

Understanding Similarities
and Differences between

Accrual and
Cash Deficits



GAO-07-117SP

December 2006

Preface

Two key measures that have been used as indicators of the government's annual fiscal condition are the unified budget deficit measured primarily on a cash basis and the net operating cost measured on an accrual basis for financial statement purposes. The unified budget deficit has historically been the focus of budget debates and media reports in part because it closely approximates the government's short-term borrowing needs.¹ Cash accounting can also be useful for controlling spending in the current year. However, the cash measure of fiscal condition, which is similar to keeping a checkbook, by nature excludes information about the long-term consequences of today's policy decisions and operations. Indeed, understanding our nation's long-term fiscal outlook is important because, as GAO's long-term simulations show, current fiscal policy is unsustainable.² The accrual measure primarily provides more information on the longer-term implications of today's policy decisions and operations by showing certain costs incurred today but not payable for years to come, such as civilian and military pensions and retiree health care.

While cash and accrual measures each serve different purposes, they present complementary information and can be used together to provide a more comprehensive picture of the government's fiscal condition today and over time. The goal of this primer is to improve understanding of the accrual deficit by describing (1) how it is similar and different from the more commonly reported cash budget deficit, (2) the key drivers behind changes in accrual deficits relative to cash budget deficits, and (3) how the two measures complement each other and give a fuller picture of the government's overall fiscal condition.

Throughout this report, we primarily used data from the *Financial Report of the United States Government*, referred to in this report as the *Financial Report*, which is prepared by the Department of the Treasury, in coordination with the Office of Management and Budget.³ However, the reader is cautioned not to focus on the precise amount of the accrual deficit, its components, or their change from year to year because significant issues regarding the reliability and presentation of the federal government's financial information still need to be addressed. GAO is responsible for auditing the consolidated financial statements of the U.S. government, but we have been unable to express an opinion on them because the government could not demonstrate the reliability of significant portions of the financial statements or that the reconciling differences between accrual and cash deficits were complete. The primary reasons for this disclaimed opinion are described in this primer.

¹The unified budget deficit is net of any Social Security surplus. See p. 1 for more information.

²GAO, *The Nation's Long-Term Fiscal Outlook: September 2006 Update*, GAO-06-1077R (Washington, D.C.: Sept. 15, 2006).

³For a guide to understanding the *Financial Report* see GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-05-958SP (Washington, D.C.: September 2005).

The *Financial Report* can be found on the Department of the Treasury's website at <http://www.fms.treas.gov/fr/index.html>. Information on the most recent President's budget can be found on the Office of Management and Budget's website at <http://www.whitehouse.gov/omb/budget/>.

This primer is structured in a question and answer format. The key questions are shown at the top of each page. To find the answers, flip to the page with your question highlighted. For easy reference, key terms are defined in the glossary located in appendix I—these glossary terms appear in bold type the first time they are used in the text. Many definitions come from *A Glossary of Terms Used in the Federal Budget Process*.⁴ Other related GAO products are listed at the end of this report.

Unless otherwise indicated, the years referred to in the primer are federal fiscal years, which run from October 1 through September 30.

This report was prepared under the direction of Susan J. Irving, Director, Federal Budget Analysis, Strategic Issues, who may be reached at (202) 512-9142 or irvings@gao.gov if there are any questions. Gary T. Engel, Director, Financial Management and Assurance, and his staff also provided key assistance. He may be reached at (202) 512-8815 or engelg@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Copies of this report are available upon request. In addition, this document will be available at no charge on the GAO Web site at <http://www.gao.gov>.



David M. Walker
Comptroller General of the United States

⁴GAO, *A Glossary of Terms Used in the Federal Budget Process*, GAO-05-734SP (Washington, D.C.: September 2005). Other terms are based on the Federal Accounting Standards Advisory Board's (FASAB) *Statements of Federal Financial Accounting Standards, Current Text*, vol. 2 (Washington, D.C.: June 30, 2004).

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Abbreviations

CFS	consolidated financial statements of the United States government
CSRS	Civil Service Retirement System
DOD	Department of Defense
DOE	Department of Energy
FERS	Federal Employee Retirement System
Financial Report	Financial Report of the United States Government
GAAP	generally accepted accounting principles
OMB	Office of Management and Budget
NFIP	National Flood Insurance Program
PBGC	Pension Benefit Guaranty Corporation
PP&E	property, plant, and equipment
Treasury	Department of the Treasury
VA	Department of Veterans Affairs

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How Are Cash and Accrual Deficits Measured?

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How Are Cash and Accrual Deficits Measured?

The Unified Budget Deficit—The Net Cash Deficit

The federal budget⁵ is the government's primary financial planning and control⁶ tool. It helps establish national spending priorities and the allocation of resources. It also helps ensure that the government spends taxpayers' money in accordance with applicable laws. The President submits his forward-looking budget to Congress each February and the Department of the Treasury (Treasury) reports the budget results in October after the end of the fiscal year.

The **unified budget deficit** (or surplus) is the federal budget's "bottom line." It represents the actual amount by which total **outlays** exceed **receipts** (or receipts exceed outlays), including any Social Security surplus. For the budget deficit, receipts and outlays are primarily measured on a **cash basis**⁷—that is, they are recorded when cash is received or paid, similar to keeping a checkbook. Because the budget deficit is primarily measured on a cash basis, it is hereafter called the **cash budget deficit** or simply **cash deficit**.

The unified budget is a comprehensive measure of all federal activities, including those that are **on-budget** and **off-budget**. The on-budget deficit includes all budgetary accounts other than those designated by law as off-budget. The off-budget accounts are the Postal Service and Social Security trust funds. In fiscal year 2005, the unified budget deficit was \$319 billion as reported in the *Financial Report of the United States Government*, hereafter referred to as the *Financial Report*.⁸ It was composed of a \$494 billion on-budget deficit, a Postal Service surplus of \$2 billion and a Social Security surplus of \$173 billion.

⁵For purposes of this primer, the "federal budget" is used broadly to include not only planning but also the end fiscal result of that plan (i.e., the fiscal effect of spending and revenue laws in effect for any given fiscal year).

⁶The federal government uses **obligational accounting** to track and control the use of funds. However, in the context of the government's fiscal condition, Congress and the public tend to focus on the cash deficit—and more recently the accrual deficit. Because of the attention to these two measures, this primer focuses on them. More information on obligational accounting is in app. III.

⁷Credit programs and certain interest payments are not measured on a cash basis in the budget. For more information see app. II.

⁸The final deficit number published in the President's budget was slightly lower—\$318 billion. However, the *Financial Report* reconciles the cash and accrual measures of fiscal condition, so we will use the number reported therein.

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Net Operating Cost—The Accrual Deficit

Similar to a corporation's annual report, the *Financial Report* is the federal government's annual general-purpose report of accountability to the American public on its finances. Some primary goals of the *Financial Report* are to provide a comprehensive overview of the cost⁹ of the federal government's operations, the sources used to finance them, and the implications of long-term obligations and commitments.¹⁰ However, significant issues regarding the reliability and reporting of this financial information still need to be addressed. The *Financial Report* is prepared by Treasury, in coordination with the Office of Management and Budget (OMB). GAO is responsible for auditing the consolidated financial statements of the United States government (CFS). OMB requires the *Financial Report* to be published in December following the end of the fiscal year. For example, the *Financial Report* for fiscal year 2005, which ended on September 30, 2005, was published in December 2005.

The **net operating cost** (or net operating revenue) is found in the *Financial Report*. Net operating cost (or net operating revenue) is the amount by which **expenses** exceed **revenue** (or revenue exceeds expenses). For this measure, expenses are recorded on an **accrual basis**—in the period when goods are used or services are performed as opposed to when the resulting cash payments are made.¹¹ In some cases, expenses are estimates of amounts that will be outlays in the future and thus depend on assumptions for interest rates, inflation, and wage growth, among other things.

Most revenues in the *Financial Report* are recorded on a **modified cash basis**.¹² This means they are essentially recorded when collected, but there is an accrual adjustment for some taxes due that have not been paid by the taxpayer and refunds due to taxpayers that have not been paid by the government. A modified cash basis of accounting is used in part because of inherent limitations estimating the amount of revenue arising from underlying events (e.g., taxpayers may not know their taxable income until after the underlying event, they may not file returns on their due dates, or they may underpay).

For simplicity, the net operating cost (or net operating revenue) is hereafter called the **accrual deficit** (or surplus).

⁹The term "cost" can have different meanings depending on the context in which it is used. Throughout this report, cost is used in a general sense to mean the value of resources used to produce a program, provide a service, or achieve an objective.

¹⁰Unless otherwise noted, the term "commitments" is used in this report to mean potential draws on future resources that flow not only from the law but also from public expectations.

¹¹Accrual accounting, which is also used by private business enterprises for financial reporting, is generally the basis for U.S. generally accepted accounting principles (GAAP) for federal government entities. However, for some revenue, a modified cash basis of accounting is used and is also considered as GAAP.

¹²While most revenue, including taxes, duties, and fines, are recorded on a modified cash basis, revenues from providing goods and services to the public at a price (e.g., user fees, premiums) are recorded on an accrual basis.

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What Purpose Does Each Measure Serve?

The cash basis of accounting has traditionally been used for federal budgeting for several reasons. Because cash can be tracked throughout the year it can be useful for controlling spending in the current year. Also, because the time between the occurrence of a transaction that commits the government to make a payment and the cash flow to make the payment is relatively short for many program areas, the cash measure provides adequate information about the government's total commitment at the time budget decisions are made for these programs. Finally and perhaps most notably, the cash budget deficit closely approximates the government's short-term borrowing needs and so is a widely used and traditionally accepted measure of the government's effect on current financial markets.

There are several areas, however, in which outlays measured on a cash basis do not provide complete information about the total amount of the government's **obligation** upfront when decisions are made. For some of these program areas, the budget records outlays on an accrual basis. Perhaps the best known of these are credit programs—loans and loan guarantees. Appendix II provides more information on which programs' outlays are measured on an accrual basis and how they affect the cash budget deficit.

Accrual measures are useful for understanding the government's annual operating cost, including costs **incurred** today but not payable for years to come. As such, it adds a longer-term focus to the government's financial picture by providing more information on longer-term consequences of today's policy decisions and operations. Under federal accounting standards, the long-term costs for social insurance (primarily Medicare and Social Security) are not included in the accrual deficit. However, the Statement of Social Insurance provides information about the future costs of these programs.¹³

Finally, financial accounting standards are intended to result in the provision of financial information that will be useful for decision making. Once the information reported in the financial statement is auditable, it would provide integrity to related information in the budget, including actual receipts and outlays, if the amounts are materially consistent and reliable.

¹³The Statement of Social Insurance has been included in the required supplemental stewardship section of the *Financial Report* and will be incorporated into the primary financial statements for fiscal year 2006.

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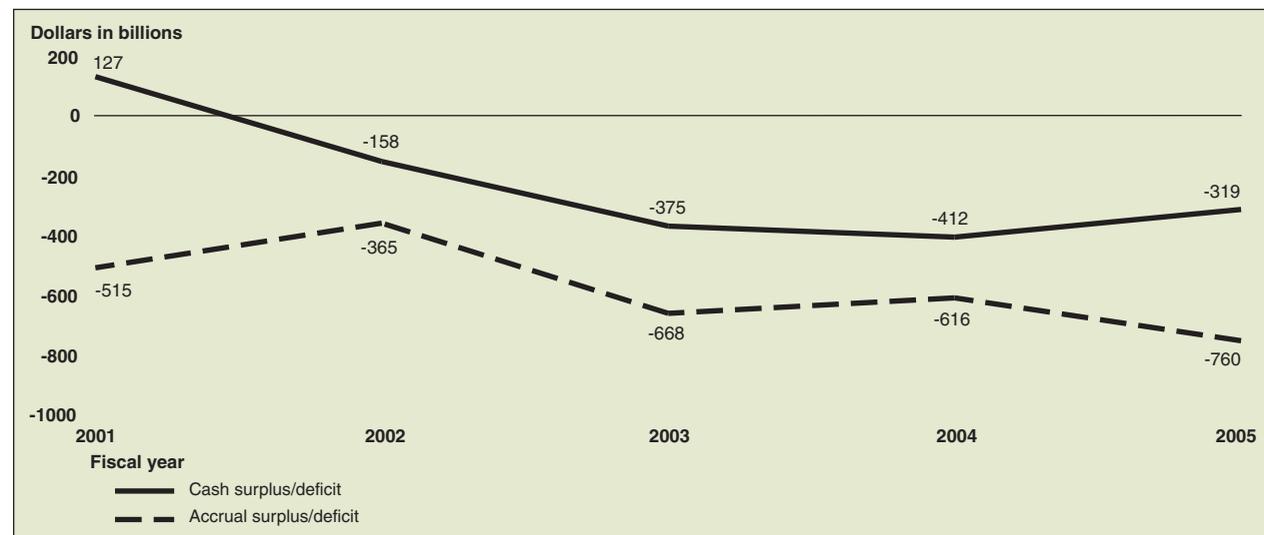
How Can Accrual and Cash Measures Complement Each Other?

How Are Cash and Accrual Deficits Similar? How Are They Different?

The cash and accrual deficits are based on the same underlying activities—the differences arise due to the timing of when the costs of certain activities are recognized. For the accrual deficit, costs are recognized when goods are used or services are performed. For the cash deficit, costs are recorded when cash payments are made for goods received or services performed. For many program areas, the timing difference is small but for others the timing differences can amount to billions of dollars each year. For example, in 2005, the reported accrual deficit was \$760 billion—more than twice the size of the \$319 billion cash deficit.

Not only are some of the differences caused by timing large, but they can cause the cash and accrual deficits to send different signals. For example, accrual and cash measures have sent different signals about whether the government is in surplus or deficit. Figure 1 shows that in 2001 the budget was running a cash surplus but the accrual measure showed a large deficit.

Figure 1: The Cash and Accrual Measures of Fiscal Surplus and Deficit



Source: Treasury.

Note: Data from unaudited *Financial Reports*. In some years, the budget deficit reported in the *Financial Report* differs from the final deficit number published in the President's budget. For example, the 2005 *Financial Report* issued in December 2005 reported a \$319 billion cash budget deficit. However, the final deficit number published in the President's budget 2 months later was slightly lower—\$318 billion.

The two measures can also send different signals about the direction in which the government's fiscal condition is heading. For example, although both measures were in deficit in 2005, the cash budget deficit decreased from the previous year while the accrual deficit increased. This leads to questions of how the two measures are similar, how they're different, and what drives changes in the two measures.

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How Are Cash and Accrual Deficits Similar?

Since revenue is primarily recorded on a modified cash basis in the financial statements, there is very little difference between cash receipts and accrued revenue.¹⁴

On the spending side, many programs are also recorded similarly because the time between the occurrence of the underlying transaction and the cash flow is relatively short. So, for some program areas such as federal employee salaries and grants there is little difference between accrual and cash measures. Figure 2 below illustrates this point using federal salaries.

Figure 2: Cost of Federal Salaries Reflected Similarly in Accrual and Cash Deficits

For federal salaries, the time between when salaries are earned and when they are paid is short—a little over a week. Under accrual accounting, an expense for federal salaries is recognized when the salaries are earned. Under cash accounting an outlay is recorded in the following week when the salary is paid. At year's end, there is little difference between the cash and accrual measure of salaries because both include salary payments or expenses for roughly 52 weeks of work.

However, the cash and accrual measures may not include the exact same 52 weeks of salary. Because the accrual deficit includes an expense as the salary is earned, regardless of when paid in cash, it will include the 52 weeks of salary earned in the current year. However, the cash deficit includes cash payments for salaries earned in the prior year and excludes cash payments for salaries earned in the last week of the current year that will be paid in the next year.

Source: GAO.

¹⁴The budget uses the term "receipts" while the financial statements use "revenue." Both have the same meaning.

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How Can Accrual and Cash Measures Complement Each Other?

Cash and accrual measures are also similar in that they both exclude the value of

- future payments for certain contingencies and financial commitments and
- future benefits for entitlement programs, including social insurance.

Neither **contingencies** nor **financial commitments** are reflected in the cash deficit until the government makes the cash payment. Only some contingencies are reflected in the accrual deficit—those that are assessed as “probable” as to the likelihood of loss and can be reasonably measured. However, many contingencies are not reflected in the accrual deficit in part because it is difficult to anticipate the amount to be paid. Contingencies assessed as “reasonably possible” as to the likelihood of loss, or assessed as “probable” as to the likelihood of loss but that cannot be reasonably measured, are not included in the accrual deficit but are disclosed in the notes to the financial statements. For example, in fiscal year 2005, possible estimated losses of \$1.2 billion to \$7.9 billion from administrative claims and legal actions were assessed as “reasonably possible” and therefore not included in the accrual deficit. Also, the potential costs associated with future natural disasters are not recorded in the accrual deficit even though the public anticipates and has received large amounts of assistance following natural disasters. Finally, financial commitments, such as contracted goods or services that have not yet been delivered, are not recorded in the accrual deficit until the goods or services are delivered but are disclosed in the notes to the financial statements.¹⁵

While both the cash and accrual deficits include payments to current beneficiaries for entitlement programs, including social insurance, neither the cash nor accrual deficit reflects the serious future fiscal challenges of Social Security, Medicare, and other social insurance programs. Future scheduled benefits and estimated receipts are included in the Statement of Social Insurance.¹⁶ However future benefits are not a **liability** under federal accounting standards.¹⁷

¹⁵Even though they are not reflected in the cash budget deficit, the budget records an obligation, or **legal liability**, under obligational accounting at the time the government enters into a contract. See app. III for more information on the differences in when transactions are recorded under obligational accounting compared to accrual and cash accounting.

¹⁶The Statement of Social Insurance has been included in the required supplemental stewardship information section of the *Financial Report*. Beginning with fiscal year 2006, the statement will be incorporated into the primary financial statements and audited. Information on the effect of large social insurance programs on the budget can be found in GAO-06-1077R.

¹⁷A liability is recorded for unpaid amounts due at the end of the fiscal year. This is similar to how other countries budget and account for social insurance. See GAO, *Accrual Budgeting: Experiences of Other Nations and Implications for the United States*, GAO/AIMD-00-57 (Washington, D.C.: Feb. 18, 2000).

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How Are Cash and Accrual Deficits Different?

The differences between cash and accrual deficits are almost entirely on the spending side since revenues are recorded similarly in the budget and financial statements. Differences arise when a cost is accrued (and affects the accrual deficit) in 1 fiscal year but paid (and affects the cash deficit) in another fiscal year.

While there are a number of areas in the federal government where differences exist, the six listed below account for the largest differences between accrual and cash deficits:

- civilian employee benefits,
- military employee benefits,
- veterans compensation,
- environmental liabilities (e.g., cleanup and disposal),
- insurance programs, and
- capital assets.

For all of these areas except capital assets, the key difference between the accrual and cash measures is the annual change in the liability. Each year as expenses are accrued, those that are not paid (and not reflected in the budget) increase the government's liability. As such, the liability represents unpaid expenses. The change in the liability from year to year is generally equal to accrued expenses less cash payments made to cover expenses. Figure 3 illustrates this point using federal employee benefits other than salaries.

Figure 3: Difference between Accrual and Cash Measures of Federal Employee Benefits

The accrual deficit includes an accrued expense for each current employee's pension and other retirement benefits, which are earned during the employee's working years but not paid until sometime in the future when the employee retires.

The cash budget deficit does not include retirement benefits earned today, but it does reflect payments made to current retirees. (These cash payments reflect past expenses.)

The difference between the accrued retirement benefits recognized and cash payments made during the year is generally the change in the liability from year to year. It is also the amount of the difference between the accrual and cash measures due to employee benefits.

Source: GAO.

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Capital assets are treated differently. When **capital assets** such as structures and equipment are purchased, the budget recognizes the full cost up front in order to provide decision makers with the information and incentives to make efficient decisions at the only time that they can control the cost.¹⁸ Specifically, the cost of a capital asset is recorded as an outlay and included in the cash budget deficit when the asset is paid for. However, under the accrual basis of accounting used in the financial statements, the cost of the asset is initially recorded on the balance sheet. The cost of the asset is then spread over its expected useful life to match the asset's cost with its use. Therefore, each year the accrual deficit only reflects 1 year's worth of cost, called **depreciation** expense. Figure 4 below illustrates this point.

Figure 4: Difference between Accrual and Cash Measures of Capital Assets

Let's assume that the federal government purchased a building this year for \$50 million and expected the building to be used for the next 50 years. The cash budget deficit would reflect the \$50 million cost this year. The accrual deficit would only reflect a \$1 million depreciation expense (assuming a straight-line depreciation method)^a in the current year. The remaining cost of the asset would be reflected in the accrual deficit over the next 49 years at an annual expense of \$1 million.

Source: GAO.

^aThe straight-line depreciation method assumes the asset will provide an equal amount of benefit each year. The annual depreciation expense is calculated by dividing the purchase price of the asset (less its estimated salvage or residual value) by the estimated useful life of the asset.

¹⁸For capital assets, **budget authority** for the asset's cost must generally be provided up front before the asset can be purchased.

How Are Cash and Accrual Deficits Measured?

How Are Cash and Accrual Deficits Similar? How Are They Different?

What Drives Changes in Cash and Accrual Deficits from Year to Year?

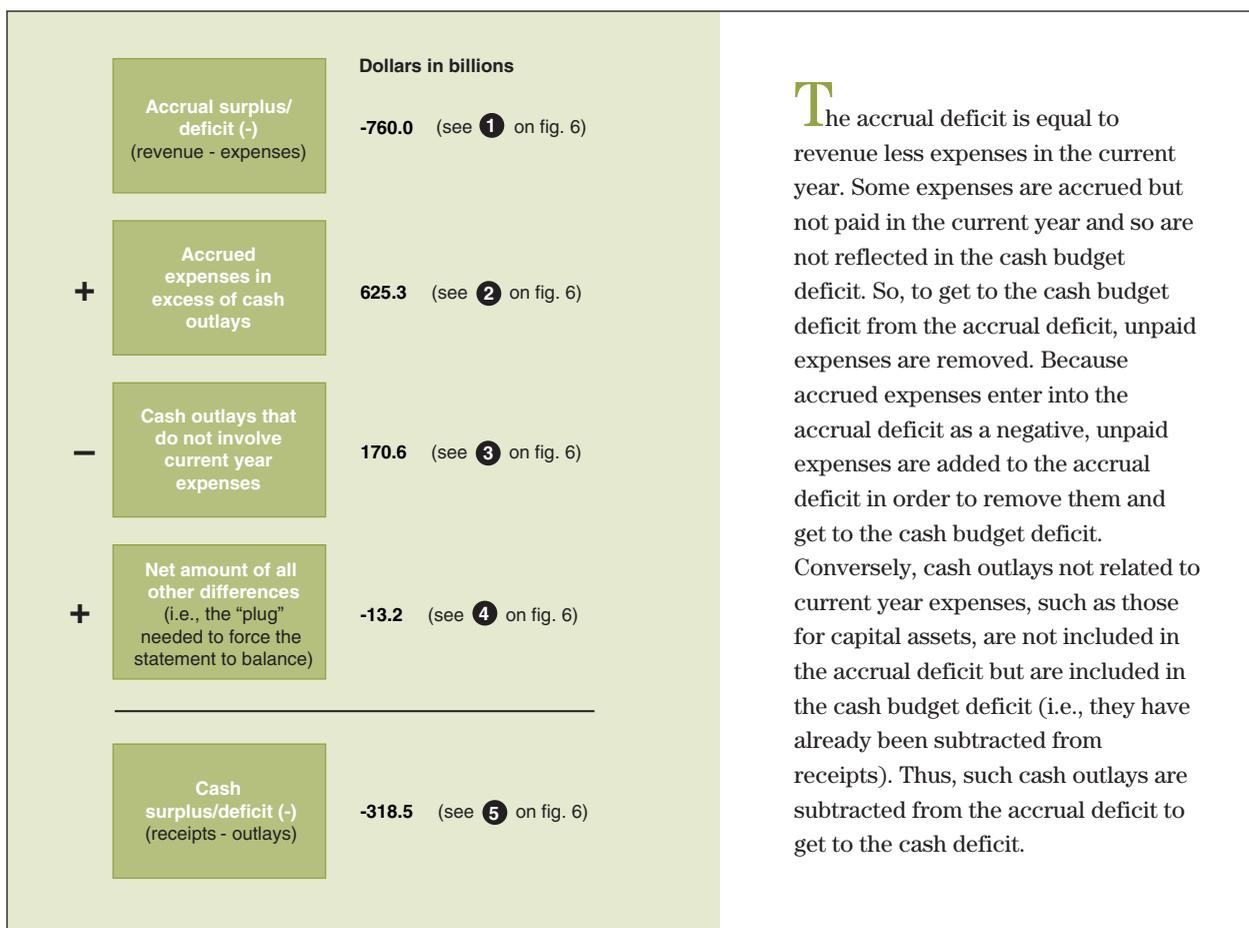
What Areas Explain the Largest Differences between Cash and Accrual Deficits?

How Can Accrual and Cash Measures Complement Each Other?

How Do You Get to the Cash Deficit from the Accrual Deficit?

The *Financial Report* includes a statement called Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit), hereafter called the “reconciliation statement,” that provides a crosswalk between the net operating cost (accrual deficit) and the unified budget deficit (cash budget deficit). Figure 5 below shows the general relationship underlying the reconciliation statement and how to get to the cash budget deficit from the accrual deficit.

Figure 5: Moving from the Accrual Deficit to the Cash Budget Deficit (Using Fiscal Year 2005 Numbers to Illustrate)



Source: Treasury.

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Figure 6 summarizes the reconciliation statements contained in the CFS for fiscal years 2001–2005. In the figure, annual changes in liabilities can be either positive or negative:

- If accrued expenses exceed cash payments, liabilities increase (a positive change). A positive change represents accrued expenses that are in the accrual deficit but not the cash budget deficit.
- If cash payments exceed accrued expenses, liabilities decrease (a negative change). A negative change represents cash payments that are not included in the accrual deficit but are included in the cash budget deficit.

Figure 6: Crosswalk between Accrual and Cash Deficits/Surpluses

	Fiscal year (dollars in billions)					
	2001	2002	2003	2004	2005	
Net operating cost (i.e., accrual deficit)	-514.8	-364.9	-667.6	-615.6	-760.0	1
Components of accrual deficit not part of the cash budget deficit						
Changes in liability for military employee benefits (see p. 20)	406.8	32.4	101.1	143.4	169.6	
Changes in liability for veterans compensation (see p. 24)	139.3	157.3	105.6	-30.0	197.8	
Changes in liability for civilian employee benefits (see p. 22)	50.1	38.9	83.9	68.7	62.3	
Changes in environmental liabilities (see p. 26)	5.7	-33.8	-23.1	-0.7	10.6	
Depreciation expense (see p. 30)	21.4	20.5	71.2	89.9	79.7	
Changes in insurance liabilities (see p. 28)	a	a	a	37.0 ^a	31.0	
Other (e.g., disposals/reevaluations of capital assets) (see p. 30)	42.2	25.2	47.1	-4.1	74.3	
Total	665.5	240.5	385.8	304.2	625.3	2
Components of cash budget deficit not part of the accrual deficit						
Outlays for capitalized fixed assets (see p. 30)	-34.4	-40.9	-102.0	-112.1	-146.6	
Other (e.g., principal repayments on precredit reform loans)	17.1	6.6	12.5	-12.0	-24.0	
Total	-17.3	-34.3	-89.5	-124.1	-170.6	3
Net amount of all other differences						
Net amount of all other differences (i.e., the “plug” needed to force the statement to balance) (see p. 16)	-6.4	1.0	-3.5	23.2	-13.2	4
Unified budget surplus/deficit (i.e., cash surplus/deficit)						
	127.0	-157.7	-374.8	-412.3	-318.5^b	5

Information available on www.fms.treas.gov/fr/index.html

Source: Treasury.

Notes: Data reported in the unaudited *Financial Reports* for fiscal years 2001–2005.

^aThe change in insurance liabilities was not included in the reconciliation statement prior to the *Financial Report* for 2005. The 2005 reconciliation statement included comparative data for both 2004 and 2005.

^bThe final deficit number published in the President's budget was slightly lower—\$318.3 billion.

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How Can Accrual and Cash Measures Complement Each Other?

While the reconciliation statement is useful for illustrating which program areas explain large differences between the cash and accrual measures in each year, too much focus should not be placed on the amounts shown for items listed in the reconciliation statement—nor the actual amount of the accrual deficit itself—for a number of reasons, which are discussed below.

First, as of 2005, Treasury has not been able to identify all items needed to reconcile the accrual and cash deficits. As a result, certain items that would cause the accrual and cash deficits to be different are not itemized in the reconciliation statement. To make the statement balance, Treasury includes an entry—labeled “net amount of all other differences”—that is needed to force the statement into balance (i.e., a “plug”). In 2005, this entry was \$13.2 billion (or 3 percent of the total difference between the accrual and cash budget deficits).¹⁹

Second, we identified material weaknesses relating to some of the areas listed in the reconciliation statement—namely capital assets, environmental liabilities, and military postretirement health benefits.²⁰ Errors in the reported expenses for these areas could lead to errors in the amount of the accrual deficit itself. For example, the failure to report a depreciation expense for a certain capital asset would tend to result in an understatement of the accrual deficit while overreporting depreciation expense would overstate the accrual deficit.

Finally, the accrual deficit itself includes an amount needed to force the CFS into balance (i.e., a “plug”). The accrual deficit should typically equal the annual change in net position, which is the difference between the assets and liabilities reported in the balance sheet. However, Treasury could not completely reconcile the difference between ending and beginning of year net position and thus included an amount labeled “unreconciled transactions affecting the change in net position” to force the CFS into balance. Also, as part of our audit of the CFS, we identified a number of issues, including problems relating to the compilation of the CFS and the reconciliation of intragovernmental activity and balances between federal agencies.²¹

¹⁹For more information on the issues GAO identified with the reconciliation statement and related recommendations see GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Improvement*, GAO-04-45 (Washington, D.C.: Oct. 30, 2003).

²⁰See pp. 15–26 for information on weaknesses in the reported expenses of these program areas.

²¹For a list of GAO’s recommendations addressing these and other weaknesses in the financial statements, see GAO, *Financial Audit: Significant Internal Control Weaknesses Remain in Preparing the Consolidated Financial Statements of the U.S. Government*, GAO-06-415 (Washington, D.C.: Apr. 21, 2006).

How Are Cash and Accrual Deficits Measured?

How Are Cash and Accrual Deficits Similar? How Are They Different?

What Drives Changes in Cash and Accrual Deficits from Year to Year?

What Areas Explain the Largest Differences between Cash and Accrual Deficits?

How Can Accrual and Cash Measures Complement Each Other?

What Drives Changes in Cash and Accrual Deficits from Year to Year?

In recent years, both cash and accrual measures show a general deterioration in the government's fiscal condition. This deterioration was due to both tax and spending legislation, sometimes in response to outside events, such as the attacks of September 11, 2001 and the ensuing economic slowdown, operations in Iraq and Afghanistan, and Hurricanes Katrina and Rita, which together affected the government's operating costs and revenue.

Some changes in the cash deficit from year to year can be and have been due to changes in dates when cash is scheduled to be paid or received. For example, when October 1 falls on a weekend, certain federal payments due on that date, such as salaries for military employees, are paid in September. This shifts the cash outlay into the previous fiscal year. However, because these benefits are recorded as expenses when due and payable, the shift in the payment date would not affect the accrual deficit. In contrast, Congress sometimes changes the due date for tax payments, which can shift cash receipts from one year to the next. For example, Congress changed the corporate tax payment due date from September 15, 2001, to October 1, 2001, resulting in a shift of about \$23 billion in revenue from fiscal year 2001 to 2002. Because revenues are generally recorded when collected in both the cash and accrual deficits, the change in the tax due date would affect both the cash and accrual deficits.

However, the accrual deficit has also been driven by three additional factors:

- legislation that obligates future government resources,
- changes in methods or assumptions for estimating long-term liabilities, and
- changes in federal accounting standards.

For example, enacting a law that expands future federal employee retirement benefits or insurance programs would be reflected immediately in the accrual deficit but would not affect the cash budget deficit until future years when the benefits are paid. Indeed, the largest change in the accrual deficit in recent years occurred between 2000 and 2001²² when legislation was passed that extended TRICARE—health care benefits for military employees—to Medicare-eligible military retirees and their beneficiaries. This change alone increased the estimated value of future benefit payments and the accrual deficit by over \$290 billion in 2001. However, because these benefits will not be paid until future years, the cost was not reflected in the cash budget deficit.

²²The accrual measure went from a surplus of \$40 billion in 2000 to a deficit of \$515 billion in 2001—a swing of about \$555 billion.

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Second, whereas the cash measure is sensitive to changes in dates when cash is scheduled to be paid or received, accrual measures are sensitive to changes in assumptions—such as future salary increases, changes to the general price level, interest rates, and technology—used to estimate future payments. For example, some future payments are discounted into **present value** terms using nominal interest rate assumptions. Changes in interest rates can and have caused changes—and sometimes large ones—in expenses and the accrual deficit. For example, the change in interest rate assumptions drove wide swings in the liability for veterans compensation in recent years. This liability increased by \$105 billion in 2003, decreased by \$30 billion in 2004, and then increased by \$228 billion in 2005. From 2003 to 2004, the Department of Veterans Affairs (VA) raised its long-term interest rate assumption from 4.91 to 5.23 percent. In 2005, VA reduced its long-term interest rate to 4.74 percent.

Finally, changes in federal accounting standards can also drive large changes in the accrual deficit without any effect on the cash budget deficit. For example, beginning in fiscal year 2003, a new accounting standard was adopted that required national defense equipment to be capitalized—that is, included on the balance sheet—and depreciated. Prior to 2003, the purchases of national defense equipment were expensed in the year they were bought and the assets were not capitalized or depreciated.²³ A primary reason for the increase in the amount of capitalized assets reported in the reconciliation statement from \$40.9 billion in 2002 to \$102.0 billion in 2003 was the capitalization of national defense equipment purchased in 2003. Also primarily as a result of national defense equipment being capitalized, the depreciation expense more than tripled from \$20.5 billion in 2002 to \$71.2 billion in 2003.

While a lot of variation in the accrual deficit may lead some to believe the measure is less reliable than the cash measure, the changes often result from improvements in government estimation methods or the implementation of new accounting standards. This suggests that caution must be taken when interpreting year-to-year changes in the accrual deficit. Sometimes a change in the accrual deficit may not mean a change in fiscal condition, but rather a change in the government's methods of measuring its condition. As the reliability issues we raised in our audits are addressed, the accrual deficit will become a more meaningful complement to the cash measure.

²³National defense equipment was considered **stewardship property, plant, and equipment** and reported as required supplemental stewardship information to the financial statements.

How Are Cash and Accrual Deficits Measured?

How Are Cash and Accrual Deficits Similar? How Are They Different?

What Drives Changes in Cash and Accrual Deficits from Year to Year?

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What Areas Explain the Largest Differences between Cash and Accrual Deficits?

In the following pages, we provide more detailed information on the six areas that explain the largest differences between accrual and cash deficits. As we stated before, the six areas are

- military employee benefits,
- civilian employee benefits,
- veterans compensation,
- environmental liabilities (e.g., cleanup and disposal),
- insurance programs, and
- capital assets.

We explain how each area's costs are reflected under the two measures and how the numbers in the reconciliation statement are developed. Also, because changes in the accrued liability for these programs can lead to changes in the accrual deficit without any corresponding changes to the cash budget deficit, we explain what drives the accrual measures of each area and the key events or changes in assumptions that led to large changes in their liabilities from fiscal years 2001 to 2005.

How Are Military Employee Benefits Recorded in the Cash and Accrual Deficits?

Military employee benefits include retirement benefits, such as pensions, health benefits, and insurance, for military personnel who remain on active duty for 20 years or more. The cash budget deficit reflects the payments made to retired military in the current year but not the estimated long-term costs.²⁴ However, the accrual deficit reflects an expense for the estimated long-term cost of military pensions and other retirement benefits during the years the service members are working. The expense reflects services rendered in the current year, accrued interest on the outstanding liability, and adjustments for any pension plan amendments or deviations between actual experience and assumptions used to estimate past expenses.

Table 1 shows the accrued liabilities—or the actuarial present value of the expected cost of military employee benefits that is unpaid at the end of the reporting year—and the corresponding year-to-year change in liabilities from 2001 to 2005.

Table 1: Military Employee Benefit Liabilities

Dollars in billions					
	Fiscal year				
	2001	2002	2003	2004	2005
Accrued liability	1,309.7	1,342.1	1,443.2	1,586.6	1,756.2
Pensions	708.3	730.0	739.0	837.7	895.4
Postretirement health	580.9	592.0	683.0	725.3	833.9
Other (e.g., insurance)	20.5	20.1	21.2	23.6	26.9
Change in liability from previous year	406.8	32.4	101.1	143.4	169.6
Pensions	17.8	21.7	9.0	98.7	57.7
Postretirement health	388.6	11.1	91.0	42.3	108.6
Other (e.g., insurance)	0.4	-0.4	1.1	2.4	3.3

Source: Treasury.

Note: Data from unaudited *Financial Reports* for 2001 to 2005.

The change in liability from the previous year (in the highlighted row of table 1) represents the primary difference between accrual and cash measures of military employee benefits. The change in liability is generally equal to expenses accrued for current workers less cash outlays to pay current retirees' benefits, which were expensed in the past. Therefore a positive change in the liability represents accrued expenses in excess of cash outlays. Because accrued expenses enter into the accrual deficit as a negative, one must add the change in liability to the accrual deficit to get to the cash deficit.

²⁴The Department of Defense (DOD) makes contributions for some retirement benefits but the payments are intragovernmental—that is, they are recorded as outlays by DOD and receipts by the military retirement trust funds. Since no cash actually leaves the government, such contributions do not affect the governmentwide cash deficit. See app. II for more information.

What Drives Changes in Military Employee Benefit Liabilities?

Changes in the military employee benefit liabilities have accounted for large swings in the accrual deficit without any corresponding change in the cash budget deficit. The largest change in the military employee benefit liability during the period of 2001 to 2005 was due to a change in law. In 2001, the liability for military employee benefits increased by \$406.8 billion. A large part of the increase—over \$290 billion—stemmed from the initial nonrecurring effect of the 2001 National Defense Authorization Act (Pub. L. No. 106-398). This legislation extended TRICARE—health care benefits for military employees—to Medicare-eligible military retirees and their beneficiaries. Prior to 2001, military retirees who were eligible for Medicare relied on Medicare benefits.

The change in liability has also varied from year to year because of differences between actual experience and what was originally assumed. For example, from 2004 to 2005, the change in the military health liability was \$108.6 billion. According to the Department of Defense (DOD), about \$60 billion of this change reflects higher-than-assumed health care cost growth.

It should be noted that DOD was unable to provide support for a significant portion of the reported military retiree health liability. DOD's auditors found that DOD's systems could not accurately report the costs of health care provided by DOD facilities or develop reliable projections of future health care costs and the military retiree health liability.

How Are Civilian Employee Benefits Recorded in the Cash and Accrual Deficits?

Civilian employees earn pension and other retirement benefits over the course of their working years, but these benefits are not paid until the employee retires. Currently, pensions represent the largest civilian employee benefit, and postretirement health benefits are a relatively small but growing share of civilian employee benefits. In the cash budget, the payments made to retired employees are recorded as outlays and reflected in the cash budget deficit. Any contributions made by employees are recorded as receipts and offset part of the cash outlays.²⁵ However, the accrual deficit reflects an annual expense for the estimated long-term cost of these benefits each year as the employee renders his or her services. The annual expense includes the pension, health, or other benefits accrued for current workers, accrued interest on the outstanding liability, and adjustments for any changes to assumptions or the plans' benefits and any deviations between actual experience and assumptions. Contributions made by employees towards pension, health, or other benefits are recorded as earned revenue, which offset part of the expense.²⁶

The reported civilian employee benefit liabilities—or the present value of the benefits that have been earned but not paid at the end of the reporting year—and the changes in liabilities are shown in table 2.

Table 2: Civilian Employee Benefit Liabilities

Dollars in billions					
	Fiscal year				
	2001	2002	2003	2004	2005
Accrued liability	1,359.2	1,398.1	1,482.0	1,550.7	1,613.0
Pensions	1,112.9	1,129.8	1,190.4	1,230.2	1,273.8
Postretirement health	205.2	221.4	244.4	266.1	290.7
Other benefits	41.1	46.9	47.2	54.4	48.5
Change in liability from previous year	50.1	38.9	83.9	68.7	62.3
Pension	41.0	16.9	60.6	39.8	43.6
Postretirement health	7.2	16.2	23.0	21.7	24.6
Other benefits	1.9	5.8	0.3	7.2	-5.9

Source: Treasury.

Note: Data from unaudited *Financial Reports* for 2001 to 2005.

²⁵Agencies also make contributions for some accrued pension benefits but the payments are intragovernmental—that is, they are recorded as outlays by one agency and receipts by the civil service retirement and disability trust fund. Since no cash actually leaves the government, such contributions do not affect the governmentwide cash deficit. See app. II for more information. Most civilian agencies are not required to make contributions for future health and life insurance benefits.

²⁶Agency contributions are also recorded as earned revenue but since these contributions are intragovernmental, they are netted out in the CFS.

The change in the liability from the previous year (in the highlighted row of table 2) is the primary difference between what is recorded in the accrual deficit and the cash budget deficit for civilian employee benefits. The change in liability is generally equal to the accrued expense less payments made to current retirees during the current year. Therefore a positive change in the liability represents accrued expenses in excess of cash outlays. Because accrued expenses enter into the accrual deficit as a negative, the change in liability is added to the accrual deficit to get to the cash deficit.

What Drives Changes in Civilian Employee Benefit Liabilities?

Changes in civilian employee benefit liabilities can affect the accrual deficit with no corresponding change to the cash budget deficit. The accrued benefit expense depends on assumptions and projections for salaries, years of service, interest rates, inflation, and other economic and demographic variables. As such, deviations between actual experience and these assumptions can lead to large changes in the civilian employee benefit liability and the accrual deficit itself. For example, the change in liability attributed to pensions in 2002—\$16.9 billion—was lower than in 2001—\$41.0 billion—because actual pay raises given to federal employees and the cost of living allowance given to retirees were both less than previously assumed. As a result, the previous year's liability was reduced because of these deviations from the assumptions. Conversely, the change in liability attributed to pensions in 2003—\$60.6 billion—was significantly larger than 2002 because actual pay raises were larger than assumed.

Most of the year-to-year changes in the postretirement health liability were also due to differences between actual experience and assumptions about health care costs and utilization. Health care cost trends have been more volatile than factors underlying estimates of pension benefit liabilities (e.g., wage growth and cost of living allowances); hence, estimates of postretirement health liabilities can be more volatile than pension liability estimates.

How Is Veterans Compensation Recorded in the Cash and Accrual Deficits?

The veterans compensation program provides eligible veterans and their survivors with benefits to compensate for the loss of potential earnings due to service-connected disability or death. The cash budget deficit reflects compensation payments made in the current year to current veterans but not the estimated costs of future benefits. However, the accrual deficit reflects an expense for future payments to current veterans already receiving benefits, veterans that aren't currently receiving benefits but will in the future, and a portion of those in active military service assumed by the VA to become eligible for benefits in the future.

Table 3 shows the reported veterans compensation liability—or the present value of the estimated cost of future benefit payments earned but not paid at the end of the year—and the corresponding change in each year from 2001 to 2005.

Table 3: Veterans Compensation Liabilities

Dollars in billions

	Fiscal year				
	2001	2002	2003	2004	2005
Accrued liability	691.9	849.2	954.8	924.8	1,122.6
Change in liability from previous year	139.3	157.3	105.6	-30.0	197.8

Source: Treasury.

Note: Data from unaudited *Financial Reports* for 2001 to 2005.

The difference between the cash and accrual measures of veterans compensation is the change in the liability from year to year (in the highlighted row of table 3). The change in the liability is generally equal to accrued compensation expense plus accrued interest on the outstanding liability less benefits paid to current beneficiaries. As such, a positive change in the liability represents accrued expenses (in excess of cash payments). Because accrued expenses enter into the accrual deficit as a negative, one must add the change in liability to the accrual deficit to get to the cash budget deficit.

What Drives Changes in Veterans Compensation Liabilities?

Changes in the veterans compensation liability can affect the accrual deficit with no corresponding change to the cash budget deficit. VA estimates the compensation liability using assumptions for the number of beneficiaries, life expectancy, future cost of living adjustments, and interest rates, among other things, and the liability is sensitive to changes in these assumptions.

Indeed, the veterans compensation liability experienced wide fluctuations in recent years driven by changes in assumptions. The liability increased by \$105.6 billion in 2003, decreased by \$30.0 billion in 2004, and then increased by \$197.8 billion in 2005. These large swings resulted not from changes to benefit provisions, laws, or regulations, but from changes in the assumptions used—primarily for interest rates—to estimate the value of future benefits. Beginning in 2004, VA used current market-based interest rates—rather than historical averages—on Treasury securities to discount future payments into present value terms for presentation in the financial statements. Interest rates can be—and have been—quite volatile, which can lead to volatility in the reported liability. Increases in the interest rate used to discount the liability would reduce the liability whereas decreases in the interest rate would increase the liability. For example, from 2003 to 2004, rates on longer-term Treasury securities increased from 4.91 to 5.23 percent, leading to a \$30 billion reduction in VA's liability. Conversely, for the next year, VA reduced its long-term interest rate assumption from 5.23 percent in 2004 to 4.74 percent in 2005. Reducing the interest rate resulted in a higher present value estimate of future benefit payments and thus a greater liability.

Military
Employee
Benefits

Civilian
Employee
Benefits

Veterans
Compensation

**Environmental
Liabilities**

Insurance

Capital

How Are Environmental Liabilities Recorded in the Cash and Accrual Deficits?

Federal, state, or local laws and regulations require the federal government to clean up hazardous and radioactive waste resulting from its operations (e.g., nuclear submarines and nuclear weapons). While the cash deficit reflects cleanup costs when they are paid, accounting standards require agencies to recognize in their financial statements each year a portion of the estimated probable and measurable environmental cleanup costs associated with assets as they are used operations, even though cleanup will not actually occur for many years. In addition, agencies are required to include estimates to clean up and dispose of existing contamination and waste resulting from nuclear weapon production during World War II and the Cold War—also called “legacy waste.” These estimates make up the majority of the Department of Energy’s (DOE) environmental liabilities.

Each year a portion of the estimated total cleanup costs for operating assets is to be recognized as an expense. Accounting standards require that this allocation be based on a systematic and rational method, such as the expected life of the asset and the amount of capacity used each period. So, for example, a nuclear submarine may have an estimated useful life of 10 years and estimated cleanup costs of \$80 million. Under a straight-line allocation method, the expense and liability accrued in each year of its life would be \$8 million. This \$8 million would be reflected in the accrual deficit for that year but not the cash budget deficit. In contrast, any increase to the estimated cost of cleaning up legacy waste must be recognized in full in the period it is identified. Table 4 shows reported environmental liabilities from 2001 to 2005 and the change in the liability each year.²⁷ The change in the liability from the previous year (in the highlighted row of table 4) represents

Table 4: Environmental Liabilities

Dollars in billions

	Fiscal year				
	2001	2002	2003	2004	2005
Accrued liability	306.8	273.0	249.9	249.2	259.8
DOE	238.3	209.7	183.4	181.7	189.8
DOD	63.3	59.3	61.5	64.3	65.0
Others	5.2	4.0	5.0	3.2	5.0
Change in liability from previous year	5.7	-33.8	-23.1	-0.7	10.6
DOE	4.1	-28.7	-26.2	-1.7	8.1
DOD	0.1	-4.0	2.2	2.8	0.7
Others	1.5	-1.2	1.0	-1.8	1.8

Source: Treasury.

Note: Data from unaudited *Financial Reports* for 2001 to 2005.

²⁷For assets in operation, cleanup costs are recognized over the expected life of the asset and thus the reported liability does not include the full cleanup cost until the end of the asset’s life.

accrued expenses in the current year less payments for current year cleanup activities, which were expensed in the past:

- If accrued expenses exceed cash payments, liabilities increase and a positive change is shown (see 2001 and 2005).
- If cash payments exceed accrued expenses, liabilities decrease and a negative change is shown (see 2002, 2003, and 2004).

To move from the accrual deficit to the cash deficit requires adjustment for these accrued expenses and cash payments. Because accrued expenses (in excess of cash payments) enter into the accrual deficit as a negative, they must be added to the accrual deficit in order to get to the cash deficit. Conversely, cash payments in excess of accrued expenses are subtracted from the accrual deficit to get to the cash deficit.

What Drives Changes in Environmental Liability Estimates?

Estimates of cleanup costs are inherently uncertain. Estimates must assume the use of current technology and involve making a number of assumptions about the level of restoration of the site; detailed projections about the schedule of funding and cleanup activities; and inflation. Costs (and hence the liability) may also change if there is a change in the laws or regulations determining the level of restoration. For example, restoration to “pristine condition” would have a higher cost than restoration to a point deemed to “pose no near-term health risks.”

The changes in DOE’s estimated environmental liability in 2002 and 2003 illustrate the role assumptions play in these estimates. DOE reduced its environmental liability estimate by \$28.7 billion in 2002 and \$26.2 billion in 2003 primarily by assuming it could accelerate the timing of cleanup activities, which would lead to cost savings. However, we reported in 2005 that while some progress had been made under its accelerated approach, it is not likely DOE will achieve its projected cost reductions in part because the plan depends on technological improvements and changes in regulatory requirements that may not occur as planned.²⁸

While the accrual deficit reflects more long-term environmental cleanup costs than does the cash deficit, it does not include all long-term cleanup costs and some of the costs recorded may not be reliable. For example, if no technology exists to clean up the site, the costs are not measurable and agencies do not accrue expenses for the site. Also, we identified some issues with DOD’s environmental liability estimates. For example, DOD’s estimates have not reflected major changes to federal accounting standards that became effective in 2003. Also, the Navy had not been estimating and reporting all costs for disposing of spent nuclear fuel produced by its nuclear ships and submarines.²⁹

²⁸GAO, *Nuclear Waste: Better Performance Reporting Needed to Assess DOE’s Ability to Achieve the Goals of the Accelerated Cleanup Program*, GAO-05-764 (Washington, D.C.: July 29, 2005).

²⁹GAO, *Environmental Liabilities: Long-Term Fiscal Planning Hampered by Control Weaknesses and Uncertainties in the Federal Government’s Estimates*, GAO-06-427 (Washington, D.C.: Mar. 31, 2006).

How Are Insurance Programs Recorded in the Cash and Accrual Deficits?

The federal government insures individuals and firms against a variety of risks, such as loss of deposits from bank failures, crop failures, property damages from flood, and loss of pension benefits. Although there are many federal insurance programs, only two—the National Flood Insurance Program (NFIP) and the Pension Benefit Guaranty Corporation (PBGC)³⁰—are separately listed in the *Financial Report* for 2005.

Budget reporting for insurance programs focuses on annual cash flows. Outlays are recorded when claims are paid and collections for insurance programs—such as premiums—are recorded in the budget when received. For example, in 2005, NFIP paid about \$3.3 billion in claims and collected about \$2.1 billion in premiums. Its net effect on the cash budget deficit was a net outlay of about \$1.2 billion.

In contrast, the *Financial Report* records expenses or losses for estimated insurance claims when events have occurred or are probable to occur and can be reasonably estimated. Accordingly, losses are recognized as a liability in the balance sheet when claims have not been paid and generally represent a difference between the cash and accrual deficits. Whether or not the increase in insurance liability constitutes the majority of the difference between the accrual and cash deficits depends on the type of federal insurance program that has been reported in the CFS. Table 5 shows the reported liabilities as of the end of 2004 and 2005 and the change in liability from the previous year.

Table 5: Insurance Liabilities

Dollars in billions

	Fiscal year	
	2004	2005
Insurance liability	62.2	93.2
PBGC	60.8	69.8
NFIP	1.4	23.4
Change in liability from previous year	17.0^a	31.0
PBGC	16.3	9.0
NFIP	0.7	22.0

Sources: Treasury, PBGC, and the Department of Homeland Security.

Notes: Data from unaudited *Financial Report* for 2005, PBGC 2004 Annual Report, and Department of Homeland Security Performance and Accountability Report 2005. Insurance programs were not specifically reported in the reconciliation statement prior to 2005. Because the *Financial Report* for 2005 only includes information on fiscal years 2004 and 2005, we did not include information prior to 2004 in table 5.

^aTotal for PBGC and NFIP only; does not equal total reported in CFS.

³⁰Although PBGC's financial activity and balances are shown in the *Financial Report*, under current law PBGC's liabilities may be paid only from PBGC's assets and not from the General Fund of the Treasury or assets of the government generally.

For NFIP, the difference between the accrual and cash deficit is the change in insurance liabilities, which reflects claims approved but not paid and estimated claims for events that have occurred. The increase in the NFIP liability from 2004 to 2005 accounted for \$22 billion of the \$31 billion increase in insurance liabilities for the year. This means that the accrual deficit was \$22 billion greater than the cash budget deficit due to changes in NFIP's liability. Because the accrued expense for NFIP enters into the accrual deficit as a negative, the change in the liability must be added back to the accrual deficit to get to the cash deficit.

PBGC is somewhat different than NFIP and other insurance programs. For PBGC, the difference between the cash and accrual measures is not simply the change in the liability from the previous year. The difference between the cash and accrual deficits attributable to PBGC is also due to changes in the value of plan assets, whereas assets are not an important factor for NFIP's reconciliation. The difference between the cash and accrual deficits attributable to PBGC is composed primarily of (1) losses (i.e., the difference between the present value of estimated future benefits and plan assets) that are recorded in the *Financial Report* for completed and probable pension plan terminations and (2) cash benefit payments that are recognized in the budget. The loss represents the amount PBGC estimates it will ultimately be responsible for. Because losses are included in the accrual deficit as a negative they are added back to the accrual deficit to get to the cash deficit. This total loss amount is not specifically identified in the reconciliation statement.

What Drives Changes in Insurance Programs?

The change in the NFIP liability each year is driven by external factors such as natural disasters that produce floods and damage property. In the 2 years shown in table 5, flood insurance had the largest single-year effect on the insurance liability and the accrual deficit. The \$22 billion increase in the flood insurance liability in 2005 was primarily a result of Hurricane Katrina. Many insurance claims from individuals who lost property from flooding as a result of Hurricane Katrina were not yet paid at the end of the fiscal year.³¹

The economic health and benefit obligations of companies that sponsor defined-benefit pension plans are the primary drivers of accrued losses recognized by PBGC. PBGC estimates the loss for pension plans that are probable to be terminated in the near future by assessing macroeconomic conditions that can influence firms and investments and the specific performance of particular companies. In 2004 PBGC recognized losses due to probable plan terminations of \$14.4 billion, primarily due to the struggling airline industry. The loss also includes adjustments for deviations between actual experience and PBGC's estimates and the underlying assumptions. As mentioned above, the loss represents the primary difference between the cash and accrual deficits but is not equal to the change in liability in table 5.³²

³¹GAO identifies a list of high-risk federal programs that warrant attention by both Congress and the administration. NFIP was added to the list for 2006. See GAO's *High-Risk Program*, GAO-06-497T (Washington, D.C.: Mar. 15, 2006).

³²PBGC's Single-Employer Insurance Program has been listed on GAO's High-Risk List since 2003. See GAO-06-497T.

How Are Capital Assets Recorded in the Cash and Accrual Deficits?

The federal government acquires a wide variety of capital assets for its own use including land, structures, equipment, vehicles, and information technology. The differing treatment of capital assets between the budget and the financial statements is part of the reconciliation between the accrual deficit and the cash budget deficit. Table 6 below shows the components of the reconciliation statement attributable to capital assets.

Table 6: Capital Asset Accounts

	Fiscal year				
	2001	2002	2003	2004	2005
Dollars in billions					
Components of accrual deficit not part of the cash budget deficit					
Depreciation expense	21.4	20.5	71.2	89.9	79.7
Property, plant, and equipment disposals and revaluations	0	0	13.0	0.2	47.8
Components of cash budget deficit not part of the accrual deficit					
Outlays for capitalized fixed assets	-34.4	-40.9	-102.0	-112.1	-146.6

Source: Treasury.

Note: Data from unaudited *Financial Reports* for 2001 to 2005.

To determine the accrual deficit (or the annual cost of operations), the financial statements recognize the expense for a capital asset by spreading its cost over its expected useful life. This is known as depreciation expense and increases the accrual deficit each year of the asset's life. Depreciation is not recognized in the cash deficit so it must be added back to the accrual deficit to get to the cash deficit.

In addition, capital assets may be sold or destroyed or revalued to reflect the true value of the asset. For a sale, the difference between the amount that is received for the asset upon disposal and the book value of the asset is recognized in the accrual deficit but not in the budget deficit.³³ The budget deficit reflects a cash receipt for the full amount of the sale. Similarly, if an asset is destroyed or revalued to reflect a better estimate of its value, this is recognized in the accrual deficit but not the cash deficit. Disposals and revaluations can increase or decrease the accrual deficit and must be accounted for when reconciling between the accrual and cash measures.

³³The book value is the amount paid less depreciation already recognized.

In the budget, outlays made to purchase capital assets are recorded on a cash basis. Outlays are recorded when capital assets are paid for and therefore the cost of the asset increases the cash budget deficit in the year that the outlay is made. The cash cost of accrued expenses (in excess of assets—called “capitalized fixed assets” in table 6—must be subtracted from the accrual deficit to get to the cash budget deficit.

What Drives Changes in Depreciation Expense and Capitalized Assets?

Changes in accounting standards such as what assets are included in capitalized assets or how assets are depreciated can cause changes in accrual measures. For example, prior to 2003, the depreciation of national defense equipment (e.g., ships, aircraft, combat vehicles, and weapons) was not reflected in the accrual deficit because national defense equipment was reported as part of “stewardship assets,” which were not on the balance sheet, and thus not depreciated. Beginning in 2003, a change in accounting standards required that DOD’s national defense equipment be recorded as capitalized assets on the balance sheet and depreciated. The primary reason for the increase in the depreciation expense from \$20.5 billion in 2002 to \$71.2 billion in 2003 was the addition of these DOD assets. It is important to note that the change in accounting standards changed what was reported on the balance sheet and not what was actually owned by the government.

Prior to the accounting change relating to national defense equipment, the cost of purchasing such equipment was not included in the reconciliation statement because it was reflected in both the accrual and cash budget deficits. Under the accounting change, the cost of purchasing national defense equipment is now capitalized and therefore not included in the accrual deficit, while such costs are still included in the budget deficit. The capitalization of purchases of DOD’s national defense equipment was a primary contributor to an increase in the amount of capitalized assets reported in the reconciliation statement from \$40.9 billion in 2002 to \$102.0 billion in 2003.³⁴

Although the addition of national defense equipment to the balance sheet accounted for a large part of the increase in capitalized assets and depreciation expense, too much focus should not be placed on the exact size of the increase. As we have reported in the past, the federal government can not satisfactorily determine that capital assets are properly reported in the CFS. A majority of capital assets are the responsibility of the DOD and it has not maintained adequate systems or sufficient records to provide reliable information on these assets.

³⁴The increase in outlays for capitalized assets reported in the reconciliation statement only reflects assets that were purchased in 2003. The total increase in the balance sheet as a result of adding national defense equipment that was purchased in previous years was much greater.

How Are Cash and Accrual Deficits Measured?

How Are Cash and Accrual Deficits Similar? How Are They Different?

What Drives Changes in Cash and Accrual Deficits from Year to Year?

What Areas Explain the Largest Differences between Cash and Accrual Deficits?

How Can Accrual and Cash Measures Complement Each Other?

How Can Accrual and Cash Deficit Measures Complement Each Other?

Neither the accrual nor the cash budget deficit alone provides a full picture of the government's fiscal condition or the cost of government. For example, the cash deficit provides information on borrowing needs and current cash flow. The accrual deficit provides information on the current cost of government, but it does not tell one how much the government has to borrow in the current year to finance government activities. Also, accrual deficits provide more information on the longer-term consequences of current government activities but by nature do not include information about the timing of payments and receipts, which can be important. Therefore, just as investors need income statements, statements of cash flow, and balance sheets to understand a business's financial condition, both cash and accrual measures are important for understanding the government's financial condition. Cash and accrual measures together provide a more complete picture of the government's fiscal stance today and over time; however, additional measures of the long-term implications of existing programs and tax policies are needed to have a fully complete picture.

Other Measures Are Also Needed to Understand the Government's Fiscal Condition

Beyond accrual and cash budget deficits, there are even more measures, statements, and information that are used or could be used to more fully understand the government's fiscal condition, including

- projected cash flows of large spending and tax programs,
- summary present value measures of large spending and tax programs,
- reports on the nation's fiscal exposures,
- governmentwide financial statements of fiscal sustainability, and
- a summary annual report.

Some of this information is currently available, but more should be developed or made more transparent. For example, the long-term cash flow is projected for Social Security and Medicare. These cash flow projections help in understanding the expected timing of future payments and receipts and hence the potential effect of these programs on future borrowing needs and financial markets. Summary present value measures are a way to show the long-term expected cost of current or proposed policies in a single number. These are also available for Social Security and Medicare. However, projected cash flows and summary present value measures are still needed for other major spending and tax programs—both existing programs and new programs or benefits being considered by Congress.

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Measures or statements that illustrate the future cost of government as a whole would also be beneficial. For example, we have suggested that OMB report on the nation's fiscal exposures—the wide range of responsibilities, programs, and activities that may explicitly or implicitly expose the federal government to future spending. This would include reporting liabilities, obligations, commitments, contingencies, and implicit promises embedded in current policy or public expectations.³⁵ Some of these, such as environmental cleanup and disposal costs and postretirement benefits, are reported in the financial statements as liabilities. Others, such as financial commitments, certain contingencies, and future social insurance benefits are not reported as liabilities but are reported elsewhere in the *Financial Report*.³⁶ Pulling all these together into one presentation would improve transparency and may prompt more explicit deliberation of the government's long-term fiscal commitments.

An even more comprehensive statement illustrating the long-term fiscal sustainability of the government as a whole, including future tax receipts and the cost of providing basic government services such as education and defense, might also be useful. Improved reporting would also involve a summary annual report that summarizes in a clear, concise, and transparent manner key financial and performance information embodied in the *Financial Report*. Such a report could be useful to both Congress and the American people.

Some Federal Programs Use Both Cash and Accrual Measures in the Budget but More Could Be Done

Some federal programs use both cash- and accrual-based measures but more can be done. For example, agencies pay the cost of accrued pension benefits for some civilians (i.e., those hired since 1984) and military personnel (i.e., those in service after October 1, 1984) as they are earned. While the accrued cost is not reflected in the budget's bottom line (i.e., the cash deficit),³⁷ information on the full cost of current services is available to decision makers responsible for resource allocation. However, the full cost of all pensions (i.e., employees hired before 1984), retiree health, environmental liabilities, and insurance are still not recognized in the budget when the commitments are made.

³⁵GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

³⁶Information on the long-term costs of social insurance programs has been included in the required supplemental stewardship information section of the *Financial Report* and a Statement of Social Insurance will be incorporated into the primary financial statements for the first time for fiscal year 2006.

³⁷See app. II for more information.

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Accrual measures can be used to a greater extent to inform decision making. Although long-term estimates, including those used in the accrual deficit, are inherently uncertain, cash measures alone do not provide information about the longer-term consequences of today's decisions. We have previously suggested³⁸ that Congress consider expanding the selective use of accrual-based measures in the budget to program areas where it would enhance spending control and provide more information on the full cost at the time decisions to commit the government are made (i.e., up front).³⁹ We identified several alternative approaches for Congress and the Executive Branch to consider that would improve the recognition of long-term costs in the budget. For example, accrual budgeting could be adopted for programs that currently do not capture the long-term commitment entered into by the government such as:

- employee pension programs,
- retiree health programs for federal employees,
- federal insurance programs, and
- environmental clean up.

The bottom line is that having one measure without the other does not provide complete information about the government's fiscal condition. The government—just like businesses and individuals—should not ignore the balance in its checking account or its longer-term financial picture.

³⁸See GAO, *Budget Issues: Budgeting for Federal Insurance Programs*, GAO/AIMD-97-16 (Washington, D.C.: Sept. 30, 1997), *Long-Term Commitments: Improving the Budgetary Focus on Environmental Liabilities*, GAO-03-219 (Washington, D.C.: Jan. 24, 2003), and GAO/AIMD-00-57.

³⁹For purchases of capital assets, we do not recommend the use of accrual accounting for budget decisions because it would sacrifice up-front control of budgetary resources. Recording depreciation rather than the purchase cost would delay budget recognition of the resource commitment.

Appendix I: Glossary of Key Terms

Term	Definition
Accrual basis	The basis of accounting whereby revenue is recognized when it is earned and expenses are recognized in the period incurred, regardless of when cash is received or paid.
Accrual deficit	The term used in this report to refer to the net operating cost. (See net operating cost.)
Actuarial liability	A liability based on statistical calculations and actuarial assumptions, which are conditions used to resolve uncertainties in the absence of information concerning future events affecting insurance, pension expenses, and so forth.
Budget authority	Authority provided by federal law to enter into financial obligations that will result in immediate or future outlays involving federal government funds.
Capital assets	Land, structures, equipment, intellectual property (e.g., software), and information technology (including information technology service contracts) that are used by the federal government and have an estimated useful life of 2 years or more.
Capitalized	Recorded as an asset on the balance sheet. Some capital assets may not be reported on the balance sheet if they fail to meet the entity's criteria (e.g., a dollar threshold) for balance sheet reporting.
Cash basis	The basis whereby receipts are recorded when received and expenditures are recorded when paid, without regard to the accounting period in which the receipts are earned or the costs are incurred.
Cash budget deficit, cash deficit	The term used in this report to refer to the unified budget deficit. (See unified budget deficit.)
Contingency	An existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur.
Cost	For purposes of this primer, the value of the resources used to produce a program, provide a service, or achieve an objective.
Depreciation	The systematic and rational allocation of the acquisition cost of an asset, less its estimated salvage or residual value, over its estimated useful life.
Disclaimer of opinion	A statement in an auditor's report indicating the inability of the auditor to express an opinion on the fairness of the financial statements referred to in the report.
Expense	Outflow or other use of assets, or incurrence of liability, during an operating period as a result of providing goods, services, or other activities the benefits from which do not extend beyond the present operating period.
Financial commitment	For federal proprietary accounting, contractual obligations that require the future use of resources.
Incur	To sustain, become liable for; the term is said of a cost, expense, loss, or debt.
Legal liability	Under obligational accounting, a claim that may be legally enforced against the government. It may be created in a variety of ways, such as by signing a contract, grant, or cooperative agreement by operation of law. (See also obligation.)
Liability	For federal proprietary accounting, a probable future outflow or other sacrifice of resources as a result of past transactions or events.
Modified cash basis	A term used to describe the federal government's hybrid system for accounting for revenues from taxes and duties. Under a modified cash basis, revenue is recognized when received in cash except for tax receivables (taxes owed from taxpayers but not yet collected) and refunds payable (refunds owed to taxpayers but not yet paid by the federal government), which are both measured on an accrual basis.
Net operating cost	The excess of expenses over tax revenue. (See revenue; expenses.)
Net operating revenue	The excess of tax revenue over expenses. (See revenue; expenses.)



Term	Definition
Obligation	A definite commitment that creates a legal liability of the government for the payment of goods and services ordered or received, or a legal duty on the part of the United States that could mature into a legal liability by virtue of actions on the part of the other party beyond the control of the United States.
Obligational accounting	The accounting systems, processes, and people involved in collecting financial information necessary to control, monitor, and report on all funds made available to federal entities by legislation, including permanent, indefinite appropriations as well as appropriations enacted in annual and supplemental appropriations laws that may be available for 1 or multiple fiscal years.
Off-budget	Those budgetary accounts (either federal or trust funds) designated by law as excluded from budget totals. As of the date of this primer, the revenues and outlays of the two Social Security trust funds (the Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund) and the transactions of the Postal Service are the only off-budget accounts. The budget documents routinely report the on-budget and off-budget amounts separately and then add them together to arrive at the consolidated government totals. (See also on-budget; unified budget deficit; unified budget surplus.)
On-budget	All budgetary accounts other than those designated by law as off-budget. (See also off-budget; unified budget deficit; unified budget surplus.)
Outlay	The issuance of checks, disbursement of cash, or electronic transfer of funds made to liquidate a federal obligation.
Present value	The worth of a future stream of returns or costs in terms of money paid immediately (or at some designated date). A dollar available at some date in the future is worth less than a dollar available today because the latter could be invested at interest in the interim. In calculating present value, prevailing interest rates provide the basis for converting future amounts into their "money now" equivalents. The net present value is the present value of estimated future cash inflows minus the present value of cash outflows.
Receipts	Collections from the public based on the government's exercise of its sovereign powers, including individual and corporate income taxes and social insurance taxes, excise taxes, duties, court fines, compulsory licenses, and deposits of earnings by the Federal Reserve System. Total governmental receipts include those specified as off-budget by law. Total receipts are compared with total outlays in calculating the deficit or surplus.
Revenue	As used in federal accounting, an inflow of resources that the government demands, earns, or receives by donation. As used in the congressional budget process, a synonym for governmental receipts.
Stewardship property, plant, and equipment	Property owned by the federal government and meeting the definition of one of the following two categories: <ul style="list-style-type: none"> • Heritage Assets—property, plant, and equipment (PP&E) of historical, natural, cultural, educational, or artistic significance, or • Stewardship Land—land other than that acquired for or in connection with general PP&E. The acquisition cost of stewardship PP&E is generally recognized as a cost when incurred. However, multiuse heritage assets, such as the White House, are used in an entity's operations and are reported as capitalized assets on the balance sheet.
Unified budget deficit	The amount by which the government's on-budget and off-budget outlays exceed the sum of its on-budget and off-budget receipts for a given period, usually a fiscal year. (See also off-budget; on-budget.)
Unified budget surplus	The amount by which the sum of the government's on-budget and off-budget receipts exceed the sum of its on-budget and off-budget outlays for a given period, usually a fiscal year. (See also off-budget; on-budget.)

Appendix II: Budget Outlays Recorded on an Accrual Basis

Outlays in the cash budget deficit are primarily measured on a cash basis. However, there are some areas, such as federal credit programs, pensions, insurance, and environmental liabilities, where cash measurement does not reveal the full extent of the government's commitment up front when the commitment is made. In some of these areas, the budget records outlays on an accrual basis rather than cash. The accrual-based outlays for program areas shown in table 7 affect the bottom line cash budget deficit. However, accrual-based outlays for other program areas shown in table 8 do not affect the bottom line cash budget deficit because the outlays are paid by one agency to another (i.e., intragovernmental) and so offset each other. Only payments that flow from or to entities outside the government affect the cash budget deficit.

Table 7: Budget Outlays Measured on an Accrual Basis That Affect the Cash Budget Deficit

Program area	Budget treatment
Credit programs	Outlay recorded for the credit subsidy cost, which is the net present value of the estimated cash flows over the life of a loan or loan guarantee (excluding administrative costs).
Interest on the debt held by the public	Outlay recorded when interest accrues on public debt securities, ^a not when payments are made.

Source: GAO.

^aSome outlays from the Department of the Treasury to pay interest on special Treasury securities held by some federal trust funds are also recorded on an accrual basis but they are intragovernmental and do not affect the cash deficit.



Table 8: Intragovernmental Outlays/Receipts Measured on an Accrual Basis That Do Not Affect the Cash Budget Deficit

Program area	Budget treatment
Federal Employees Retirement System (FERS) pensions	<p>Civilian agencies are charged for the full cost of pension benefits as they accrue for employees covered by FERS.^a An accrual-based outlay is recorded by the employing agency for accruing pension costs not covered by employee contributions. The receipt is recorded by the civilian retirement system. Since no cash actually leaves the government, there is no effect on the governmentwide cash deficit.</p> <p>Only cash outlays from the civilian retirement system to current retirees are reflected in the cash budget deficit.</p>
Military pensions	<p>The Department of Defense (DOD) is charged for the accrued cost of military pension benefits as they accrue. An accrual-based outlay is recorded by DOD for accruing pension costs. The receipt is recorded by the military retirement system. Since no cash actually leaves the government, there is no effect on the governmentwide cash deficit.</p> <p>Only cash outlays from the military retirement system to current retirees are reflected in the cash budget deficit.</p>
Military retiree health for Medicare-eligible retirees	<p>DOD is charged for the accrual cost of retirees' health care for benefits received by annuitants who are eligible for Medicare. An accrual-based outlay is recorded by DOD and the receipt is recorded by the Medicare-eligible military retiree health fund.^b Since no cash actually leaves the government, there is no effect on the governmentwide cash deficit.</p> <p>Only cash outlays from the Medicare-eligible military military retiree health fund to current retirees are reflected in the cash budget deficit.</p>

Source: GAO.

^aFERS is the retirement system for civilian employees hired after 1983. The Civil Service Retirement System (CSRS) provides defined benefits to most federal employees hired before 1984. Currently, federal agencies pay only about 40 percent of the pension costs for CSRS-covered employees.

^bUnder the Floyd D. Spence National Defense Authorization Act of Fiscal Year 2001 (Pub. L. No. 106-398), the Secretary of Defense was required to make contributions into the Medicare-Eligible Retiree Health Care Fund. However, beginning in 2006, DOD stopped making contributions because the Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005 (Pub. L. No. 108-375) directed the Department of the Treasury to make the annual contribution instead of DOD.

For additional information on program areas where the budget does not recognize their total commitment up front, see GAO reports titled *Accrual Budgeting: Experiences of Other Nations and Implications for the United States*, GAO/AIMD-00-57 (Washington, D.C.: Feb. 18, 2000) and *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).



Appendix III: Obligational Accounting

In addition to cash and accrual accounting, Congress and federal agencies also track funds using obligational accounting—a separate and distinct administrative control through which federal agencies control, monitor, and report on the status of the funds at their disposal.

Obligational accounting differs from cash and accrual accounting by when transactions are recorded. For example, an agency can incur a legal liability (i.e., a claim that may be legally enforced against the government) in a variety of ways, such as by signing a contract, grant, or cooperative agreement, or by operation of law. When an agency creates a legal liability, it “obligates” itself to pay and records an obligation against available funds. Recording the obligation effectively sets aside those funds for the actual cash outlay. Under cash and accrual accounting, the recognition of the legal liability doesn’t show up until later. No transaction is recorded under accrual, or proprietary accounting, until the entity accepts the goods or services, at which point an account payable and related expense will be recorded. Under cash accounting, an outlay is recorded when the obligation is liquidated.

The federal budget and budget process largely use obligational accounting. The obligational system of accounting is rooted in the Antideficiency Act.¹ It is through this obligational accounting that federal agencies ensure compliance with the fiscal laws that Congress has enacted including the Antideficiency Act, the “recording statute,” and the “purpose” and “time” statutes. Thus, if an agency controls its obligations, it is unlikely to overspend its appropriations.

A detailed discussion of obligations and obligational accounting can be found in GAO’s *Glossary of Terms Used in the Federal Budget Process*, GAO-05-734SP (Washington, D.C.: September 2005), appendix III, page 120.

¹The Antideficiency Act prohibits an officer or employee of the United States government from: obligating or spending in excess or in advance of an appropriation, accepting voluntary services except in emergencies, and obligating or spending in excess of amounts apportioned or in excess of amounts permitted by agency regulations that subdivide amounts apportioned.

Related GAO Products

The Nation's Long-Term Fiscal Outlook: September 2006 Update. GAO-06-1077R. Washington, D.C.: September 15, 2006.

Financial Audit: Significant Internal Control Weaknesses Remain in Preparing the Consolidated Financial Statements of the U.S. Government. GAO-06-415. Washington, D.C.: April 21, 2006.

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