

ARTHUR ANDERSEN & Co.

1345 AVENUE OF THE AMERICAS
NEW YORK, N.Y. 10105

WRITER'S DIRECT DIAL NUMBER

(212) 708-4855

June 18, 1987

The Honorable Joseph J. Dio Guardi
Congressman
325 Cannon House Office Building
Washington, D.C. 20515

Dear Joe:

As requested, I am summarizing the principal causes of differences in the Federal deficit as determined on the accrual-basis of accounting as compared with the cash-basis deficit.

As I said in a March 10, 1987 Wall Street Journal article:

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

Since the government does not maintain accrual basis accounting systems, there can be no precise determination of the accrual-basis Federal deficit. As you know, Arthur Andersen & Co. performed a study of U.S. Government accounting practices at its own initiative in 1975 and produced the first set of accrual-basis financial statements for the Federal government as of the fiscal 1974 year-end. Subsequently, a Commission was formed by U.S. Treasury Secretary Bill Simon that reviewed the results of our study and developed a methodology to carry-forward the results of our study so that for each year since, the U.S. Treasury has prepared prototype accrual-basis financial statements. As confirmed by the recent update of our 1974 study and our publication released in February 1986, "Sound Financial Reporting In the U.S. Government," such financial statements represent the best indication available of the real cost of government and the accumulated deficit after reflecting all known liabilities.

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Our study confirmed an accrual-basis deficit for fiscal 1984 of \$333 billion as compared with \$185 billion on a cash basis, a variance of \$148 billion. The financial statements in our publication include a statement on page 17 which summarizes the differences between accrual-basis and cash-basis accounting for the Federal budget.

As shown in that statement, the principal causes of the higher annual-basis deficits are:

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

Following is a brief description of the above items, which are discussed in more detail in our publication:

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

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

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

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

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

While the deficits are higher on the accrual-basis of accounting, they are actually trending down under Ronald Reagan. As shown on page 4 of our study published in "Sound Financial Reporting In the U.S. Government," the accrual basis deficit was 9.3% of GNP in 1984 vs. 12.5% of GNP in 1980. Under Ronald Reagan the growth segment of the budget has been expenditures for long-lived military equipment, which is capitalizable, and the social security program and pension programs have been put on a sounder footing, which has curtailed the growth of unrecorded liabilities. The principal cause of a rise in accrual-basis deficits during the Carter years was due to the "stagflation" years of the late 1970's which created the anomaly of benefits increasing much faster than tax revenues. The cash-basis deficits were affected, but the greater impact was on the unrecorded liabilities to be paid in the future.

We believe that failure by the government to follow sound financial reporting is not merely a lack of accounting sophistry. It is a crucial question of governance -- a missing link in our constitutional system that allows public officials to commit resources without reporting to the public. This lack of public accountability has resulted in fiscal recklessness and an unstable economic environment that threatens the foundations of our society. The lack of public accountability fosters cynicism among the citizenry and can weaken the nation's resolve and its ability to act appropriately when challenges arise.

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

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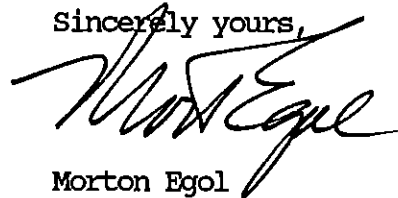
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"I think it an object of great importance...to simplify our system of finance, and to bring it within the comprehension of every member of Congress...the whole system (has been) involved in impenetrable fog. There is a point...on which I should wish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

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

Please let me know if you require additional information.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Morton Ego", written in a cursive style.

Morton Ego