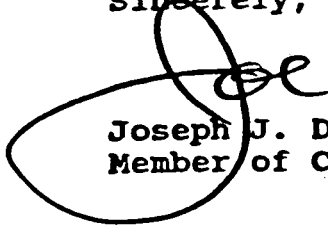
The notion that the Federal government should improve its accounting practices is not new. As Thomas Jefferson said in a letter to the Secretary of the Treasury in 1802:

"I think it an object of great importance. . .to simplify our system of finance, and to bring it within the comprehension of every member of Congress. . .the whole system (has been) involved in impenetrable fog. There is a point. . .on which I should wish to keep my eye. . .a simplification of the form of accounts. . . so as to bring everything to a single center; we might hope to see the finances of the Union as clear and intelligible as a merchant's books, so that every member of Congress, and every man of any mind in the Union, should be able to comprehend them to investigate abuses, and consequently to control them."

If citizens and creditors were to demand the financial information to which they're clearly entitled, incentives would be created for sound fiscal management and perhaps for more enlightened political leadership. We would then see better-informed decision-making that could set the brakes on fiscal recklessness. Ultimately, effective reporting of government activities should improve public confidence in public officials. And maybe--just maybe--citizens might feel less cynical about the idea that concerted action and some personal sacrifice are still the requirements for effective self-government.

Please let me know if you want to discuss this further.

Sincerely,



Joseph J. DiGuardi
Member of Congress

Enclosures (3)