

**THE FEDERAL GOVERNMENT'S CONSOLIDATED  
FINANCIAL STATEMENTS: ARE THEY RELIABLE?**

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**HEARING**

BEFORE THE  
SUBCOMMITTEE ON GOVERNMENT EFFICIENCY,  
FINANCIAL MANAGEMENT AND  
INTERGOVERNMENTAL RELATIONS  
OF THE  
COMMITTEE ON  
GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

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# **THE FEDERAL GOVERNMENT'S CONSOLIDATED FINANCIAL STATEMENTS: ARE THEY RELIABLE?**

**TUESDAY, APRIL 9, 2002**

HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON GOVERNMENT EFFICIENCY, FINANCIAL  
MANAGEMENT AND INTERGOVERNMENTAL RELATIONS,  
COMMITTEE ON GOVERNMENT REFORM,  
*Washington, DC.*

The subcommittee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representative Horn.

Staff present: J. Russell George, staff director and chief counsel; Bonnie Heald, deputy staff director; Henry Wray, senior counsel; Rosa Harris, professional staff member, GAO detailee; Justin Paulhamus, clerk; Michael Sazonov, subcommittee intern; David McMillen, minority professional staff member; and Jean Gosa, minority clerk.

Mr. HORN. A quorum being present, the hearing of the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations will come to order.

We are here today to examine the financial management practices of the executive branch of the Federal Government. Specifically, we want to learn whether Federal departments and agencies have made any progress in accounting for the billions of taxpayer dollars they spend each year.

Throughout the past decade, Congress has sought ways to make the executive branch of the government financially accountable to the Nation's taxpayers. The Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994, is one of several financial reforms that received bipartisan support from Congress and the President.

The law requires that 24 major departments and agencies in the executive branch of the government prepare annual, audited financial statements. These reports are to be submitted to the Office of Management and Budget by March 1st. The law also requires the Department of the Treasury to prepare annual consolidated, governmentwide financial statements and the General Accounting Office to audit and report on these financial statements by March 31st.

The General Accounting Office's report on the consolidated, governmentwide statements for fiscal year 2001 was released on

March 29, 2002. Based on the GAO report, agency auditors' findings and a survey of agency Inspectors General, the subcommittee is releasing its governmentwide financial management report card today.

This year, the subcommittee used more rigorous criteria to determine agency grades than in the previous years when the subcommittee focused on criteria such as whether agencies could produce clean, auditable financial statements in a timely fashion.

This year, similar to last year, 18 agencies were able to produce clean statements, although they often required extraordinary efforts to do so. Likewise, all 24 agencies filed their financial statements on time again this year.

Nevertheless, these criteria do not guarantee that agencies are capable of producing reliable and useful financial information for day-to-day decisionmaking, including information on program costs. Although agencies have improved, they are still unable to achieve that goal.

This year, the executive branch of the Federal Government has earned a grade of D for its overall financial management during fiscal year 2001. Sixteen of the 24 agencies received a lower grade than last year. Most noticeable among those agencies, three that received As on last year's report card fell miserably this year. The National Aeronautics and Space Administration's grade fell to an F. The Small Business Administration's grade fell to a D plus. And the Department of Energy received a mediocre C this year. The Department of Energy's lower grade may be attributed to the subcommittee's new criteria. However, even without the more rigorous criteria, NASA still would have earned an F this year, and the Small Business Administration still would have earned a D plus.

In NASA's case, new auditors took a fresh look at the agency's books and found several significant problems. Auditors at the Small Business Administration found that the agency did not have effective internal controls and did not comply with all Federal financial management laws, as it had in previous years.

The failures of a few agencies continue to tarnish the overall record of the executive branch of government. For the 5th consecutive year, the Agency for International Development and two of the government's largest departments, the Department of Defense and the Department of Agriculture, still face significant financial management challenges. They again received the unacceptable grade of F.

Until Federal agencies have financial systems that can generate reliable and useful information to support day-to-day management and policymaking, the Government's financial challenges will continue and the taxpayers of this Nation will rightly question the government's ever-increasing need for tax dollars.

[The prepared statement of Hon. Stephen Horn follows:]

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**Opening Statement**  
**Chairman Steve Horn**  
**Subcommittee on Government Efficiency,**  
**Financial Management and Intergovernmental Relations**  
**April 9, 2002**

A quorum being present, this hearing of the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations will come to order.

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Throughout the past decade, Congress has sought ways to make the executive branch of the Government financially accountable to the nation's taxpayers. The Chief Financial Officers (CFO) Act of 1990, as amended by the Government Management Reform Act of 1994, is one of several financial reforms that received bipartisan support from congress and the president. The law requires that the 24 major departments and agencies in the executive branch of the government prepare annual, audited financial statements. These reports are to be submitted to the Office of Management and Budget by March 1<sup>st</sup>. The law also requires the Department of the Treasury to prepare annual consolidated, government-wide financial statements and the General Accounting Office to audit and report on those financial statements by March 31<sup>st</sup>.

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This year, similar to last year, 18 agencies were able to produce clean statements, although they often required extraordinary efforts to do so. Likewise, all 24 agencies filed their financial statements on time again this year.

Nevertheless, these criteria do not guarantee that agencies are capable of producing reliable and useful financial information for day-to-day decision-making, including information on program costs. Although agencies have improved, they are still unable to achieve that goal.

This year, the executive branch of the federal government has earned a grade of "D" for its overall financial management during fiscal year 2001. Sixteen of the 24 agencies received a lower grade than last year. Most notable among those agencies, three that received "A's" on last year's report card fell miserably this year. The National Aeronautics and Space Administration's grade fell to an "F." The Small Business Administration's grade fell to a "D+," and the Department of Energy received a mediocre "C" this year. The Department of Energy's lower grade may be attributed to the subcommittee's new criteria. However, even without the more rigorous criteria, NASA still would have earned an "F" this year, and the Small Business Administration still would have earned a "D+."

In NASA's case, new auditors took a fresh look at the agency's books and found several significant problems. Auditors at the Small Business Administration found that the agency did not have effective internal controls and did not comply with all federal financial management laws, as it had in previous years.

The failures of a few agencies continue to tarnish the overall record of the executive branch of government. For the fifth consecutive year, the Agency for International Development, and two of the government's largest departments -- the Department of Defense and the Department of Agriculture -- still face significant financial management challenges. They, again, received the unacceptable grade of "F."

Until federal agencies have financial systems that can generate reliable and useful information to support day-to-day management and policy-making, the government's financial challenges will continue, and the taxpayers of this Nation will rightly question the government's ever-increasing need for tax dollars.

I welcome today's panel of witnesses, all of whom have key roles in determining the government's financial credibility.



**Fiscal Year 2001** (for the period ended September 30, 2001)

**Financial Management Status Report**

<b>Federal Departments and Agencies</b>	<b>Grade</b>	<b>Federal Departments and Agencies</b>	<b>Grade</b>
SSA Social Security Administration	B	Commerce Department of Commerce	D-
GSA General Services Administration	B-	Education Department of Education	D-
DOE Department of Energy	C	Treasury Department of the Treasury	D-
OPM Office of Personnel Management	C	NRC Nuclear Regulatory Commission	D-
Labor Department of Labor	C-	Justice Department of Justice	D-
NSF National Science Foundation	C-	State Department of State	D-
EPA Environmental Protection Agency	D+	DOT Department of Transportation	D-
SBA Small Business Administration	D+	AID Agency for International Development	F
HHS Department of Health and Human Services	D	FEMA Federal Emergency Management Administration	F
HUD Department of Housing and Urban Development	D	Agriculture Department of Agriculture	F
Interior Department of the Interior	D	DOD Department of Defense	F
VA Department of Veterans Affairs	D	NASA National Aeronautics and Space Administration	F
		Governmentwide Grade	D

Prepared for Subcommittee Chairman Stephen Horn, Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations, April 9, 2002.

Fiscal Year 2000 (for the period ended September 30, 2000)  
**Financial Management Status Report**

Federal Departments and Agencies	RELIABLE FINANCIAL INFORMATION (yes/qualified/no)	EFFECTIVE INTERNAL CONTROLS (yes/no)	COMPLIANCE WITH LAWS AND REGULATIONS (yes/no)	GRADE FY 1996	GRADE FY 1997	GRADE FY 1998	GRADE FY 1999	GRADE FY 2000
DOE Department of Energy	YES	YES	YES	A	A	C	B-	A
NASA National Aeronautics and Space Administration	YES	YES	YES	A	A	A	A	A
SBA Small Business Administration	YES	YES	YES	B-	D+	D+	D+	A
EPA Environmental Protection Agency	YES	YES	NO	C	D+	D+	D-	B-
GSA General Services Administration	YES	YES	NO	D+	B-	B-	B-	B-
Labor Department of Labor	YES	YES	NO	D	B-	B-	B-	B-
NSF National Science Foundation	YES	YES	NO	D	B+	A	A	B-
OPM Office of Personnel Management	YES	YES	NO	F	F	F	F	B-
SSA Social Security Administration	YES	YES	NO	A	B-	B-	B-	B- *
Commerce Department of Commerce	YES	NO	NO	F	F	F	D+	D+
FEHA Federal Emergency Management Administration	YES	NO	NO	F	D-	D+	D+	D+
HHS Department of Health and Human Services	YES	NO	NO	F	D-	D-	D+	D+
HUD Department of Housing and Urban Development	YES	NO	NO	D-	D-	D+	F	D+
Interior Department of the Interior	YES	NO	NO	D+	B-	D+	D+	D+
NRC Nuclear Regulatory Commission	YES	NO	NO	A	B-	D+	D+	D+
State Department of State	YES	NO	NO	D-	D-	D+	D+	D+
Treasury Department of the Treasury	YES	NO	NO	F	D-	D-	D-	D+
VVA Department of Veterans Affairs	YES	NO	NO	F	D-	D-	D+	D+
Education Department of Education	Qualified	NO	NO	D+	D+	F	D-	D-
Justice Department of Justice	Qualified	NO	NO	F	F	F	D-	D-
DOT Department of Transportation	Qualified	NO	NO	F	F	F	D+	D-
AID Agency for International Development	NO	NO	NO	F	F	F	F	F
Agriculture Department of Agriculture	NO	NO	NO	F	F	F	F	F
DOD Department of Defense	NO	NO	NO	F	F	F	F	F
<b>FEDERAL GOVERNMENT</b>								<b>C-</b>

## NOTES:

Agency grades are based on the audited financial statements prepared pursuant to the Government Management Reform Act of 1994 for three categories: RELIABLE FINANCIAL INFORMATION, EFFECTIVE INTERNAL CONTROLS, AND COMPLIANCE WITH LAWS AND REGULATIONS.

\*The grade for SSA is based on the SSA Office of the Inspector General's belief that SSA does not substantially comply with laws and regulations; however the independent public accountant who performed the audit believes that SSA does substantially comply.

FINANCIAL MANAGEMENT STATUS REPORT  
FOR FISCAL YEAR 2001

GRADING METHODOLOGY

This is the fifth year that the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations (and its predecessor subcommittee) has issued a report card on the status of financial management at the 24 Federal agencies that are subject to the Chief Financial Officers Act. The report card grades each agency's progress in achieving good financial management.

In previous years, the subcommittee based its grades on the agencies' annual audited financial statements, required under the Government Management Reform Act of 1994. The subcommittee evaluated three categories: the nature of the audit opinions; whether the agencies had effective internal controls; and whether agencies were in compliance with Federal financial management laws and regulations.

In the audit opinion category, an unqualified, or "clean," opinion earned 4 points. A qualified opinion received 2 points; and a disclaimer received 0 points.<sup>1</sup> If auditors reported no material weaknesses in internal controls, the agency received 4 points. Conversely, if material weaknesses were reported, the agency received 0 points in that category. If auditors reported that the agency appeared to be in compliance with Federal financial management laws and regulations, the agency received 4 points. Any reports of material noncompliance resulted in 0 points.

The points in the three categories were then averaged (with equal weight) to determine the overall grade for the agency. Thus, if an agency received an unqualified audit opinion and the auditors reported no material internal control weaknesses or instances of non-compliance, the agency received a grade of A ( $4+4+4=12 \div 3=4$ ).

The subcommittee reviewed each financial report on an absolute scale and assigned grades based on a four point scale. An agency that scored 4 points received an "A;" 3 points = a "B;" 2 points = a "C;" 1 point = a "D;" and 0 points = an "F."

This year, the subcommittee has added four new categories to its grading criteria. These additional categories place greater emphasis on whether agency financial systems can produce reliable and useful data on a real-time basis to support day-to-day management and policy-making. This is consistent with the view espoused by the General Accounting Office, the Office of Management and Budget and other experts that

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<sup>1</sup> There were no adverse opinions rendered in fiscal years 1996 through 2001; however, an adverse opinion would have also received 0 points.

a successful financial management program requires much more than simply getting an unqualified audit opinion and complying with legal and accounting requirements.<sup>2</sup> The subcommittee's new grading criteria also come closer to the Executive Branch Management Scorecard, which sets more demanding standards for financial management success.

The four new grading categories are based on the results of a survey that the subcommittee sent to the Inspectors General of the 24 agencies. The categories are as follows:

- Whether this year's financial statements were prepared from data produced routinely by the agency's financial management systems;
- Whether the agency's financial and performance management systems were integrated;
- Whether the agency's financial systems contained complete and reliable data on the costs of its programs and activities;
- Whether the agency's financial systems provided timely, accurate and useful data to support day-to-day management and policy-making.

The possible responses to each of the four categories were "entirely," "for the most part," and "to a limited extent or not at all." Agencies received 4 points for a response of "entirely;" 2 points for the response of "for the most part;" and 0 points for "to a limited extent or not all."

This year, the subcommittee gave equal weight to the three categories used in prior years and the four new categories. Thus, agency grades are based on the total points assigned for each category divided by seven.<sup>3</sup>

The subcommittee believes that the revised grading criteria provide a more accurate measure of financial management successes than the former criteria. At the same time, the subcommittee regards the new criteria only as a starting point toward defining a truly successful financial management program. The subcommittee welcomes and invites suggestions for improvements to these criteria for future years.

<sup>2</sup> Indeed, an unqualified audit opinion may actually be a misleading indicator that masks weaknesses in an agency's financial management systems. Many Federal agencies achieve "unqualified" opinions only through time-consuming and costly manual efforts that work around, rather than rely upon, the agency's systems.

<sup>3</sup> In addition to the four questions described above, the subcommittee also asked the Inspectors General whether their agencies had violated the Anti-deficiency Act (i.e., overspent their appropriation accounts) for fiscal year 2001. The responses to this question were not factored into the grades since only two agencies—the Departments of Defense and Agriculture--had actual or potential violations, and they both received failing grades irrespective of these violations.

Mr. HORN. I welcome today the panel of witnesses, all of whom have key roles in determining the government's financial credibility.

Now, as you know, this is an investigating committee of the Government Reform full committee, and we do have to ask you to stand and present your right arm. If you have aides to back you up, place adhere and affirm to this oath.

[Witnesses sworn.]

The clerk will note the three primary witness have taken the oath, and in back of them are six more.

So we thank you, and we thank you particularly to—we have here today a distinguished member of the government, the Honorable David M. Walker, Comptroller General of the United States, who heads the U.S. General Accounting Office. I want to thank General Walker, that we have, on this committee, have been very helpful, your staff, to come with us on our various hearings we have recently held in Nashville, Albuquerque, Phoenix, Los Angeles, San Francisco—and we have got only 50 to go. We thank the GAO for being always present to help bring things together with the two panel witnesses that we have at each of those. Thank you, Mr. Comptroller General.

**STATEMENT OF DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GENERAL ACCOUNTING OFFICE**

Mr. WALKER. Thank you, Mr. Chairman. I am pleased to be here today to discuss our report on the U.S. Government's consolidated financial statements for fiscal years 2001 and 2000.

Mr. Chairman, with your permission I would ask that my full statement be included in the record, and I will move to summarize it.

Mr. HORN. Without objection, it is in the record.

Mr. WALKER. Thank you, Mr. Chairman.

As in the four previous fiscal years, GAO was unable to express an opinion on the consolidated financial statements of the U.S. Government because of certain material weaknesses in internal controls and accounting and reporting issues.

Progress is being made in addressing the various impediments to an unqualified opinion on the U.S. Government's consolidated financial statements. However, many of the pervasive and generally longstanding material weaknesses that we have reported for the past 4 years have not been fully resolved.

Across government, there has been a range of financial management improvement initiatives undertaken, and many are now under way, that if effectively implemented will improve the quality of the government's financial management reporting.

We have a chart, Mr. Chairman, that shows for fiscal year 2001, as you noted, 18 of the 24 Chief Financial Officers Act agencies were able to attain unqualified audit opinions on their financial statements, which is the same number of agencies as last year, and up from six in fiscal 1996.

Additionally, for fiscal years 2001 and 2000, the reports of the Inspectors General and the various contract auditors indicated that only three of the 24 CFO Act agencies had neither material control weaknesses, an issue involving compliance with applicable laws

and regulations, nor an instance of a lack of substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996.

In addition, it looks as if no agency fully met the new criteria for success in the financial management area based upon the fiscal 2001 results.

Mr. Chairman, I would respectfully ask that this chart be entered into the record.

Mr. HORN. It is. And it is being—going over the television.

Mr. WALKER. Thank you.

[The information referred to follows:]

**FY 2001 CFO Act Agency Results Reported by Auditors**

<p><b>Agencies with Clean Opinions</b></p>	<p><b>Agencies with Clean Opinions and No Material Weaknesses or Noncompliances</b></p>	<p><b>Agencies with Clean Opinions, No Material Weaknesses or Noncompliances, and Integrated Financial and Performance Management Systems Containing Accurate and Timely Financial Information to Support Financial Statement Preparation and Day-to-Day Operations</b></p>
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**18<sup>a</sup> 3<sup>b</sup> 0**

<sup>a</sup>Commerce, Energy, Health and Human Services, Housing and Urban Development, Interior, Justice, Labor, State, Transportation, Treasury, Veterans Affairs, Environmental Protection Agency, General Services Administration, National Science Foundation, Nuclear Regulatory Commission, Office of Personnel Management, Small Business Administration, and Social Security Administration.

<sup>b</sup>Energy, General Services Administration, and Social Security Administration.



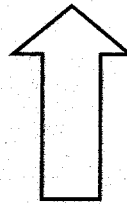
**Results of FY2001  
Agency Financial Audits**

**Improvement**

Clean: DOJ, DOT

Qualified: Education

Disclaimers: USDA, USAID



**Unchanged**

Clean: Commerce, HHS,

HUD, DOE, DOI, DOL,

State, Treasury, VA,

EPA, GSA, NRC, NSF,

OPM, SBA, SSA

Disclaimer: DOD

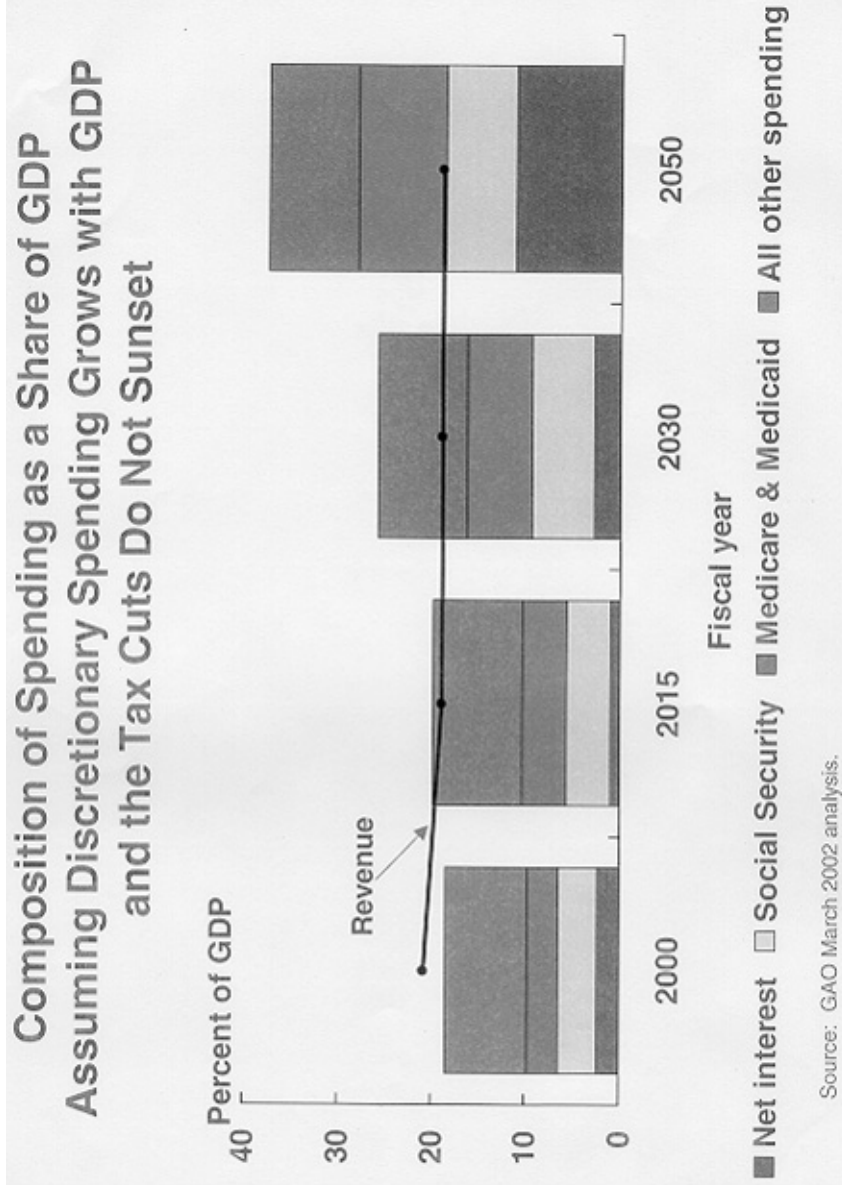
**Deterioration**

Qualified: FEMA

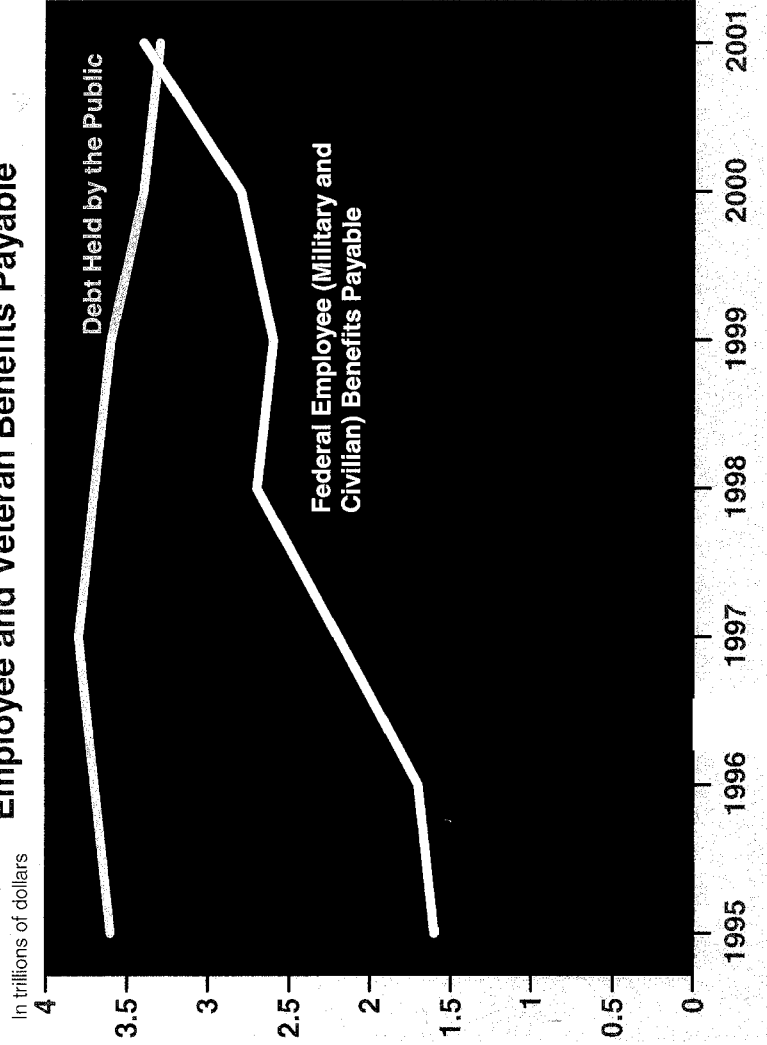
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### Debt Held by the Public Compared to Federal Employee and Veteran Benefits Payable



Mr. WALKER. In summary, 18 had a clean opinion, but only three of which had a clean opinion with no material weaknesses or non-compliance issues, and none of which appear to meet the new fuller criteria as established by the JFMIP principals, which I believe are clearly appropriate. We want meaningful success in the financial management area, not superficial success.

The largest impediment to an unqualified opinion on the consolidated financial statements continues to be the Department of Defense, which faces serious financial management problems that we have designated as a high-risk area since 1995. Fortunately, in September 2001, Secretary of Defense Rumsfeld announced a DOD-wide initiative intended to transform the full range of the Department's business processes, including decades-old financial systems that are not well interconnected. For the first time in history the Department's Quadrennial Defense Review, the so-called QDR, which is prepared by DOD, includes business process transformation as a key element.

The Secretary has also taken action to set aside \$100 million for financial modernization and has established a number of top-level committees, councils, and boards, including the Business Initiative Council and the Defense Practices Implementation Board, to develop and implement an integrated DOD-wide strategy for fundamentally transforming business practices.

I am convinced, Mr. Chairman, that this Secretary and his top management team are serious, but only time will tell whether or not we will achieve the desired outcomes.

Importantly, the President's Management Agenda Fiscal Year 2002 includes improved financial management performance as one of his top five governmentwide management goals.

In addition, in August 2001, the principals of the Joint Financial Management Improvement Program, which include Secretary of the Treasury O'Neil, Director of OMB Daniels, Director of OPM James, and I as Comptroller General and the current chair of the group, began a series of periodic meetings that have resulted in unprecedented substantive deliberations and agreements focused on key financial management reform issues such as better defining measures for financial success.

Mr. Chairman, we have already met three times in the last several months. We are scheduled to meet again next month. This group had not met more than once in the last 10 years. We have already met three times, and each meeting has been substantive, and at each meeting we achieve agreement on important issues as we expect to in this next meeting.

Mr. Chairman, there are a couple of issues in the last year's financial statements and our report that I would like to bring to your attention.

No. 1, for fiscal year 2001, the military post-retirement health benefits liability increased by \$389 billion on a net present value basis, due primarily to a \$293 billion increase attributable to provisions of the fiscal year 2001 National Defense Authorization Act, which is Public Law 106-398, that expanded certain benefits to Medicare-eligible DOD retirees, their dependants and survivors, and to a \$91 billion increase associated with changes in medical cost trend assumptions.

Mr. Chairman, it is my understanding that the Congress did not have accurate, timely and useful information when it considered and debated this change in law and that the amounts that the Congress was provided with regard to the estimated fiscal effects of this change were substantially less than what the actuaries are now estimating. Mr. Chairman, this serves to reinforce the need to make sure that the Congress has timely, accurate and useful information, not just for accounting purposes but also for budgetary considerations, because there are many things that we may be able to afford today but we may not be able to sustain tomorrow.

I point to the board and the second chart, which you are familiar with, Mr. Chairman. This chart is based upon the GAO's long-range budget simulation which shows that, due primarily to known demographic trends and rising healthcare costs, we face serious budget challenges in the years ahead. As a result, it is critically important that we have timely, accurate and useful information not just for accounting purposes but for informed decisionmaking with regard to legislation and other resource allocation decisions.

Once again, the U.S. Government's consolidated financial statements reported an update of the key indicators of the financial status of Social Security and Medicare trust-fund reports from the trustees' reports. The trustees issued their reports the same week as the consolidated financial statements.

Without this update, the government would have provided two different reports on the sustainability of those important programs which could cause confusion and reduce confidence in the credibility of the U.S. Government's consolidated financial statements. This updated information will not be available when the U.S. Government consolidated financial statements are issued on an accelerated basis beginning for fiscal year 2004.

The JFMIP principals are considering ways to ensure that the reports issued by Social Security and Medicare trustees, these agencies financial statements and the U.S. Government's consolidated financial statements present timely and consistent information.

I would argue, Mr. Chairman, that the information on these programs arguably is among the most if not the most important from the standpoint of taxpayers. They care deeply about this. In our view, the Congress may need to enact legislation that will require earlier reporting and issuance of the trustees' reports in order to allow for timely social insurance information to be included in agencies' and the U.S. Government's consolidated financial statements. This is very important, Mr. Chairman.

In closing, our report on the U.S. Government's consolidated financial statements highlights the need to continue addressing the government's serious financial management weaknesses. The requirement for timely, accurate and useful financial and performance management information is greater than ever as the Congress and the administration prepare to meet today's and tomorrow's fiscal challenges.

The cooperative effort spearheaded by the JFMIP principals have been most encouraging in developing the short- and long-term strategies and plans necessary to address the many problems that I have discussed.

In addition, GAO has probably never had a better working relationship with OMB and Cabinet-level and other key officials on a range of good government issues that are of critical importance and are inherently nonpartisan in nature. While these and other factors provide an enhanced likelihood for success, in the end it is results that count.

Finally, I want to reiterate the value of sustained congressional interest in these issues as demonstrated by this hearing and your commitment over a number of years. I also want to note that such congressional interest is critically important to sustaining progress in this area, and it is key that the appropriations, budget, authorizing and oversight committees hold agency top leadership accountable for resolving these problems and that they support related improvement efforts. Because many of these improvement efforts will take years, continued congressional interest is important and necessary.

Thank you, Mr. Chairman.

Mr. HORN. Thank you very much.

[The prepared statement of Mr. Walker follows:]

United States General Accounting Office

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**GAO**

**Testimony**

Before the Subcommittee on Government Efficiency,  
Financial Management, and Intergovernmental Relations,  
Committee on Government Reform, House of  
Representatives

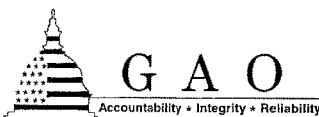
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For Release on Delivery  
Expected at 10 a.m.  
Tuesday, April 9, 2002

**U.S. GOVERNMENT  
FINANCIAL  
STATEMENTS**

**FY 2001 Results Highlight  
the Continuing Need to  
Accelerate Federal  
Financial Management  
Reform**

Statement of David M. Walker  
Comptroller General of the United States



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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our report on the U.S. government's consolidated financial statements for fiscal years 2001 and 2000. Both the consolidated financial statements and our report are included in the fiscal year 2001 *Financial Report of the United States Government*, which was issued by the Department of the Treasury (Treasury) on March 29, 2002, and is available through GAO's Internet site, at [www.gao.gov](http://www.gao.gov). Your work and that of this subcommittee have been a catalyst to facilitate government management reform over the past 5 years and will be critical to ultimately restoring the confidence of citizens in the federal government as a financial steward that is accountable for its finances.

As in the 4 previous fiscal years, we were unable to express an opinion on the consolidated financial statements because of certain material weaknesses in internal control and accounting and reporting issues. These conditions prevented us from being able to provide the Congress and American citizens an opinion as to whether the consolidated financial statements are fairly stated in conformity with U.S. generally accepted accounting principles.

Until the problems discussed in our report are adequately addressed, they will continue to (1) hamper the government's ability to accurately report a significant portion of its assets, liabilities, and costs, (2) affect the government's ability to accurately measure the full cost and financial performance of certain programs and effectively manage related operations, and (3) significantly impair the government's ability to adequately safeguard certain significant assets and properly record various transactions.

Progress is being made in addressing impediments to an unqualified opinion on the U.S. government's consolidated financial statements. For example, in fiscal year 2001, the Department of Agriculture (USDA) and certain other key agencies made significant improvements in estimating the cost of the government's lending programs and the net loan amounts expected to be collected, which had contributed to our disclaimer of opinion in prior years. However, many of the pervasive and generally long-standing material weaknesses we have reported for the past 4 years have not been fully resolved. The underlying causes of these issues are significant financial management systems weaknesses, problems with

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fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal control.

Across government, there are a range of financial management improvement initiatives underway that, if effectively implemented, will improve the quality of the government's financial management and reporting. For fiscal year 2001, 18 of the 24 Chief Financial Officers (CFO) Act agencies were able to attain unqualified audit opinions on their financial statements, which is the same number of agencies as last year and up from 6 agencies for fiscal year 1996. Also, the Office of Management and Budget (OMB) reported that, for the second consecutive year, all 24 CFO Act agencies met the statutory reporting deadline. Further, two agencies that did not receive unqualified opinions from their auditor last year were able to do so this year, including the Department of Justice, which received an unqualified opinion for the first time. However, two other agencies were unable to sustain the unqualified opinions received from their auditor last year. Additionally, for fiscal years 2001 and 2000, reports of inspectors general and their contract auditors indicated that only 3 of the 24 CFO Act agencies had neither a material control weakness, an issue involving compliance with applicable laws and regulations, nor an instance of lack of substantial compliance with requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996.

The largest impediment to an unqualified opinion on the consolidated financial statements continues to be the Department of Defense's (DOD) serious financial management problems, which we have designated as high risk since 1995. DOD faces financial management problems that are pervasive, complex, long-standing, and deeply rooted in virtually all business operations throughout the department. To date, none of the military services or major DOD components has passed the test of an independent financial audit because of pervasive weaknesses in financial management systems, operations, and controls. Overhauling financial management represents a major management challenge that goes far beyond financial accounting to the very fiber of the department's business operations and management culture. Cultural resistance to change and military service parochialism have played a significant role in impeding previous attempts to implement broad-based management reforms at DOD. The department has acknowledged that it confronts decades-old problems deeply grounded in the bureaucratic history and operating practices of a complex, multifaceted organization, and that many of these practices were developed piecemeal and evolved to accommodate different organizations, each with its own policies and procedures. In September 2001, Secretary of



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Defense Rumsfeld announced a DOD-wide initiative intended to transform the full range of the department's business processes, including decades-old financial systems that are not well interconnected. For the first time, the *Quadrennial Defense Review* prepared by DOD includes business process transformation as a key element. The Secretary has also taken action to set aside \$100 million for financial modernization and to establish a number of top-level committees, councils, and boards, including the Business Initiative Council and the Defense Business Practices Implementation Board, to help develop and implement an integrated DOD-wide strategy for fundamentally transforming business practices.

Two other major impediments that must be overcome are the government's inability to account for billions of dollars of transactions between federal government entities and to properly prepare the consolidated financial statements. The heart of the intragovernmental transactions issue is that the government lacks clearly articulated business rules for these transactions so that they are handled consistently by agencies. Compounding this problem, agencies have not reconciled intragovernmental balances with their trading partners.<sup>1</sup> As a result, information reported to Treasury is not reliable. OMB and Treasury have several initiatives underway to address this issue. With respect to properly preparing the consolidated financial statements, Treasury plans to develop a new system and procedures to prepare the financial statements. The continued leadership of both OMB and Treasury will be important to resolving both of these issues.

Many agencies have been able to obtain unqualified audit opinions only by expending significant resources on extensive ad hoc procedures and making billions of dollars in adjustments to derive financial statements months after the end of a fiscal year. As I previously testified<sup>2</sup> before this subcommittee, if agencies continue year after year to rely on significant costly and time-intensive manual efforts to achieve or maintain unqualified opinions without improving underlying financial management systems, it can serve to mislead the public as to the true status of the agency's financial

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<sup>1</sup>Trading partners are U.S. government agencies, departments, or other components included in the U.S. government's consolidated financial statements that do business with each other.

<sup>2</sup>U.S. General Accounting Office, *U.S. Government Financial Statements: FY 2000 Reporting Underscores the Need to Accelerate Federal Financial Management Reform*, GAO-01-570T (Washington, D.C.: Mar. 30, 2001).

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management capabilities. An unqualified opinion achieved on this basis will become an accomplishment without much substance.

Irrespective of the unqualified opinions on their financial statements, many agencies do not have timely, accurate, and useful financial information, including cost data, and do not have sound controls with which to make informed decisions and ensure accountability on an ongoing basis. For example, for fiscal year 2001, auditors for 17 of the 24 CFO Act agencies reported at least one material control weakness, compared to 15 such agencies for fiscal year 2000. In addition, for fiscal year 2001, reports of inspectors general and their contract auditors indicated that 20 of the 24 CFO Act agencies' financial management systems were not in substantial compliance with at least one of FFMIAs three federal financial management systems requirements, compared to 19 such agencies for fiscal year 2000. For the remaining four CFO Act agencies (the Departments of Energy and Labor, the General Services Administration (GSA), and the Social Security Administration (SSA)), auditors provided negative assurance, meaning that nothing came to their attention indicating these agencies' financial management systems do not meet FFMLA requirements. The auditors for these four agencies did not definitively state whether these agencies' systems substantially complied with FFMIAs requirements, which we believe is required under the statute. Ultimately, to fully meet the goals of financial management reform legislation, agencies will need to be able to generate timely, accurate, and useful financial and management information, including reporting performance results, to make decisions and monitor government performance every day. Agencies will also need to have effective internal controls in place and must ensure compliance with applicable laws and regulations.

*The President's Management Agenda Fiscal Year 2002* includes improved financial management performance as one of his five top governmentwide management goals. Other governmentwide initiatives include strategic management of human capital, competitive sourcing, expanded electronic government, and budget and performance integration. These initiatives cannot be addressed in an isolated or piecemeal fashion, but must be addressed in an integrated way to ensure that they drive a broader transformation of the cultures of federal agencies. The administration plans to use the Executive Branch Management Scorecard, which includes broad standards, to highlight agencies' progress in achieving management and performance improvements embodied in *The President's Management Agenda Fiscal Year 2002*. This is a step in the right direction to improving management and performance, but the value of the scorecards is not in the

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scoring, but in the degree to which scores lead to sustained focus and demonstrable improvements. It will be important that there be continuous rigor in the scoring process in order for this approach to be credible and effective.

In August 2001, the Principals of the Joint Financial Management Improvement Program (JFMIP)—Secretary of the Treasury O'Neill, Office of Management and Budget Director Daniels, Office of Personnel Management (OPM) Director James, and I, as Comptroller General of the United States and chair for the group—began a series of periodic meetings that have resulted in unprecedented substantive deliberations and agreements focused on key financial management reform issues such as better defining measures for financial management success. These measures include being able to routinely provide timely, accurate, and useful financial information and having no material internal control weaknesses or material noncompliance with laws and regulations and FFMA requirements, which are essential to meeting the CFO Act's expectations, *The President's Management Agenda Fiscal Year 2002*, and Secretary of Defense Rumsfeld's business process transformation initiative. In addition, the JFMIP Principals have agreed to significantly accelerate financial statement reporting so that the government's financial statements are more timely and to discourage costly efforts designed to obtain unqualified opinions on financial statements without addressing underlying systems challenges. For fiscal year 2004, audited agency financial statements are to be issued no later than November 15, with the U.S. government's audited consolidated financial statements becoming due by December 15.

Federal agencies have started to make progress in their efforts to modernize their financial management systems. However, the need for timely, accurate, and useful financial and performance management information is greater than ever given the increasing demands on the federal budget.<sup>3</sup> Indeed, the challenges of combating terrorism and ensuring our homeland security have come to the fore as urgent claims on

<sup>3</sup>Additionally, beginning on April 4, 2002, the Secretary of the Treasury exercised statutory authority to suspend some investments and reinvestments of the Federal Employees Retirement System's Government Securities Investment Fund's (G-Fund) receipts and maturing securities to prevent Treasury from exceeding the government's current \$5,950 billion debt ceiling. The Secretary reported that the G-Fund will receive complete restoration of all funds temporarily affected by this action, including full and automatic restoration of any interest that would have been credited to the Fund.

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our attention and on the federal budget. At the same time, the known fiscal pressures created by the retirement of the baby boom generation and rising health care costs remain. Correspondingly, the ultimate task of addressing today's needs without unduly exacerbating the long-range fiscal challenge has become much more difficult.

As we look ahead we face an unprecedented demographic challenge. A nation that has prided itself on its youth will become older. In fact, in 2008—only 6 years from now—the first wave of baby boomers become eligible to claim their Social Security benefits. As the share of the population over 65 climbs to more than 20 percent in 2035, federal spending on the elderly will absorb larger and ultimately unsustainable shares of the federal budget. Federal health and retirement spending are expected to surge as people live longer and spend more time in retirement. In addition, advances in medical technology are likely to keep pushing up the cost of providing health care. Absent substantive reform of these entitlement programs, a rapid escalation of federal spending for Social Security, Medicare, and Medicaid is virtually certain to overwhelm the rest of the federal budget.

On March 26, 2002, the Trustees of the Social Security and Medicare trust funds reported on the current and projected status of these programs over the next 75 years. The Trustees' reports highlight the need to address the long-term fiscal challenges facing the nation. The Trustees state that, while the near-term financial conditions have improved slightly since last year's reports, the programs continue to face substantial financial challenges in the not-too-distant future that need to be addressed soon. Once again, the Trustees underscored the fact that the most significant implication of these findings is that both Social Security and Medicare need to be reformed and strengthened at the earliest opportunity. The Trustees also stated that Medicare faces financial difficulties that in many ways are more severe than those confronting Social Security.

These long-term demographic and fiscal pressures and the new commitments undertaken after September 11 sharpen the need to look at competing claims and new priorities. While reforming health and retirement entitlement programs is essential to preserving fiscal flexibility in the long term, a fundamental review of all programs and operations can create much-needed fiscal flexibility to address emerging needs and unexpected requirements. Given our long-range budget simulation work and various key trends, there is a clear and compelling need to consider

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what the proper role of the federal government should be in the 21st century and how the government should do business in the future.

Timely, accurate, and useful financial and performance information can form the basis for reconsidering the relevance or "fit" of any federal program or activity in today's world and for the future. Such a review might identify programs that have proven to be outdated or persistently ineffective, or alternatively could prompt the government to update and modernize activities through such actions as improving program targeting and efficiency, consolidation, or reengineering processes and operations. The budget and performance integration initiative under *The President's Management Agenda Fiscal Year 2002* should help provide information for use in conducting such a review. In addition, any review should not be limited to only spending programs but should include the full range of more indirect tools of governance that the federal government uses to address national objectives. These tools include loans and loan guarantees, tax expenditures, and regulations. Ultimately, we should strive to hand to the next generation the legacy of a government that is effective, respected, responsive, and relevant to a changing society—a government that is as free as possible from outmoded commitments and operations that can inappropriately encumber the future.

The Congress and President Bush face the challenge of sorting out these many claims on the federal budget without the fiscal benchmarks that guided us through the years of deficit reduction into surplus. Going forward, new rules and goals will be important both to ensure fiscal discipline and to prompt a focus on the longer term implications of decisions. It is still the case that the federal government needs a decision-making framework that permits it to evaluate choices against both today's needs and the longer term fiscal future that will be handed to future generations. As stewards of our nation's future, we must begin to prepare for tomorrow. In this regard, we must determine how best to address these structural challenges in a reasonably timely manner in order to identify specific actions that need to be taken.

I would now like to highlight the major issues relating to the U.S. government's consolidated financial statements for fiscal years 2001 and 2000. I will then discuss the urgency of providing sustained leadership and oversight to accelerate financial management reform, provide my perspectives on the importance of agencies' building upon their unqualified audit opinions by significantly improving underlying financial management systems, and underscore the need to address major impediments to an

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unqualified opinion on the consolidated financial statements. Also, I will present my observations on selected audit matters that are essential to protect the public interest and conclude with a few thoughts on several key challenges in preparing to meet tomorrow's fiscal needs.

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### Highlights of Major Issues Relating to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2001 and 2000

As I mentioned earlier, as has been the case for the past 4 fiscal years, a significant number of material weaknesses<sup>4</sup> related to financial systems, fundamental recordkeeping and financial reporting, and incomplete documentation continued to (1) hamper the government's ability to accurately report a significant portion of its assets, liabilities, and costs, (2) affect the government's ability to accurately measure the full cost and financial performance of certain programs and effectively manage related operations, and (3) significantly impair the government's ability to adequately safeguard significant assets and properly record various transactions. Several of these material weaknesses (referred to hereafter as material deficiencies) resulted in conditions that continued to prevent us from expressing an opinion on the U.S. government's consolidated financial statements for the fiscal years ended September 30, 2001 and 2000.<sup>5</sup> There may also be additional issues that could affect the consolidated financial statements that have not been identified.

Major challenges include the federal government's inability to

- properly account for and report property, plant, and equipment and inventories and related property, primarily at DOD;
- use effective processes and procedures to estimate the cost of certain major federal credit programs and the related loans receivable and loan guarantee liabilities;

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<sup>4</sup>A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis.

<sup>5</sup>We previously reported that material deficiencies prevented us from expressing an opinion on the U.S. government's consolidated financial statements for fiscal years 1997, 1998, and 1999.

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- support amounts reported for certain liabilities, such as environmental and disposal liabilities and related costs at DOD, and ensure complete and proper reporting for commitments and contingencies;
  - support major portions of the total net cost of government operations, most notably related to DOD and USDA, and ensure that all disbursements are properly recorded;
  - fully account for and reconcile intragovernmental activity and balances; and
  - properly prepare the federal government's financial statements, including balancing the statements, eliminating substantial amounts of transactions between governmental entities, fully ensuring that the information in the consolidated financial statements is consistent with the underlying agency financial statements, and adequately reconciling the results of operations to budget results.

In addition, we identified material weaknesses in internal control related to improper payments, tax collection activities, and computer security. Further, the financial management systems of most CFO Act agencies were again reported by their auditors not to be in substantial compliance with certain FFMA requirements.

For the fiscal year 2001 *Financial Report of the United States Government*, the government has for the first time presented: (1) comparative financial statements;<sup>6</sup> (2) two new financial statements, namely, the Reconciliations of Net Operating Revenue/(Cost) to the Budget Surplus (Unaudited), and the Dispositions of the Budget Surplus (Unaudited); and (3) a Statement of Net Cost that arrays information classified by agency rather than by function, as was shown in prior years.

I would now like to discuss in more detail the material deficiencies identified by our work.

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<sup>6</sup>Numerous amounts previously reported for fiscal year 2000 have been restated in the U.S. government's consolidated financial statements for fiscal years 2001 and 2000. Given our disclaimer of opinion on the U.S. government's consolidated financial statements for fiscal year 2000 and because the dollar amounts involved were not material, we did not audit these changes.

Property, Plant, and Equipment and Inventories and Related Property	The government could not satisfactorily determine that all such assets were included in the consolidated financial statements, verify that certain reported assets actually exist, or substantiate the amounts at which they were valued. A majority of the property, plant, and equipment and inventories and related property is the responsibility of DOD. Certain agencies, including DOD, did not maintain adequate systems or have sufficient records to provide reliable information on these assets.
Loans Receivable and Loan Guarantee Liabilities	For fiscal year 2000, certain federal credit agencies responsible for significant portions of the government's lending programs, most notably USDA, were unable to properly estimate the cost of these programs, or estimate the net loan amounts expected to be collected, in conformity with U.S. generally accepted accounting principles and budgeting requirements. In fiscal year 2001, USDA and other key agencies made significant improvements to these estimates, and as a result, this item is not a material deficiency contributing to our disclaimer of opinion on the fiscal year 2001 consolidated financial statements. However, significant adjustments to the initial estimates of program costs, net loan amounts to be collected, and related footnotes were required during the audit process at certain key agencies, indicating that material internal control weaknesses continue to exist in processes and procedures for making such estimates.
Liabilities and Commitments and Contingencies	The government could not adequately support amounts reported for certain liabilities. For example, it could not develop an accurate estimate of key components of DOD's environmental and disposal liabilities and accurately estimate military postretirement health benefits liabilities included in federal employee and veteran benefits payable, which were reported at \$581 billion in fiscal year 2001 and \$192 billion in fiscal year 2000. <sup>7</sup> In addition, the government could not determine whether commitments and contingencies, including those related to treaties and other agreements entered into to further the U. S. government's interests, were complete and properly reported.
Cost of Government Operations and Disbursement Activity	The previously discussed material deficiencies in reporting assets and liabilities, material deficiencies in financial statement preparation, as

<sup>7</sup>For fiscal year 2001, the military postretirement health benefits liability increased by \$389 billion due primarily to (1) a \$293 billion increase attributable to provisions of the fiscal year 2001 National Defense Authorization Act (Public Law 106-398) that expand certain benefits to Medicare-eligible DOD retirees, their dependents, and survivors, and (2) a \$91 billion increase associated with changes in medical trend assumptions.



discussed below, and the lack of effective agency disbursement reconciliations affect reported net costs. As a result, the government was unable to support significant portions of the total net cost of government operations, most notably related to DOD and USDA. As it relates to disbursement reconciliations, several major agencies did not effectively reconcile disbursements to Treasury's records of disbursements, which is intended to be a key control to detect and correct errors and other misstatements in financial records in a timely manner. This is similar in concept to individuals reconciling their checkbooks with their bank statements each month. Although we have seen progress in this area over the past 5 years, there continued to be billions of dollars of unreconciled differences between agencies' and the Treasury's records of disbursements as of September 30, 2001 and 2000, which could also affect the balance sheet.

Accounting for and  
Reconciliation of  
Intragovernmental Activity and  
Balances

For several years, OMB and Treasury have required the CFO Act agencies to reconcile selected intragovernmental activity and balances with their trading partners. However, numerous agencies did not fully perform such reconciliations for fiscal years 2001 and 2000. For these fiscal years, amounts reported for agency trading partners for certain intragovernmental accounts were significantly out of balance. I will further discuss these issues later in this testimony.

Preparation of Consolidated  
Financial Statements

The government did not have adequate systems, controls, and procedures to properly prepare its consolidated financial statements. Specifically, we identified problems with the elimination of intragovernmental activity and balances, reconciling operating results with budget results, and compiling the consolidated financial statements, such as adequately ensuring that the information for each agency that was included in the consolidated financial statements was consistent with the underlying agency financial statements. These matters are discussed further later in this testimony. Also, disclosure of certain financial information was not presented in the consolidated financial statements in conformity with U.S. generally accepted accounting principles.

Ineffective Internal Control

In addition to the material deficiencies noted above, we found that (1) most agencies have not estimated the magnitude of improper payments in their programs, (2) material internal control weaknesses and systems deficiencies continue to affect the government's ability to effectively

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manage its tax collection activities, and (3) widespread and serious computer control weaknesses affect virtually all federal agencies.

#### Improper Payments

Across government, improper payments occur in a variety of programs and activities, including those related to health care, contract management, federal financial assistance, and tax refunds, and include payments made for unauthorized purposes and for excessive amounts, such as overpayments to program recipients or contractors and vendors. The reasons for improper payments range from program design issues, to inadvertent errors, to fraud and abuse. While reported estimates of improper payments totaled approximately \$19 billion for both fiscal years 2001 and 2000, the government did not estimate the full extent of improper payments.

The Department of Health and Human Services (HHS) has been reporting a national estimate of improper Medicare Fee-for-Service payments as part of its annual financial statements since fiscal year 1996. In fiscal year 2001, HHS reported estimated improper Medicare Fee-for-Service payments of \$12.1 billion, or about 6.3 percent of such benefits—up from \$11.9 billion, or 7 percent, a year earlier and down from \$23.2 billion, or 14 percent, for fiscal year 1996. HHS's reporting and analysis of improper Medicare payments has helped lead to the implementation of several initiatives to identify and reduce such payments. Annual estimates of improper payments in future audited financial statements will provide information on the progress of these initiatives.

However, most agencies have not estimated the magnitude of improper payments in their programs and comprehensively addressed this issue in their annual performance plans under the Government Performance and Results Act (GPRA) of 1993.<sup>8</sup> For example, the Internal Revenue Service (IRS) follows up on only a portion of the suspicious Earned Income Tax Credit (EITC) claims it identifies, although the EITC has historically been vulnerable to high rates of invalid claims. During fiscal year 2000, IRS released the results of its study of EITC compliance for tax year 1997. In this study, which is not performed annually, IRS estimated that taxpayers filed returns claiming about \$9.3 billion in invalid EITCs, of which \$1.5 billion (16 percent) either was recovered or was expected to be recovered through compliance efforts. Although the full extent of refunds

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<sup>8</sup>U.S. General Accounting Office, *Financial Management: Billions in Improper Payments Continue to Require Attention*, GAO-01-44 (Washington, D.C.: Oct. 27, 2000).

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resulting from invalid EITCs is unknown, the IRS has not routinely estimated the potential magnitude of invalid refunds and has not disclosed an annual estimate of improper payments in its financial reports. As a result, the amount of improper payments included in the almost \$26 billion IRS disbursed for EITC in fiscal year 2001 is unknown.

Without a systematic measurement of the extent of improper payments, agency management cannot determine (1) if the problem is significant enough to require corrective action, (2) how much to invest in preventative internal control, (3) the success of efforts implemented to reduce improper payments, or (4) the magnitude or trends of improper payments, which limits the ability to pinpoint or target mitigation strategies. To help in making such determinations, OMB now requires agencies to provide information on erroneous payment rates for benefit and assistance programs expending over \$2 billion annually.

#### Tax Collection Activities

Material internal control weaknesses and systems deficiencies continue to affect the government's ability to effectively manage its tax collection activities.<sup>9</sup> This situation continues to result in the need for extensive, costly, and time-consuming ad hoc programming and analyses, as well as material audit adjustments, to prepare basic financial information. As further discussed later in this testimony, this approach cannot be used to prepare such information on a timely, routine basis to assist in ongoing decision-making. Additionally, the severity of the system deficiencies that give rise to the need to resort to such procedures for financial reporting purposes, as well as deficient physical safeguards, result in burden on taxpayers and lost revenue.

The lack of appropriate subsidiary systems to track the status of taxpayer accounts and material weaknesses in financial reporting affect the government's ability to make informed decisions about collection efforts. Due to errors and delays in recording activity in taxpayer accounts, taxpayers were not always being credited for payments made on their tax liabilities. In addition, the government did not always follow up on potential unreported or underreported taxes and did not always pursue collection efforts against taxpayers owing taxes to the federal government. This could result in billions of dollars not being collected and adversely affect future compliance.

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<sup>9</sup>U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2001 and 2000 Financial Statements*, GAO-02-414 (Washington, D.C.: Feb. 27, 2002).

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The federal government continues to be vulnerable to lost tax revenue due to weaknesses in controls intended to maximize the government's ability to collect what is owed and to minimize the risk of payment of improper refunds. The government identifies billions of dollars of potentially underreported taxes and improper refunds each year. However, due in large part to perceived resource constraints, the federal government selects only a portion of the questionable cases it identifies for follow-up investigation and action. In addition, the federal government often does not initiate follow-up on the cases it selects until months after the related tax returns have been filed and any related refunds disbursed, affecting its chances of collecting amounts due on these cases. Consequently, the federal government is exposed to potentially significant losses from reduced revenue and disbursements of improper refunds. Finally, continued weaknesses in physical controls over cash, checks, and sensitive data received from taxpayers increase both the government's and the taxpayers' exposure to losses and increases the risk of taxpayers becoming victims of crimes committed through identity fraud.

IRS senior management continues to be committed to addressing many of these operational and financial management issues and has made a number of improvements to address some of these weaknesses. Successful implementation of long-term efforts to resolve these serious problems will require the continued commitment of IRS management as well as substantial resources and expertise.

#### Computer Security Weaknesses

GAO has reported computer security as a governmentwide high-risk area since February 1997.<sup>10</sup> Computer security weaknesses are placing enormous amounts of government assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. The government is not in a position to estimate the full magnitude of actual damage and loss resulting from federal computer security weaknesses because it is likely that many such incidents are either not detected or not reported. Agencies have not yet established comprehensive security management programs that would provide the government with a framework for resolving computer security problems and managing computer security risk on an ongoing basis.

<sup>10</sup>See, for example, U.S. General Accounting Office, *High-Risk Series: An Update*, GAO-01-263 (Washington, D.C.: Jan. 2001).

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The computer security weaknesses continue to cover the full range of computer security controls. For example, access controls were not effective in limiting or detecting inappropriate access to computer resources, such as ensuring that only authorized individuals can read, alter, or delete data. In addition, software change controls were ineffective in ensuring that only properly authorized and tested software programs were implemented. Further, duties were not appropriately segregated to reduce the risk that one individual could conduct unauthorized transactions without being detected. Finally, sensitive operating system software was not controlled, and adequate steps had not been taken to ensure continuity of operations.

As we recently testified, the initial implementation of government information security reform provisions contained in the National Defense Authorization Act for fiscal year 2001 is a significant step in improving federal agencies' information security programs and addressing their serious, pervasive information security weaknesses.<sup>11</sup> In its first report on the reform provisions, OMB commended agencies' improvement efforts but noted that many agencies have significant deficiencies in every important area of security. Agencies have noted benefits of this first-year implementation, including increased management attention to and accountability for information security. In addition, the administration has taken important actions to address information security, such as (1) development of plans to integrate information security into the Executive Branch Management Scorecard, which is discussed later in this testimony, (2) appointment of a Special Advisor for Cyberspace Security to coordinate interagency efforts to secure information systems, and (3) creation of the President's Critical Infrastructure Protection Board to recommend policies and coordinate programs, including government and industry's working closely together to address increasing interconnections and shared risks.

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**Compliance with Applicable  
Laws and Regulations and  
FFMIA Requirements**

Our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting was limited by the material weaknesses discussed above. Instances of noncompliance, some of which the agency auditors reported were material to individual agency financial statements, are included in individual agency audit reports. However, none of these instances were material to the U.S. government's

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<sup>11</sup>U.S. General Accounting Office, *Information Security: Additional Actions Needed to Fully Implement Reform Legislation*, GAO-02-4797 (Washington, D.C.: Mar. 6, 2002).

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consolidated financial statements. Additionally, as further discussed later in this testimony, for most CFO Act agencies, the auditors reported that agencies' financial management systems did not substantially comply with certain FFMA requirements.

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### Providing Sustained Leadership and Oversight to Accelerate Financial Management Reform

A year ago, in testimony<sup>12</sup> before this subcommittee on the U.S. government's consolidated financial statements, I said that Treasury Secretary O'Neill, OMB Director Daniels, and I (who, as I mentioned earlier, along with OPM Director James, are the JFMIP Principals) had agreed on the need for aggressive action to accelerate progress in financial management reform. This has sparked our personal commitment to provide the leadership necessary to address pressing governmentwide financial management issues. Also since that time, President Bush has launched a promising new initiative, *The President's Management Agenda Fiscal Year 2002*, to provide direction to, and to closely monitor, management reform across government, which will encompass improved financial performance. Actions such as these are important elements of ensuring the government's full and effective implementation of the federal financial management reforms enacted by the Congress.

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### The JFMIP Principals' Initiative

Over the past year, the JFMIP Principals have established an excellent working relationship, a basis for action, and a new sense of urgency through which significant and meaningful progress can be achieved. In August 2001, the JFMIP Principals began a series of periodic meetings that marked the first time all four of the Principals had gathered together in over 10 years. To date, these sessions have resulted in substantive deliberations and agreements focused on key issues such as

- Defining success measures for financial management performance that go far beyond an unqualified audit opinion on financial statements and include measures such as financial management systems that routinely provide timely, reliable, and useful financial information and no material internal control weaknesses or material noncompliance with laws and regulations and FFMA requirements;

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<sup>12</sup>GAO-01-570T.

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- Restructuring the Federal Accounting Standards Advisory Board's (FASAB) composition to enhance the independence of the Board and increase public involvement in setting standards for federal financial accounting and reporting;
  - Significantly accelerating financial statement reporting so that the government financial statements are timely and to discourage costly efforts designed to obtain unqualified opinions on financial statements without addressing underlying systems challenges;
  - Establishing audit committees for the major federal agencies;
  - Addressing the impediments to an audit opinion on the U.S. government's consolidated financial statements; and
  - Reporting social insurance financial information in the U.S. government's consolidated financial statements that includes information from the most recent reports issued by the Social Security and Medicare Trustees.

Various aspects of the matters outlined above are further discussed in applicable sections later in this testimony. Future meetings, with the next meeting planned for May 2002, will enable the JFMIP Principals to reach agreements and monitor progress on strategies critical to the full and successful implementation of federal financial management reform and to provide greater transparency and accountability in managing federal programs and financial resources.

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#### The President's Management Agenda

President Bush has established an agenda for improving the management and performance of the federal government that targets the most apparent deficiencies where the opportunity to improve performance is the greatest. It is no accident that the President's Management Agenda has a strong correlation to GAO's high-risk list. This is just one example of how GAO and OMB have worked constructively to identify key issues deserving increased attention throughout government. As stated in the President's Management Agenda—and we wholeheartedly agree—there are few items more urgent than ensuring that the federal government is well run and results-oriented.

The President's Management Agenda, which is a starting point for management reform, includes improved financial management

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performance as one of his five governmentwide management goals. Other governmentwide initiatives include strategic management of human capital, competitive sourcing, expanded electronic government, and budget and performance integration.

The results of our audits of the U.S. government's consolidated financial statements helped to lay the foundation for the President's Management Agenda financial management performance initiative. The President's Management Agenda frames the problem this way: "A clean financial audit is a basic prescription for any well-managed organization, yet the federal government has failed all four [now five] audits since 1997. Moreover, most federal agencies that obtain clean audits only do so after making extraordinary labor-intensive assaults on financial records. Without accurate and timely financial information, it is not possible to accomplish the president's agenda to secure the best performance and high measure of accountability for the American people."

In particular, the improved financial performance initiative is aimed at ensuring that federal financial systems produce accurate and timely information to support operating, budget, and policy decisions. Also, this initiative focuses special attention on addressing erroneous payments, which as discussed earlier, is another problem our audit identified.

Under this governmentwide initiative, OMB will work with agencies to improve the timeliness, enhance the usefulness, and ensure the reliability of financial information. The expected result is financial management systems that routinely produce information that is (1) timely, to measure and effect performance immediately, (2) useful, to make more informed operational and investing decisions, and (3) reliable, to ensure consistent and comparable trend analysis over time and to facilitate better performance measurement and decisionmaking. This result is a key to successfully achieving the goals set out by the Congress in the CFO Act and other federal financial management reform legislation.

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#### The Executive Branch Management Scorecard

As we recently testified before this subcommittee,<sup>18</sup> the administration plans to use the Executive Branch Management Scorecard to highlight

<sup>18</sup>U.S. General Accounting Office, *Managing for Results: Next Steps to Improve the Federal Government's Management and Performance*, GAO-02-439T (Washington, D.C.: Feb. 15, 2002).



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agencies' progress in achieving management and performance improvements embodied in the President's Management Agenda. The Executive Branch Management Scorecard grades agencies' performance regarding the five governmentwide initiatives by using broad standards and a red-yellow-green coding system to indicate the level at which agencies are meeting the standards.

In the financial management area, while recognizing the importance of achieving a clean opinion from auditors on financial statements, the scorecard focuses on the fundamental and systemic issues that must be addressed in order to generate timely, accurate, and useful financial information, sound internal structures, and effective compliance systems. The first scorecard's results show dramatically the extent of work remaining across government to improve financial and other management areas. For financial management, most agencies were scored in the red category. This is not surprising, considering the well-recognized need to transform financial management and other business processes at agencies such as DOD, the results of our analyses under FFMA, and the various financial management operations we have designated as high risk.

Also, central to effectively addressing the federal government's management problems is recognition that the five governmentwide initiatives cannot be addressed in an isolated or piecemeal fashion. As stated in the President's Management Agenda, they are mutually reinforcing. More generally, the initiatives must be addressed in an integrated way to ensure that they drive a broader transformation of the cultures of federal agencies.

Improved financial management, for example, is also a key to successfully achieving other governmentwide initiatives set out in the President's Management Agenda:

- Strategic management of human capital: Financial management reform will require having the right people in CFO leadership positions and enough people with the right skills and knowledge to perform important financial operations.
- Competitive sourcing: For example, accurately knowing the cost for providing goods and services in-house for comparison with private sector performance will be important in making sound sourcing decisions.

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- Expanded electronic government: Many e-government applications will likely be financial in nature, interact with financial systems and reporting, and greatly change the internal control environment.
  - Budget and performance integration: It is critical to focus on integrating accounting, budget, and performance information, which the CFO Act requires; reporting the cost of performance, which is essential to successfully implementing GPRA; and providing useful information for setting priorities and making informed budget decisions.

The focus that the administration's scorecard approach brings to improving management and performance, including financial performance, is certainly a step in the right direction. The value of the scorecards is not in the scoring, but in the degree to which scores lead to sustained focus and demonstrable improvement over time. This will depend on continued efforts to assess progress and maintain accountability to ensure that agencies are able to, in fact, improve their performance. It will be important that there be continuous rigor in the scoring process in order for this approach to be credible and effective. Also, it is important to recognize that many of the challenges the federal government faces, such as improving financial management, are long-standing and complex, and will require sustained attention.

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### Looking Beyond Unqualified Audit Opinions

Across government, there are financial management improvement initiatives that could ultimately lead to an unqualified opinion on the U.S. government's consolidated financial statements. However, accelerating the pace of completing ongoing and planned efforts to implement financial management reform is essential, as shown by reports of inspectors general and their contract auditors indicating that only 3 of the 24 CFO Act agencies had neither a material control weakness, an issue involving compliance with applicable laws and regulations, nor an instance of lack of substantial compliance with FFMA requirements. While many of the pervasive and generally long-standing material weaknesses we have reported for the past 4 years remain to be fully resolved, some progress continues to be made in addressing the underlying causes of these problems—significant financial systems weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal control.

For fiscal year 2001, 18 of the 24 CFO Act agencies were able to attain unqualified audit opinions on their financial statements, which is the same

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number of agencies as last year and up from 6 agencies for fiscal year 1996. Also, OMB reported that, for the second consecutive year, all 24 CFO Act agencies met the statutory reporting deadline. Further, two agencies that did not receive unqualified opinions from their auditor last year were able to do so this year, including the Department of Transportation (DOT) and the Department of Justice, which received an unqualified opinion for the first time. However, two other agencies, the National Aeronautics and Space Administration (NASA) and the Federal Emergency Management Agency, were unable to sustain the unqualified opinions received from their auditor last year.

In the case of NASA, as we recently testified<sup>14</sup> before this subcommittee, after 5 years of receiving unqualified opinions on financial statements from its previous independent auditor, the new independent auditor disclaimed an opinion on the agency's fiscal year 2001 financial statements. The fiscal year 2001 audit report also identified a number of significant internal control weaknesses related to accounting for space station material and equipment and to computer security. Finally, the auditor concluded that NASA's financial management systems do not substantially comply with federal financial management systems requirements and applicable federal accounting standards, as required by FFMA. NASA's financial management difficulties are not new. The weaknesses discussed in the auditor's report are consistent with the findings discussed in our previous reports. Since 1990, we have designated NASA's contract management problems as a high-risk area, due in part to financial management systems problems that make it difficult for NASA to assure contracts are being efficiently and effectively implemented.<sup>15</sup> We have also reported on NASA's misstatement of its Statement of Budgetary Resources, lack of detailed support for amounts reported against certain cost limits, and lack of historical cost data for accurately projecting future cost.<sup>16</sup>

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<sup>14</sup>U.S. General Accounting Office, *National Aeronautics and Space Administration: Leadership and Systems Needed to Effect Financial Management Improvements*, GAO-02-551T (Washington, D.C.: March 20, 2002).

<sup>15</sup>See, for example, GAO-01-268.

<sup>16</sup>U.S. General Accounting Office, *Major Management Challenges and Program Risks: NASA*, GAO-01-268 (Washington, D.C.: Jan. 2001); U.S. General Accounting Office, *Financial Management: Misstatement of NASA's Statement of Budgetary Resources*, GAO-01-438 (Washington, D.C.: Mar. 30, 2001); and U.S. General Accounting Office, *NASA: International Space Station and Shuttle Cost Limits*, GAO-01-1000R (Washington, D.C.: Aug. 31, 2001).

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Irrespective of the unqualified opinions on their financial statements, many agencies do not have timely, accurate, and useful financial information and sound controls with which to make informed decisions and to ensure accountability on an ongoing basis. While agencies are making some progress in obtaining unqualified audit opinions on annual financial statements, many of these opinions were obtained by expending significant resources on extensive ad hoc procedures and making billions of dollars in adjustments to derive financial statements months after the end of a fiscal year. Several examples follow. The need for such time-consuming procedures primarily results from inadequate financial management systems.

- Our unqualified opinions on IRS's fiscal years 2001 and 2000 financial statements were made possible by the extraordinary efforts of IRS senior management and staff to develop processes to compensate for serious internal control and systems deficiencies. IRS was again compelled to rely extensively on costly, time-consuming processes; statistical projections; external contractors; substantial adjustments; and monumental human efforts that extended nearly four months after the September 30, 2001, fiscal year-end to derive reliable year-end balances for its financial statements. For example, IRS does not have a detailed record, or subsidiary ledger, for taxes receivable to allow it to track and manage amounts due from taxpayers. To enable it to report a reliable taxes receivable balance in the absence of a subsidiary ledger, IRS has, for the last five years, relied on a complex statistical sampling approach that requires substantial human and financial resources to conduct, takes months to complete, and yields tens of billions of dollars of adjustments. Similarly, IRS does not have an integrated property management system that appropriately records property and equipment additions and disposals as they occur and links costs on the accounting records to the property records. During fiscal year 2001, IRS expensed property additions during the year and then capitalized them at year-end based on analysis of expense records conducted by a contractor.
- DOT's major agencies use the Departmental Accounting and Financial Information System (DAFIS), which cannot produce financial statements based on the information included within the system. As a result, DOT made about 850 adjustments, totaling about \$41 billion, outside DAFIS to prepare the financial statements. These adjustments were recorded in a financial statement module, a tool used to process the adjustments. However, all DOT agencies did not use the financial statement module to prepare the financial statements, and the

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adjustments were not recorded in DAFIS. The DOT inspector general reported that DOT plans to have a new accounting system fully operational and compliant with accounting standards by January 2003.

- Again, in fiscal year 2001, HHS attained an unqualified opinion on its financial statements. However, system and internal control weaknesses, such as lack of an integrated financial management system, continued to make it difficult for certain HHS components to prepare timely and reliable financial statements. For example, the National Institutes of Health used a manual year-end process to create and post correct Standard General Ledger accounts, generating about 19,000 nonstandard accounting entries with an absolute value of approximately \$348 billion. Also, the Centers for Medicare and Medicaid Services, continued to contract with independent public accounting firms, as it has since FY 1999, to validate contractor receivables. Further, the Administration for Children and Families and the Centers for Disease Control, produced their financial statements using a manually intensive process that required adjusting entries to their general ledgers with an absolute value of approximately \$51 billion and \$2 billion, respectively.
- The Department of Education's auditor expressed a qualified opinion on the department's fiscal year 2001 financial statements, primarily because of weaknesses in the department's financial reporting process. Consistent with prior years, Education relied on work-around procedures to prepare its financial statements, including significant manual adjustments, due to deficiencies in the current general ledger system and the lack of a fully integrated financial management system. Because of errors that existed in prior years, the department performed extensive analysis of certain general ledger account balances during fiscal year 2001, which resulted in manual adjustments to correct certain general ledger balances. However, the auditor noted that there were errors in certain manual adjustments that had been processed and approved by the department, resulting in additional manual adjustments being posted to the financial statements.
- The Department of Veterans Affairs (VA) received unqualified audit opinions on its financial statements for fiscal years 2000 and 2001, but producing them required significant efforts to assemble, compile, and review the necessary financial information. In many cases, significant manual work-around procedures and "cuff" or out-of-date feeder systems are used, as VA has not yet completed its transition to a fully integrated financial management system. According to VA's auditors,

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timely account reconciliations were not consistently prepared at the department's medical centers and assets were not timely capitalized. Also, a significant number of manual adjustments were made during the year-end closing process.

Situations such as these demonstrate the tremendous efforts, lasting 5 months or more, that many agencies use to produce annual financial statements. These agencies undertake far more work to prepare financial statements, beginning at the close of a fiscal year, than would be necessary if they had financial systems in place to routinely provide the data. Information to compile agency financial statements should flow from their financial management systems. (The need for agencies to improve financial management systems is further discussed later in this testimony.)

At the same time and as agreed to by the JFMIP Principals, there is a need to accelerate the timeliness of providing audited financial statements. March 1 is the current statutory deadline for the 24 CFO Act agencies to submit audited financial statements, 5 months after the close of the fiscal year. For fiscal year 2001 reporting, OMB pushed this time frame ahead to February 27. Beginning with fiscal year 2004, OMB will require these agencies to issue audited financial statements by November 15, 6 weeks after the fiscal year end. While this is important for timely financial reporting, it will be difficult for some agencies to sustain unqualified audit opinions and still meet the accelerated time frame for submitting audited financial statements.

IRS is a case in point. With the extraordinary efforts described above, IRS found it extremely difficult to meet the February 27 reporting timeline required by OMB for fiscal year 2001. If IRS is to meet the November 15 deadline and sustain an unqualified opinion on its financial statements, the tremendous amount of hard work and commitment that IRS has demonstrated in recent years will no longer be sufficient to achieve this goal unless accompanied by systemic changes in how IRS processes transactions, maintains its financial records, and reports its financial results.

It will be difficult for agencies to continue to rely on significant costly and time-intensive manual efforts to achieve or maintain unqualified opinions until automated, integrated processes and systems are implemented that readily produce the necessary information. As a result, many agencies must accelerate their efforts to improve underlying financial management systems and controls, which is consistent with reaching the financial

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management success measures envisioned by the JFMIP Principals and called for by the President's Management Agenda. If agencies continue year after year to rely on significant costly and time-intensive manual efforts to achieve or maintain unqualified opinions without such improvements, this practice can serve to mislead the public as to the true status of the agency's financial management capabilities. An unqualified opinion will become an accomplishment without much substance.

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### Addressing Major Impediments to Unqualified Opinion on Consolidated Financial Statements

As I mentioned earlier, for the past 5 fiscal years, the federal government has been required to prepare, and have audited, consolidated financial statements. Successfully meeting this requirement is tightly linked to the requirement for the 24 CFO Act agencies to also have audited financial statements. This has stimulated extensive cooperative efforts and considerable attention by agency chief financial officers, inspectors general, Treasury and OMB officials, and the General Accounting Office. With the benefit of several years' experience by the government in having the required financial statements subjected to audit, the time has come to focus even more intensified attention on the most serious obstacles to achieving an unqualified opinion on the U.S. government's consolidated financial statements. In this regard, the JFMIP Principals have discussed plans and strategies for addressing impediments to an unqualified opinion on the U.S. government's consolidated financial statements.

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### Reforming Financial Management at DOD

This year, upon early implementation of certain provisions of the National Defense Authorization Act for fiscal year 2002,<sup>17</sup> DOD reported that the department's financial management systems are not able to provide adequate evidence supporting material amounts in its financial statements. DOD asserted that it is unable to comply with applicable financial reporting requirements for (1) property, plant, and equipment, (2) inventory and operating materials and supplies, (3) military retirement health care actuarial liability, (4) environmental liabilities, (5) intragovernmental eliminations and related accounting adjustments, and (6) cost accounting

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<sup>17</sup>The Fiscal Year 2002 National Defense Authorization Act contains provisions that will provide a framework for redirecting the department's resources from the preparation and audit of financial statements to improvement of DOD's financial management systems and financial management policies, procedures, and internal controls. Under this new legislation, the department will also be required to report to the Congress on how resources have been redirected and the progress that has been achieved.

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by suborganization/responsibility segment and major program. Based largely on DOD's assertion, the DOD inspector general disclaimed an opinion on DOD's financial statements for fiscal year 2001 as it had for the previous 5 fiscal years. DOD's financial management deficiencies and reporting weaknesses substantially impair our ability to determine the reliability of the financial information reported in the government's overall financial reports. Until DOD corrects these material weaknesses, our ability to express an unqualified opinion on the U.S. government's consolidated financial statements will be impeded.

As I previously stated, to date, none of the military services or major DOD components has passed the test of an independent financial audit because of pervasive weaknesses in DOD's financial management systems, operations, and internal control, including an inability to compile financial statements that comply with U.S. generally accepted accounting principles. The department has made progress in a number of areas, but is far from solving a range of serious financial management problems. Their resolution, however, is key to having auditable consolidated financial statements because DOD had budget authority of \$352 billion for fiscal year 2001, or about 18 percent of the entire federal budget, and is accountable for a vast amount of government assets worldwide.

Despite progress, ineffective asset accountability and lack of effective internal controls continue to adversely affect visibility over DOD's estimated \$1 trillion investment in weapon systems and inventories. These weaknesses can affect the department's ability to ensure that materials are on hand when needed and its ability to prevent the purchase of assets already on hand. Further, unreliable cost and budget information related to a reported over \$1.4 trillion of reported liabilities and about \$735 billion<sup>18</sup> of net costs negatively affects DOD's ability to effectively measure performance, reduce costs, and maintain adequate fund control.

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<sup>18</sup>This amount was reported on the department's fiscal year 2001 financial report, whereas the \$352 billion discussed in the preceding paragraph represents an estimate of the amount of budget authority shown in the documents accompanying the President's budget submission. The principal difference is attributable to a \$389 billion increase in the military postretirement health benefits liability under new legislation extending benefits to Medicare-eligible military retirees and their beneficiaries. Other differences between these amounts are the result of (1) timing differences in the receipt of budgetary resources and recording associated expenses and (2) unknown errors in the amounts shown in the financial statements, which were unauditable.



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As part of our constructive engagement approach with DOD, I met with Secretary Rumsfeld last summer to provide our perspectives on the underlying causes of the problems that have impeded past reform efforts at the department and to discuss options for addressing these challenges. The underlying causes discussed were

- a lack of sustained top-level leadership and management accountability for correcting problems;
- deeply embedded cultural resistance to change, including military service parochialism and stovepiped operations;
- a lack of results-oriented goals and performance measures and monitoring; and
- inadequate incentives for seeking change.

In this regard, I also attended the initial March 15, 2002, meeting of DOD's Business Practices Implementation Board, which is composed of outside experts to advise the department on its effort to address these underlying causes.

As we testified before this subcommittee last month and in May 2001,<sup>19</sup> our experience has shown there are several key elements that collectively would enable the department to effectively address the underlying causes of its inability to resolve its long-standing financial management problems. These elements, which are key to any successful approach to financial management reform, include

- addressing the department's financial management challenges as part of a comprehensive, integrated, DOD-wide business process reform;
- providing for sustained leadership by the Secretary of Defense and resource control to implement needed financial management reforms;

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<sup>19</sup>U.S. General Accounting Office, *DOD Financial Management: Integrated Approach, Accountability, Transparency, and Incentives Are Keys to Effective Reform*, GAO-02-537T (Washington, D.C.: Mar. 2002) and U.S. General Accounting Office, *DOD Financial Management: Integrated Approach, Accountability, and Incentives Are Keys to Effective Reform*, GAO-01-681T (Washington, D.C.: May 8, 2001).

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- establishing clear lines of responsibility, authority, and accountability for such reform tied to the Secretary;
  - incorporating results-oriented performance measures and monitoring tied to financial management reforms;
  - providing appropriate incentives or consequences for action or inaction;
  - establishing an enterprisewide system architecture to guide and direct financial management modernization investments; and
  - ensuring effective oversight and monitoring.

The department has acknowledged the need for fundamental reform of its business practices. Specifically, the department's September 30, 2001, *Quadrennial Defense Review* reported that: "While America's businesses have streamlined and adopted new business models to react to fast-moving changes in markets and technologies, the Defense Department has lagged behind without an overarching strategy to improve its business practices."

Action on many of the key areas central to successfully achieving desired financial management and related business process transformation goals—particularly those that rely on longer term systems improvements—will take a number of years to fully implement. Secretary Rumsfeld has estimated that his envisioned transformation may take 8 or more years to complete. Consequently, both long-term actions focused on the Secretary's envisioned business transformation and short-term actions focused on improvements within existing systems and processes will be critical going forward. Short-term actions in particular will be critical if the department is to achieve the greatest possible accountability over existing resources and more reliable data for day-to-day decisionmaking while longer-term systems and business process reengineering efforts are under way.

Beginning with the Secretary's recognition of the need for a fundamental transformation of the department's business processes, and building on some of the work begun under past administrations, DOD has taken a number of positive steps in many of these key areas. For example, DOD has taken action to set aside \$100 million for financial modernization and, as discussed previously, established a number of top-level committees, councils and boards to help guide its financial transformation efforts. At the same time, the challenges remaining in each of these key areas are daunting. The JFMIP Principals have invited DOD Comptroller Zakheim to

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their planned May 2002 meeting to discuss the department's transformation effort and to begin a constructive engagement with DOD on this important initiative.

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Focusing on  
Intragovernmental  
Transactions

For several years, OMB and Treasury have required the CFO Act agencies to reconcile selected intragovernmental activity and balances with their trading partners. However, numerous agencies did not fully perform such reconciliations for fiscal year 2000. Beginning with fiscal year 2001, OMB and Treasury required agency chief financial officers to report on the extent and results of intragovernmental activity and balances reconciliation efforts. The inspectors general reviewed these reports and communicated the results of their reviews to OMB, Treasury, and GAO. A substantial number of the CFO Act agencies did not fully perform the required reconciliations for fiscal year 2001, citing reasons such as (1) trading partners' not providing needed data, (2) limitations and incompatibility of agency and trading partner systems, and (3) human resource issues. For fiscal years 2001 and 2000, amounts reported for agency trading partners for certain intragovernmental accounts were significantly out of balance. In addition, solutions will be required to resolve significant differences reported in other intragovernmental accounts, primarily related to appropriations.

To help address certain issues that contributed to the out-of-balance condition for intragovernmental activity and balances, OMB has stated that it is implementing the recommendations included in a study conducted for the JFMIP in fiscal year 2001. OMB is also pursuing other changes to address core problems in this area, such as enhancing governmentwide business rules for transactions among trading partners, requiring quarterly reconciliations of intragovernmental activity and balances, and modifying certain standard general ledger accounts required to be used by federal agencies. Resolving this problem remains a difficult challenge and will require commitment by the CFO Act agencies and continued strong leadership by OMB.

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Preparing the Consolidated  
Financial Statements

The government did not have adequate systems, controls, and procedures to properly prepare its consolidated financial statements. Also, disclosure of certain financial information was not presented in the consolidated financial statements in conformity with U.S. generally accepted accounting principles.

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Elimination of Intragovernmental Activity and Balances	Consolidated financial statements are intended to present the results of operations and financial position of the components that comprise a reporting entity as if the entity were a single enterprise. When preparing the consolidated financial statements, the preparer must eliminate intragovernmental activity and balances between the agencies. Because of agencies' problems in handling their intragovernmental transactions, Treasury's ability to eliminate these transactions is impaired. Significant differences reported in intragovernmental accounts as noted above have been identified. Intragovernmental activity and balances are "dropped" or "offset" in the preparation of the consolidated financial statements rather than eliminated through balanced accounting entries. This contributes to the government's inability to determine the impact of these differences on amounts reported in the consolidated financial statements.
Reconciling Operating Results with Budget Results	The government did not have a process to effectively identify and report items needed to reconcile adequately the operating results, which for fiscal year 2001 showed a net operating cost of \$514.8 billion, to the budget results, which for the same period showed a unified surplus of \$127 billion.
Consolidated Financial Statement Compilation	The government could not adequately ensure that the information for each agency that was included in the consolidated financial statements was consistent with the underlying agency financial statements. This problem is compounded by the need for broad changes in the structure of the government's Standard General Ledger (SGL) accounts and the process for maintaining the SGL. For example, changes are needed that will result in direct alignment by SGL account from agencies' financial statement line items to like items reported in the consolidated financial statements.

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To make the fiscal year 2001 consolidated financial statements balance, Treasury recorded a net \$17.3 billion decrease to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled unreconciled transactions. For the prior fiscal year, a net \$4.8 billion in unreconciled transactions was recorded as a decrease to net operating revenue in the accompanying consolidated financial statements.<sup>20</sup> An additional net \$3.9 billion and \$.2 billion of unreconciled transactions were improperly recorded in net cost for fiscal years 2001 and 2000, respectively. Treasury attributes these net unreconciled transaction amounts primarily to the government's inability to properly identify and eliminate transactions between governmental entities, agency adjustments that affected net position, and other errors. However, Treasury was unable to adequately identify and explain the gross components of such amounts. Unreconciled transactions also may exist because the government does not have effective controls over reconciling net position.<sup>21</sup>

The net position reported in the consolidated financial statements is derived by subtracting liabilities from assets, rather than through balanced accounting entries. Further, the process used to prepare the consolidated financial statements requires significant human and financial resources and does not adequately leverage the existing work and work products resulting from federal agencies' audited financial statements.

Treasury plans to develop a new system and procedures to prepare the consolidated financial statements. These actions are intended to, among other things, directly link information from agencies' financial statements to amounts reported in the consolidated financial statements and facilitate the reconciliation of net position.

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<sup>20</sup>Last year a net \$7.3 billion in unreconciled transactions was recorded as an increase in net position. As discussed in footnote 6 of this testimony, numerous amounts previously reported for fiscal year 2000 have been restated in the U.S. government's consolidated financial statements for fiscal years 2001 and 2000, including this amount.

<sup>21</sup>In prior years, the government reported unreconciled transactions as a change in net position. Although the government was unable to determine how much of the unreconciled transactions, if any, relate to operations, it reported unreconciled transactions as a component of net operating revenue/(cost) in the U.S. government's consolidated financial statements for fiscal years 2001 and 2000.

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**Improving Financial Management Systems**

The inability to produce the data needed to efficiently and effectively manage the day-to-day operations of the federal government and provide accountability to taxpayers and the Congress has been a long-standing weakness at most federal agencies. The President's Management Agenda recognizes that the central challenge to producing reliable, useful, and timely data throughout the year and at year-end is overhauling the government's financial management information systems. The CFO Act calls for the modernization of financial management systems, including the systematic measurement of performance, the development of cost information, and the integration of program, budget, and financial information.

FFMIA builds on the CFO Act by emphasizing the need for agencies to have systems that can generate timely, accurate, and useful information with which to make informed decisions and to ensure accountability on an ongoing basis. FFMIA requires the 24 departments and agencies covered by the CFO Act to implement and maintain financial management systems that comply substantially with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the U.S. Standard General Ledger (SGL) at the transaction level. These requirements are at the center of the financial management success measures expressed by the JFMIP Principals and are key elements for scoring agencies' financial management performance using the Executive Branch Management Scorecard.

For fiscal year 2001, auditors for 20 of the 24 CFO Act agencies reported that agencies' financial management systems did not substantially comply with one or more of FFMIA's three requirements.<sup>22</sup> For the remaining four CFO Act agencies (the Departments of Energy and Labor, GSA, and SSA), auditors provided negative assurance, meaning that nothing came to their attention indicating these agencies' financial management systems do not meet FFMIA requirements. The auditors for these four agencies did not definitively state whether these agencies' systems substantially complied with FFMIA's requirements.

In this regard, OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements*, does not require auditors to make an affirmative

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<sup>22</sup>GAO plans to report to the Congress, by October 1, 2002, on agencies' FFMIA implementation for fiscal year 2001, as required by FFMIA.

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statement regarding an agency's financial management system's substantial compliance with FFMA, but rather permits auditors to report negative assurance, meaning that their report can be based on limited audit testing that disclosed no substantial instances of FFMA noncompliance. If readers of the audit report do not understand this distinction, which is important in terms of how much audit testing is required, they may have a false impression that the auditor is stating that they found the systems to be substantially compliant. To provide positive assurance, or an opinion, which is what we believe the law requires, auditors need to perform sufficient testing to determine whether the system is in substantial compliance.

Noncompliance with FFMA is indicative of the overall continuing poor condition of many financial management systems across government.<sup>29</sup> We have consistently reported over the past few years that the reasons for systems noncompliance included nonintegrated financial management systems, inadequate reconciliation procedures, untimely recording of financial information, noncompliance with the SGL, lack of adherence to the accounting standards, and weak security controls over information systems. We have also reported that agency remediation plans, required by FFMA, may not adequately address the system deficiencies.

While agencies continue to make some progress in addressing their financial management systems weaknesses, the serious shortcomings reported for these systems result in the lack of reliable financial information needed for managing day-to-day operations effectively, efficiently, and economically; measuring program performance; executing the budget; maintaining accountability; and preparing financial statements. Having such financial information is the goal of FFMA and the CFO Act, necessary for implementing GPRA, and critical to the transition to a more results-oriented federal government as envisioned in the President's Management Agenda.

For example, agency financial management systems are required to produce information on the full cost of programs and projects. This is not a new expectation—the requirement for managerial cost information has been in place for more than a decade, since 1990, under the CFO Act, and since 1998 stemming from applicable accounting standards. Yet, some

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<sup>29</sup>U.S. General Accounting Office, *Financial Management: FFMA Implementation Critical for Federal Accountability*, GAO-02-29 (Washington, D.C.: Oct. 1, 2001).

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agencies are only able to provide cost accounting information at the end of the fiscal year through periodic cost surveys. The lack of timely information on the full cost of operations precludes meaningful data that is needed to make resource allocation choices, reach contracting-out decisions, determine program efficiencies, assess user fees, and report performance.

To remedy these deficiencies and carry out the President's Management Agenda for improving financial management, OMB and the CFO Act agencies will need to aggressively and rigorously collaborate. This will be critical, since overhauling agency financial management systems is a difficult challenge. Our work to identify financial management best practices in world-class organizations<sup>24</sup> has identified key factors for successfully modernizing financial systems, including (1) reengineering business processes in conjunction with implementing new technology, (2) developing systems that support the partnership between finance and operations, and (3) translating financial data into meaningful data. We identified other financial management best practices as well, such as (1) providing clear strong executive leadership, (2) making financial management an entitywide priority, and (3) building a culture of control and accountability.

The size and complexity of many federal agencies and the discipline needed to overhaul or replace their financial management systems present a significant challenge—not simply a challenge to overcome a technical glitch, but a demanding management challenge that requires attention from the highest levels of government along with sufficient human capital resources to effect lasting change. We recognize that it will take time, investment, and sustained emphasis on correcting deficiencies to improve federal financial management systems to the level required by FFMIA. The JFMP Principals' leadership, commitment, and oversight will be important to provide the needed impetus to meet this challenge.

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### Protecting The Public Interest

Two audit matters have recently come to the fore and are key to protecting the public interest. One matter involves auditors' responsibility for reporting on internal control, and the other concerns auditor independence.

<sup>24</sup>U.S. General Accounting Office, *Executive Guide: Creating Value Through World-class Financial Management*, GAO/AIMD-00-134 (Washington, D.C.: Apr. 2000).



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**Auditors' Responsibility for Reporting on Internal Control**

We have long believed that auditors have an important responsibility to provide an opinion on the effectiveness of internal control over financial reporting and compliance with applicable laws and regulations. Currently, this is not required by American Institute of Certified Public Accountants (AICPA) auditing standards or by OMB in its guidance<sup>25</sup> to auditors conducting federal agency financial statement audits.

For financial statements audits that we conduct—which include the U.S. government's consolidated financial statements, the financial statements of the IRS, the Schedules of Federal Debt managed by the Bureau of Public Debt, and the financial statements of the Federal Deposit Insurance Corporation and numerous small entities' operations and funds—we issue a separate opinion on the effectiveness of internal control over financial reporting and compliance with applicable laws and regulations.

For years we have provided opinions on internal control effectiveness because of the importance of internal control to protecting the public's interest. Our reports have engendered major improvements in internal control. As you might expect, as part of the annual audit of our own financial statements, we practice what we recommend to others and contract with a CPA firm for both an opinion on our financial statements and an opinion on the effectiveness of our internal control over financial reporting and compliance with applicable laws and regulations.

Recently, GAO and the President's Council on Integrity and Efficiency jointly issued the *Financial Audit Manual* to provide guidance to auditors conducting federal agency financial statement audits. This manual calls for these auditors to test internal control over financial reporting and compliance with applicable laws and regulations, and thus provides a foundation for issuing a separate opinion on the effectiveness of internal control. Although OMB requires testing of these internal controls, auditors are not required to provide an opinion on internal control effectiveness. However, we found that 3 of the 24 CFO Act agency auditors (those for GSA, SSA, and the Nuclear Regulatory Commission) provided an opinion on the effectiveness of internal control as of September 30, 2001.

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<sup>25</sup>Office of Management and Budget, *Audit Requirements for Federal Financial Statements*, Bulletin 01-02 (Washington, D.C.: Oct. 18, 2000).

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Also, the JFMIP Principals have agreed that a measure of financial management success is for an agency to have no material control weaknesses. By giving assurance about internal control, auditors of federal financial statements can better serve their clients and other financial statements users and protect the public interest by having a greater role in providing assurances of the effectiveness of internal control in deterring fraudulent financial reporting, protecting assets, and providing an early warning of internal control weaknesses.

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#### Auditor Independence

The independence of auditors—both in fact and appearance—is critical to the credibility of financial reporting. Auditors have the capability of performing a range of valuable services for their clients, and providing certain nonaudit services can ultimately be beneficial to federal entities. However, in some circumstances, it is not appropriate for auditors to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor, the client, or both will have to make a choice as to which of these services the auditor will provide.

These concepts, which I strongly believe are in the public interest, are reflected in the revisions to auditor independence requirements for government audits,<sup>26</sup> which GAO recently issued as part of *Government Auditing Standards*.<sup>27</sup> The new independence standard has gone through an extensive deliberative process over several years, including extensive public comments and input from my Advisory Council on Government Auditing Standards.<sup>28</sup> The standard, among other things, toughens the rules associated with providing nonaudit services and includes a principle-based approach to addressing this issue, supplemented with certain safeguards. The two overarching principles in the standard for nonaudit services are that

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<sup>26</sup>U.S. General Accounting Office, *Government Auditing Standards, Amendment No. 3, Independence*, GAO-02-388G (Washington, D.C.: Jan. 2002).

<sup>27</sup>*Government Auditing Standards* was first published in 1972 and is commonly referred to as the "Yellow Book." It covers federal entities and those organizations receiving federal funds. Various laws require compliance with the standards in connection with audits of federal entities and funds. Furthermore, many states and local governments and other entities, both domestically and internationally, have voluntarily adopted these standards.

<sup>28</sup>The Advisory Council includes 20 experts in financial and performance auditing and reporting—drawn from all levels of government, academia, private enterprise, and public accounting—who advise the Comptroller General on *Government Auditing Standards*.

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- auditors should not perform management functions or make management decisions, and
  - auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant or material to the subject matter of the audit.

Both of these principles should be applied using a substance-over-form determination. Under the revised standard, auditors are allowed to perform certain nonaudit services provided the services do not violate these principles; however, in most circumstances certain additional safeguards would have to be met. For example: (1) personnel who perform allowable nonaudit services would be precluded from performing any related audit work, (2) the auditor's work could not be reduced beyond the level that would be appropriate if the nonaudit work were performed by another unrelated party, and (3) certain documentation and quality assurance requirements must be met. The new standard includes an express prohibition regarding auditors' providing certain bookkeeping or record keeping services and limits payroll processing and certain other services, all of which are presently permitted under current independence rules of the AICPA.

The focus of these changes to the government auditing standards is to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities and entities that receive federal funding. However, these standards apply only to audits of federal entities and those organizations receiving federal funds, and not to auditors of public companies. In the transmittal letter issuing the new independence standard, we expressed our hope that the AICPA will raise its independence standards to those contained in the new standard in order to eliminate any inconsistency between this standard and their current standards.

The new independence standard is the first of several steps GAO has planned in connection with nonaudit services covered by government auditing standards. In May 2002, we plan to issue a question and answer document concerning our independence standard, and I will ask my Advisory Council on Government Auditing Standards to review and monitor this area to determine what, if any, additional steps may be appropriate. In addition, the JFMIP Principals have agreed that the 24 major federal departments and agencies covered by the CFO Act should have audit committees. The scope, structure, and timing of this new

requirement will be determined over the next several months. This will include determining what role these audit committees might play in connection with nonaudit services.

### Preparing to Meet Tomorrow's Fiscal Needs

Several of the matters I previously discussed related to preparing to meet tomorrow's fiscal needs warrant repeating. The requirement for timely, accurate, and useful financial and performance management information is greater than ever. Both the long-term fiscal pressures created by the retirement of the baby boom generation and the new commitments undertaken in the aftermath of September 11 sharpen the need to look at competing claims on federal budgetary resources and new priorities. In previous testimony, I noted that it should be the norm to reconsider the relevance or "fit" of any federal program or activity in today's world and for the future.<sup>29</sup> Such a fundamental review is necessary both to increase fiscal flexibility and to make government fit the modern world. Stated differently, there is a need to consider what the proper role of the federal government should be in the 21st century and how the government should do business in the future.

As we look ahead we face an unprecedented demographic challenge. A nation that has prided itself on its youth will become older. Between now and 2035, the number of people who are 65 or over will double. As the share of the population over 65 climbs, federal spending on the elderly will absorb larger and ultimately unsustainable shares of the federal budget. Federal health and retirement spending are expected to surge as people live longer and spend more time in retirement. In addition, advances in medical technology are likely to keep pushing up the cost of providing health care. Moreover, the baby boomers will have left behind fewer workers to support them in retirement, prompting a slower rate of economic growth from which to finance these higher costs. Absent substantive change in related entitlement programs, large deficits will return, requiring a combination of unprecedented spending cuts in other areas, and/or unprecedented tax increases, and/or substantially increased borrowing from the public (or correspondingly less debt reduction than

<sup>29</sup>U.S. General Accounting Office, *Budget Issues: Long-Term Fiscal Challenges*, GAO-02-467T (Washington, D.C.: Feb. 27, 2002) and U.S. General Accounting Office, *Budget Issues: Effective Oversight and Budget Discipline are Essential—Even in a Time of Surplus*, GAO/T-AIMD-00-73 (Washington, D.C.: Feb. 1, 2000).

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would otherwise have been the case). These trends have widespread implications for our society, our economy, and the federal budget.

On March 26, 2002, the Trustees of the Social Security and Medicare trust funds reported on the current and projected status of these programs over the next 75 years. The Trustees' reports highlight the need to address the long-term fiscal challenges facing the nation. The Trustees state that, while the near-term financial conditions have improved slightly since last year's reports, the programs continue to face substantial financial challenges in the not-too-distant future that need to be addressed soon. Once again, the Trustees underscored the fact that the most significant implication of these findings is that both Social Security and Medicare need to be reformed and strengthened at the earliest opportunity. The Trustees also stated that Medicare faces financial difficulties that in many ways are more severe than those confronting Social Security.

Early action to change these programs would yield the highest fiscal dividends for the federal budget and would provide a longer period for prospective beneficiaries to make adjustments in their own planning. Waiting to take action entails risks. First, we lose an important window where today's relatively large workforce can increase saving and enhance productivity, two elements critical to growing the future economy. Second, we lose the opportunity to reduce the burden of interest in the federal budget, thereby creating a legacy of higher debt as well as elderly entitlement spending for the relatively smaller workforce of the future. Third, and most critically, we risk losing the opportunity to phase in changes gradually so that all can make the adjustments needed in private and public plans to accommodate this historic shift.

In a closely related matter, I have previously testified<sup>50</sup> before this subcommittee on the need to synchronize the timing of the Trustees' reports with agency and consolidated financial statements. Once again, the U.S. government's consolidated financial statements reported an update of key indicators of the financial status of the Social Security and Medicare trust funds from the Trustees' reports. The Trustees issued their reports the same week as the consolidated financial statements. Without this update, the government would have provided two different reports on the

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<sup>50</sup>U.S. General Accounting Office, *Auditing the Nation's Finances: Fiscal Year 1999 Results Continue to Highlight Major Issues Needing Resolution*, GAO/T-AIMD-00-137 (Washington, D.C.: Mar. 31, 2000).

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sustainability of these important programs, which could cause confusion and reduce confidence in the credibility of the U.S. government's consolidated financial statements. This updated information will not be available when the U.S. government's consolidated financial statements are issued on an accelerated basis, beginning with fiscal year 2004. The JFMIP Principals are considering ways to ensure that reports issued by the Social Security and Medicare Trustees, agency financial statements, and the U.S. government's consolidated financial statements present social insurance financial information that is consistent and more timely. In our view, the Congress may need to enact legislation that will require earlier reporting and issuance of the Trustees' reports in order to allow for timely social insurance information to be included in agencies' and the U.S. government's consolidated financial statements.

While addressing the challenges of Social Security and Medicare is key to ensuring future fiscal flexibility, a fundamental review of all programs and operations can create much-needed fiscal flexibility to address emerging needs. As I have stated previously, it is healthy for the nation periodically to review and update its programs, activities, and priorities.<sup>21</sup> Many programs were designed years ago to respond to earlier challenges. Ultimately, we should strive to hand to the next generations the legacy of a government that is effective and relevant to a changing society—a government as free as possible of outmoded commitments and operations that can inappropriately encumber the future.

A reexamination of existing programs and activities could help weed out programs that have proven to be outdated or persistently ineffective or alternatively could prompt us to update and modernize activities through such actions as improving program targeting and efficiency, consolidation, or reengineering of processes and operations. Such a review should not be limited to only spending programs but should include the full range of tools of governance that the federal government uses to address national objectives such as loans, guarantees, tax expenditures, and regulations.

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<sup>21</sup>GAO-T-AIMD-00-73

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In the last decade the Congress put in place a series of laws designed to improve information about cost and performance. This framework and the information it provides can help structure and inform the debate about what the federal government should do. In addition, GAO has identified a number of areas warranting reconsideration based on program performance, targeting, and costs. Every year, we issue a report identifying specific options, many scored by the Congressional Budget Office, for congressional consideration stemming from our audit and evaluation work.<sup>32</sup> This report provides opportunities for (1) reassessing objectives of specific federal programs, (2) improved targeting of benefits, and (3) improving the efficiency and management of federal initiatives.

Today the Congress and President Bush face the challenge of sorting out these many claims on the federal budget without the fiscal benchmarks that guided us through the years of deficit reduction into surplus. However, it is still the case that the federal government needs a decision-making framework that permits it to evaluate choices against both today's needs and the longer-term fiscal future that will be handed to future generations. As a way to frame the debate, targets can remind us that today's decisions are not only about current needs but also about how fiscal policy affects the choices over the longer-term. Other nations have found it useful to embrace broader targets such as debt-to-GDP ratios, or surpluses equal to a percent of GDP over the business cycle. To work over time targets should not be rigid—it is in the nature of things that they will sometimes be missed. Reaching a target is not a straight line but an iterative process. The other nations we have studied have found that targets prompted them to take advantage of windows of opportunity to save for the future and that decisionmakers must have flexibility each year to weigh pressing short-term needs and adjust the fiscal path without abandoning the longer-term framework.

The events of the past year have served to highlight the benefits of fiscal flexibility. Addressing the long-term drivers in the budget is essential to preserving any flexibility in the long term. In the nearer term a fundamental review of existing programs and operations can also create much-needed fiscal flexibility. In this regard, we must determine how best to address the necessary structural challenges in a reasonably timely

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<sup>32</sup>U.S. General Accounting Office, *Supporting Congressional Oversight: Framework for Considering Budgetary Implications of Selected GAO Work*, GAO-01-447 (Washington, D.C.: Mar. 9, 2001).

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manner in order to identify specific actions that need to be taken. As stewards of our nation's future, we must begin to prepare for tomorrow.

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### Closing Comments

Our report on the U.S. government's consolidated financial statements for fiscal years 2001 and 2000 highlights the need to continue addressing the government's serious financial management weaknesses. Looking beyond current progress by agencies in attaining unqualified opinions on financial statements, it will be essential for the government to begin moving away from the extraordinary efforts many agencies now use to prepare financial statements and toward giving prominence to strengthening the government's financial systems, reporting, and controls. This approach becomes even more critical as the government progresses to an accelerated financial statement reporting time frame, and it is the only way the government can meet the end goal of making timely, accurate, and useful financial information routinely available to the Congress, other policymakers, and the American public.

The requirement for timely, accurate, and useful financial and performance management information is greater than ever, as the Congress and the administration prepare to meet tomorrow's fiscal challenges. This type of financial information is central to managing the government's operations more efficiently, effectively, and economically and in supporting GPRA. Moreover, meaningful financial and performance information can form the basis for reconsidering the relevance or "fit" of any federal program or activity in today's world and for the future.

In closing Mr. Chairman, I want to underscore the importance of the additional impetus provided by President Bush through his President's Management Agenda and the Executive Branch Management Scorecard for coming to grips with federal financial management problems, indeed management problems across the board. Regarding DOD in particular, Secretary of Defense Rumsfeld's vision and approach for transforming the department's full range of business processes is serious and encouraging. These efforts will be key to fulfilling the President's Management Agenda and addressing the largest obstacle to an unqualified opinion on the U.S. government's consolidated financial statements. The cooperative efforts spearheaded by the JFMIP Principals have been most encouraging in developing the short- and long-term strategies and plans necessary to address many of the problems I have discussed this morning. In addition, GAO has probably never had a better working relationship with OMB and cabinet level and other key officials on a range of "good government issues"



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that are of critical importance and are inherently non-partisan in nature. While these and other factors provide an enhanced likelihood for success, in the end it is results that count.

Finally, I want to reiterate the value of sustained congressional interest in these issues, as demonstrated by this hearing and those you have held over the past several years to oversee financial management reform. It will also be key that the appropriations, budget, authorizing, and oversight committees hold agency top leadership accountable for resolving these problems and that they support improvement efforts.

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**Contacts**

For further information regarding this testimony, please contact Jeffrey C. Steinhoff, Managing Director, and Gary T. Engel, Director, Financial Management and Assurance, at (202) 512-2600.

Mr. HORN. Our next regular witness has been here many times, and we are delighted to have him today. That is Donald V. Hammond, the Fiscal Assistant Secretary of the Department of the Treasury.

Mr. Hammond.

**STATEMENT OF DONALD V. HAMMOND, FISCAL ASSISTANT  
SECRETARY, DEPARTMENT OF THE TREASURY**

Mr. HAMMOND. Thank you, Mr. Chairman.

I am pleased to have the opportunity to appear again before you to discuss the financial report of the U.S. Government. While we continue to make progress, the government still has a considerable distance to go before the quality of our financial reporting will be equal to what taxpayers truly deserve.

Mr. Chairman, your tireless pursuit of sound government financial management has been an important element of our continued improvement. And, on a personal note, I greatly appreciate your commitment to this important, though sometimes dry subject.

Treasury shares your commitment to improving the state of Federal financial management and in particular reporting financial information that is timely, reliable and, most importantly, useful.

The Fiscal Year 2001 Financial Report was issued on March 29th, on time for the 5th consecutive year. The report showed a financial loss of \$515 billion, compared with the budget's \$127 billion surplus. The primary components of the difference between the budget and accrual numbers are increases in the liability for military healthcare and the liability for veterans disability. As a result, for the first time, the liability for Federal employee—military and civilian—pension and other post-retirement benefits exceeds the Federal debt held by the public.

I highlight those items because they provide outstanding examples of the type of unique information contained in the financial report and point out the importance of disclosing these results. The financial report presents a complete and integrated picture of the government's assets, liabilities, cash-flows and costs.

The report also discloses the government's extensive stewardship responsibilities and commitments. Only the accrual-based financial report presents this governmentwide consolidated financial information in context to the public, providing a more transparent picture of the government's financial operations and position.

One of the five governmentwide initiatives in the President's management agenda addresses improved financial performance. One component of this agenda item is the acceleration of the timing of agency and governmentwide financial reporting.

In support of this endeavor, the Chief Financial Officer's Council has created a financial statement acceleration committee which I happen to chair. Accelerated reporting will finally allow adequate time to have the financial statements considered in the budget process and time for decisionmakers to fully consider financial performance in the management of their programs.

Reflecting Treasury's commitment to improving the financial statements, the following changes were made this year to enhance the usefulness and better disclose the government's activities to the Congress and the public.

This year the report presented comparative financial statements displaying current and prior year information. In addition, we have added two new financial statements. The Reconciliation of Net Operating Revenue to the Budget Surplus explains the differences between the accrual-based loss and the budget surplus; and the Disposition of the Budget Surplus explains the excess cash collected over cash payments made was used.

Finally, we have begun reporting costs by agency rather than function, which is much more understandable by the public and more useful to the readers of the statements.

The General Accounting Office has again given a disclaimer of opinion on the statements but also acknowledges that progress is being made.

Across the agencies, specific progress was noted. For example, the Department of Agriculture and certain other key agencies made significant improvements with regard to their lending programs. However, the serious financial management and systems problems at the Department of Defense remain a huge obstacle in overcoming the impediments to reaching an opinion on the government-wide report, though Defense has evidenced a serious commitment to improving their financial condition.

With respect to the material weaknesses that are unique to the financial report, Treasury is actively working with OMB and the agencies to remove them as impediments to achieving an opinion on the financial report.

One such weakness relates to the preparation of the consolidated financial statements themselves and the need to establish consistency between the agency financial statements and the compiled information used for the governmentwide statements. We are developing and implementing a new system and procedures to prepare the consolidated financial statements that should resolve this finding.

In addition, a thorough review of the standard general ledger, or SGL, is in process that will verify that it contains all of the accounts necessary to facilitate the reconciliation of net position.

Another area of recurring material weakness relates to intergovernmental activity and balances. The government currently lacks clearly articulated business rules to ensure that agencies record transactions with each other consistently and correctly. The problem is a data problem. OMB has initiatives under way to address the data quality problem, and business rules are currently being developed that will standardize the recording of agency transactions with each other.

Treasury is also implementing a methodology that will effectively eliminate intergovernmental activity. However, until the underlying data is accurate, there will continue to be potential problems with the presentation of the government's activity.

The Treasury Department continues to develop a government-wide accounting system that will greatly improve the agencies' access to data, reduce redundant data reporting, eliminate reconciliations between the cash amounts shown on agency and Treasury books and provide a daily accounts statement. The redesigned system will be Internet-based and will be implemented in a modular, phased approach over the next several years.

Treasury's Financial Management Service also continues to improve the SGL based reporting systems. The SGL and the full implementation of it is a critical part of Treasury's goal to make financial data more accessible, more available, more accurate and more useful for management decisionmaking.

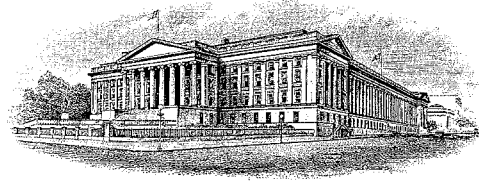
We will continue to work closely with OMB and the program agencies to raise the bar in financial management. We will consider new ideas such as audit committees and the use of pro forma financial statements with budget submissions. These changes will require the commitment and support of management throughout the Federal Government. Success will be achieved when we reliably and accurately report on the distinctly different financial activities of the many agencies of the government as if they were one entity and do so in a timeframe and a manner that is truly useful. We look forward to working together with all affected parties to reach that end.

I know I speak on behalf of the career staff at the Treasury Department that we believe that this is a truly important issue for the Financial Management Service, the Office of Accounting Policy, my office, and most particularly for the Secretary of the Treasury.

Thank you, Mr. Chairman. That concludes my remarks.

Mr. HORN. Thank you, Mr. Secretary.

[The prepared statement of Mr. Hammond follows:]



**DEPARTMENT OF THE TREASURY  
OFFICE OF PUBLIC AFFAIRS**

**EMBARGOED UNTIL 10 A.M. EST  
April 9, 2002**

**CONTACT: BETSY HOLAHAN  
202-622-2960**

**STATEMENT OF DONALD V. HAMMOND  
Fiscal Assistant Secretary  
Department of the Treasury**

**BEFORE THE HOUSE GOVERNMENT REFORM SUBCOMMITTEE  
ON GOVERNMENT EFFICIENCY, FINANCIAL MANAGEMENT AND  
INTERGOVERNMENTAL RELATIONS**

**FY 2001 FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT**

Mr. Chairman and members of the Subcommittee, I am pleased to have the opportunity to appear before you today to discuss the Financial Report of the United States Government. This is my fourth appearance before your subcommittee on reporting the government's financial results and while we continue to make progress, the government still has a considerable distance to go before the quality of its financial reporting will be equal to what the taxpayers deserve. At times this process has been frustrating but I am optimistic that we will achieve our objective. Your tireless pursuit of sound government financial management has been an important element of our continued improvement.

Treasury shares your commitment to improving the state of federal financial management and in particular reporting financial information that is timely, reliable and most importantly useful. As explained more fully in the testimony of OMB Controller Mark Everson, one of the five government-wide initiatives in the President's Management Agenda addresses improved financial performance. One component of this agenda item is the acceleration of the timing of agency and government-wide financial reporting. OMB has established a deadline of November 15, 2004 for agencies to submit their fiscal 2004 audited financial statements and December 15, 2004 for the government-wide financial statements. In support of this endeavor, the Chief Financial Officers

Council has created a Financial Statement Acceleration Committee, which I chair. The committee has set out to identify existing agency best practices for expedited preparation and issuance of audited financial statements as well as barriers to timely preparation. This information will be essential to making changes across government in the way that we process financial information. Accelerated reporting will finally allow adequate time to have the financial statements considered in the budget process, and in time for decision-makers to fully consider financial performance in the management of their programs.

#### **Financial Results**

The Fiscal Year 2001 Financial Report was issued on March 29<sup>th</sup> - on time for the 5<sup>th</sup> consecutive year. The report showed a financial loss of \$514.8 billion, compared with the budget's FY 2001 \$127 billion surplus. The primary components of the difference between the budget and accrual numbers are increases in the liability for military health liabilities of \$388.6 billion, and an increase in the liability for veterans disability of \$115.2 billion, both of which are recognized as costs in FY01. As a result, for the first time, the liability for Federal employee (civilian and military) pension and other post retirement benefits (\$3.36 trillion) exceeds the Federal debt held by the public (\$3.32 trillion). Further, the report includes an update on the latest financial projections from the Social Security Trustees' Report, released on March 26, about the Social Security and Medicare programs.

I highlight these items because they provide outstanding examples of the type of unique information contained in the Financial Report and point out the importance of disclosing these results. Similar to the private sector, the financial statements of the Federal government are presented on an accrual basis in accordance with generally accepted accounting principles (GAAP). In the case of the Federal government, GAAP is developed by the Federal Accounting Standards Advisory Board. The Financial Report presents a complete and integrated picture of the government's assets, liabilities, cash flows and costs. The report also discloses the Government's extensive stewardship responsibilities and commitments. As mentioned above, a new law requiring expanded military retiree health benefits was enacted that resulted in an increase in the government's liability for post retirement health benefits by almost \$300 billion. These benefits are payable in the future but the obligation to pay them has already been made. Only the accrual-based Financial Report presents this government-wide consolidated information in context to the public, providing a more transparent picture of the Government's financial operations and position.

#### **Progress Made**

Treasury is committed to producing accurate and useful governmentwide financial statements. Reflecting this commitment, the following changes were made to improve its usefulness and better disclose the government's activities to the Congress and the public. This year, for the first time, the report presented comparative financial statements displaying the current and prior years. This format facilitates financial analyses and highlights trends that may be of importance to analysts of the government's activity. In addition, we have added two new financial statements. The Reconciliation of Net Operating Revenue/(Cost) to the Budget Surplus explains the differences between the accrual-based loss and the budget surplus. These

differences are generally due to liabilities or future payments being recorded in the current year's financial statements, while the budget does not record these amounts until the payment is made. The Disposition of the Budget Surplus explains how the excess cash collected over cash payments made was used (for example, the amount of the budget surplus that was used to reduce the debt held by the public). In addition, we have begun reporting costs by agency rather than function. This is consistent with the new Presidential budget presentation and will provide a better basis for program performance analysis. It also is more understandable by the public. These changes were made possible through the dedicated efforts of the staff of the Financial Management Service and Treasury's accounting policy office.

#### **GAO Opinion and Material Weaknesses**

The General Accounting Office (GAO) has again given a disclaimer of opinion, but also acknowledges that progress is being made in addressing the impediments to an opinion on the Financial Report. Across the agencies, specific progress was noted. For example, the Department of Agriculture and certain other key agencies made significant improvements in estimating the cost of the government's lending programs and the net loan amounts expected to be collected. Additionally, two agencies that did not receive unqualified opinions from their auditors last year were able to do so this year. However, the serious financial management and systems problems at the Department of Defense remain a huge obstacle in overcoming the impediments to reaching an opinion on the government-wide report. Defense has evidenced a serious commitment to improving the financial situation with Secretary Rumsfeld publicly stating that effective financial management reform is one of his top priorities.

With respect to those material weaknesses that are unique to the Financial Report, Treasury is actively working with OMB and the agencies to remove them as impediments to achieving an opinion on the Financial Report. One such weakness relates to the preparation of the consolidated financial statements, and the need to establish consistency between the agency financial statements and the compiled information used for the consolidated financial statements. Treasury, in consultation with OMB and GAO, is developing and implementing a new system and procedures to prepare the consolidated financial statements that will directly link information from the agencies' financial statements to amounts reported in the consolidated financial statements and to facilitate the reconciliation of net position. This new process will involve compiling information from agency submissions taken directly from their financial statements and associated "closing packages," with these closing packages containing the data necessary to prepare the report. In some cases, the data will be audited as part of the audit of the agencies' financial statements. In other cases, auditors at the agency level will provide audit assurance through the application of agreed-upon procedures. In addition, a thorough review of the standard general ledger (SGL) is in process that will verify that the SGL contains all of the accounts necessary to facilitate the reconciliation of net position, especially between intragovernmental and public activities.

This year for the first time, FMS staff did a complete analysis of the balance sheet numbers reported by the agencies and those reported in the statements. This work involved a detailed comparison and crosswalk of the information agencies reported on their financial

statements to the data they provided independently to FMS for the preparation of the Financial Report. In a very encouraging sign, the analysis indicates that no line item differs by more than \$270 million and total assets of \$926 billion and total liabilities of \$7.4 trillion differ by \$143 million and \$369 million respectively. These differences are a significant improvement from earlier years, indicate consistency of the balance sheet information and reflect the marked improvement in the quality of the information.

Another area of recurring material weakness relates to intragovernmental activity and balances. The government currently lacks clearly articulated business rules to ensure that agencies record transactions with each other consistently and correctly. This makes it difficult for agencies to reconcile balances with each other, resulting in inconsistent information being reported to Treasury. These inconsistencies can result in total government assets, liabilities, revenues, and expenses being misstated and raise concerns about their reliability. The problem is a data problem as pointed out by GAO in its audit report. Beginning with Fiscal Year 2001, OMB and Treasury required agency chief financial officers to report on the extent and results of intragovernmental activity and balances reconciliation efforts. The inspectors general reviewed these reports and communicated the results of their reviews to OMB, Treasury, and GAO. A substantial number of the CFO Act agencies did not fully perform the required reconciliations for Fiscal Year 2001 citing reasons such as (1) trading partners not providing needed data, (2) limitations and incompatibility of agency and trading partner systems, and (3) human resources issues.

OMB has initiatives underway to address this data quality problem. Additionally, business rules are currently being developed that will standardize the recording of agency transactions with each other. Meanwhile, as part of the development of the preparation process, Treasury is implementing a methodology that will effectively eliminate intragovernmental activity. However, until the underlying data is accurate, there will continue to be potential problems with the presentation of the government's activity.

#### **Future Directions**

The Treasury Department continues to develop a governmentwide accounting system that will greatly improve the agencies' access to data, reduce redundant data reporting, and eliminate reconciliations between the cash amounts shown on agency and Treasury books. The redesigned system will be Internet-based and will be implemented in a modular, phased approach over the next several years. The necessary accounting information will be captured at the initiation of the business transaction instead of after the funds have left the Government, as is presently the case. In addition, Treasury will provide an account statement so that agencies will know their fund balances on a daily basis.

Treasury's Financial Management Service continues to improve our SGL based reporting systems. Using the Federal Financial Management Improvement Act of 1996 as a base, these systems strive to collect data needed by OMB and GAO directly from agency accounting systems. Just as manufacturers reject components that do not meet specifications, our new reporting systems reject reports that do not meet specifications of the U.S. Standard General Ledger. As agencies move toward SGL compliant accounting systems, the reports continue to



improve. The SGL and the full implementation of the SGL is a critical part of Treasury's goal to make financial data more accessible, more available, more accurate, and more useful for management decision-making.

**Conclusion**

Improving financial management and accountability is a top priority for Treasury and we are taking a lead role. We will work closely with OMB and program agencies to raise the bar in financial management improvements. As I mentioned earlier in my testimony, Treasury, OMB, and GAO have reevaluated the process we use to prepare the government-wide financial statements. Our goals include accelerating the time frames for issuing year-end audited financial statements and moving toward the preparation of quarterly statements by program agencies. We will also consider new ideas such as audit committees and the use of pro forma financial statements with budget submissions. These changes will require the commitment and support of management throughout the Federal Government. It is reasonable to expect such support since improved financial performance is part of the President's Management Agenda.

Success will be achieved when we reliably and accurately report on the distinctly different financial activities of many agencies of Government as if they were one entity and do so in a time frame and a manner that is truly useful. We look forward to working together with all affected parties to reach that end.

Thank you, Mr. Chairman. This concludes my formal remarks and I would be happy to respond to questions.

Mr. HORN. We now have our final presenter who has hit the ground running in the current administration and was here during the Reagan administration, Mark W. Everson, the Controller, Office of Federal Financial Management, Office of Management and Budget.

**STATEMENT OF MARK W. EVERSON, CONTROLLER, OFFICE OF FEDERAL FINANCIAL MANAGEMENT, OFFICE OF MANAGEMENT AND BUDGET**

Mr. EVERSON. Thank you, Mr. Chairman.

I don't really—you have my statement, which I would ask that you put in the record.

I don't have too much to add to what my colleagues have said. Because, as General Walker indicated, we have an unusual degree of agreement and a very shared sense of priorities amongst the various players here—GAO, Treasury and OMB—And those are the three big players. But I will summarize a couple of the points I have in my statement because they were touched upon in each case, but I would like to give some emphasis to them.

As to the consolidated statements themselves, clearly it is not acceptable to be sitting here almost 7 months after the end of the fiscal year and to be engaging in such a hearing. That is not your fault. That is our fault.

We are going to move forward aggressively to accelerate, as both my colleagues have indicated, the delivery dates for financial statements. The statements themselves, there was no opinion this year, as has been indicated by the Comptroller General.

The two big issues are DOD and the intergovernmental eliminations that Secretary Hammond mentioned. We are working on both of those.

I am pleased to say that the Department of Defense is right on the cusp of releasing a contract that will over the next year establish the enterprise architecture in the financial area. This is a very significant first step in what the Comptroller General indicated is a very deliberate attack of this longstanding problem.

The other issue, the intergovernmental eliminations, Secretary Hammond has touched on them.

We haven't talked about the statements of the individual CFO Act agencies. This chart over here depicts what happened. As you indicated, with the statements that came through at the end of February, there was no change in the number of clean opinions. They stood at 18. But we would characterize, if you look beyond those numbers, that there was modest but important improvement. That is because two big departments came into the clean category, Justice and Transportation.

You will remember that for years GAO has had the FAA as a real problem area. There was progress in three other departments: Education, still a qualified opinion, but they got a lot better. And, most significantly, a lot of the credit accounting was cleaned up at Agriculture, so that the principal problem at Agriculture now is in the Forest Service. And USAID for the first time had—certain of their statements actually were prepared and were auditable, which had not been the case in the past.

On the other hand, as you are aware, both NASA and FEMA deteriorated. The administration has solid plans to make sure we recover that lost ground in both of those cases.

The other points that I would just make briefly are—pertain to this area of accounting standards and trying to achieve greater transparency.

The Comptroller General mentioned this issue, the debt being eclipsed, as did Secretary Hammond, by the benefits and retiree payables. I have got a chart that—if you look over there—this just shows the growth in that. The debt has been stable these last 5 or 6 years. There has actually been some modest decrease in it. But look at the growth of the employee and veteran benefits and pensions payable. It has gone up from one half trillion dollars in just 6 years to now it is \$3.3 trillion. That is dramatic growth indeed.

The point that was taken about the linkage of financial information to the budget process, that is a key ingredient of the administration's initiatives both to improve financial performance but also to improve budget and performance integration. As I mentioned last time, we have got a pending proposal—it is a modest proposal before the Congress—to actually have the accounting for retiree costs be consistent.

This is something that we took to the JFMIP. The JFMIP supports the need for this, because it is better accounting. That is to say, all of the retiree costs get shown against the individual programs, rather than some which are currently shown centrally against OPM's budget.

This has been called for as a good step by, as I say, the JFMIP, by the AGA, which is the government accountants group, and also the AICPA. So I would draw that to your attention.

We are serious about this area. We are reconstituting the FASAB to have a private sector majority, six to three. That has generated some heat, principally because I guess there was concern about the reduction in the role of CBO. I would point out, though, that we have the same relative proportion in the government, the three members. GAO has a seat, Treasury has a seat, and OMB has a seat. So in terms of the government participation, there is really no change. What we are doing here is providing for a more independent and hopefully better accounting.

Those are the high points that I would make. But, as I said, I don't quibble with a word that was articulated by either of the other two panelists.

Mr. HORN. We thank you.

[The prepared statement of Mr. Everson follows:]

Testimony of  
the Honorable Mark W. Everson  
Controller, Office of Federal Financial Management,  
Office of Management and Budget  
before  
the Subcommittee on Government Efficiency,  
Financial Management and Intergovernmental Relations,  
Committee on Government Reform  
U.S. House of Representatives  
April 9, 2002

Thank you, Mr. Chairman.

I am honored to be with you so soon after my most recent testimony on the President's Management Agenda. Today I am here at your invitation to discuss in greater detail the state of financial management in the Federal Government. I am pleased with the steps we have taken in recent months to reinvigorate the government's efforts to improve the quality of financial information available to agencies, the Administration, the Congress, and, most importantly, the American people. But, as you know, Mr. Chairman, the challenges we face are formidable.

**Problems with Financial Management in the Government**

I am sorry to say that we were again unable to receive a clean opinion on the government's financial statements. I will, of course, leave a detailed discussion of the reasons for his disclaimer of opinion to the Comptroller General. Once again, however, poor financial management at the Department of Defense was the largest impediment to an opinion on the consolidated financial statements. In addition, the government remains unable to account for billions of dollars of transactions among Federal Government entities.

Although we made great progress with the Departments of Transportation and Justice moving from qualified to clean opinions in FY 2001, we had deterioration in two: the National Aeronautics and Space Administration (NASA) and the Federal Emergency Management Agency (FEMA). We believe the Forest Service is now the only major remaining problem area holding back the Department of Agriculture from a clean opinion.

The barriers to clean opinions aren't our only problems, of course. As your oversight has pointed out, an opinion on a financial statement, even a clean one, tells us little about whether an agency produces timely or reliable financial information on a regular, recurring basis or whether it uses that information to make more informed decisions about agency or program management. For most agencies the answer to that question is they can't.

**Progress in the Government's Financial Management**

As Comptroller General Walker noted in his March 29<sup>th</sup> transmittal letter for the Federal Government's financial statements, "Progress is being made in addressing impediments to an opinion on the United States Government's consolidated financial statements." As just noted,

the Departments of Justice and Transportation joined 16 other major agencies that received clean opinions on their financial statements for FY 2001. In addition, the Department of Agriculture and the Agency for International Development both showed substantial improvement in producing their financial statements over previous years. For the first time ever, three of five components of the Department of Agriculture obtained clean opinions. This is also the first year the Agency for International Development was able to conduct a complete financial statement audit; three of the five principal financial statements received qualified opinions, rather than disclaimers.

Also of note, the Department of Education this year has only one material weakness, down from three in FY 2000. And it is my belief that major reform efforts at the Department of Defense are making progress in developing and consolidating financial architectures and systems. But government-wide, we still have too many material weaknesses for the 24 CFO Act agencies. Agency accountability reports show that there are approximately 60 material weaknesses throughout the Federal Government. We take material weaknesses seriously. They must be addressed.

#### **The President's Management Agenda**

Our efforts to improve the way the government manages its finances should not be perceived as business as usual. Improved Financial Performance is one of the five major government-wide components of the President's Management Agenda. The criteria we will use to measure agencies in improving financial performance include not just getting clean opinions on agency financial statements, but also ensuring that financial management systems meet Federal requirements, integrating financial and performance management systems to support day-to-day agency operations, ensuring that agencies do not suffer from repeated material weaknesses, and, of course, that they have no Anti-deficiency Act violations.

Another aspect of the President's initiative to improve financial performance is our effort to reduce erroneous payments. The government makes billions of dollars in erroneous payments each year, but we have no systematic effort to measure the extent of this problem. Until now. We are insisting that agencies estimate the extent of their erroneous payments and set goals and develop plans to reduce them. As stewards of the American people's tax dollars, we have a responsibility to ensure that Federal dollars are spent as effectively and efficiently as possible. Our plan for improved financial performance will help us do that.

#### **Improved Financial Performance – Management Scorecard**

When I last testified before this Subcommittee, I briefed you on the Scorecard we were using to assess the status of agency efforts to address the government-wide initiatives on the President's Management Agenda. And I told you that the scores are almost uniformly poor. This includes the scores for financial management. There is only one green score, for financial management at the National Science Foundation. Four other agencies received yellow for financial management. One of the yellows was NASA, which as a result of its disclaimer of opinion on its FY 2001 financial statement, will now move to red. Other grades will change as we continue to assess progress toward the standards we have set.

**Actions the Government is Taking**

You can see some of the benefits of the changes we have made reflected in the quality of the reports agencies have submitted. All agencies produced their audited financial statements by the reporting deadline of February 27th. For the first time, agency reports, as well as the government-wide statements, included comparative reporting. This allows the reader to view financial information in the context of the previous year.

**Accelerated Reporting**

While there has been improvement, it is important to keep in mind that we are here today in April to discuss the release of the Government's Consolidated Financial Report for the fiscal year that ended almost seven months ago. No one could call this financial information timely. For FY 2002, combined performance and accountability reports are required and must be submitted to OMB and the Congress by February 1, 2003. We are further accelerating the deadline for financial reporting so that by FY 2004 agencies will submit audited financial statements by November 15 and we will produce a Consolidated Financial Report on December 15, in time for the Administration and Congress to use the information to make budgetary decisions.

**Interim Reporting**

To meet this accelerated timetable, agencies will be unable to rely on the current, *ad hoc* way in which many of them put together the information necessary to produce audited financial statements. The earlier dates will require agencies to fundamentally rethink the systems they now rely on to produce financial information. They will be forced to have in place substantially different systems and controls, ones that produce reliable financial information on a regular basis. In part to prompt agencies to address the requirements soon to come with accelerated reporting, we have instituted interim financial reporting. For the six-month period ending March 31, 2002, agencies must submit financial statements to OMB by May 31. In FY 2003, unaudited financial statements will be prepared and submitted to OMB on a quarterly basis. The preparation of interim financial statements will surface important challenges that, as they are resolved, will better position agencies to meet the tightened year-end deadlines that will take effect for FY 2004.

**Accounting Standards**

Reflecting our desire for increased transparency in government accounting, we are reconstituting the membership of the Federal Accounting Standards Advisory Board, the advisory committee that sets accounting standards and principles for the United States Government. Instead of the 6 to 3 ratio of Federal to non-Federal members, the board will now be made up of 6 members from outside the Federal Government and 3 from within the Federal Government. This new emphasis on outside members will bring fresh, more independent scrutiny to the accounting and financial reporting standards to which we hold ourselves. And with greater transparency comes accountability and credibility.

### **Chief Financial Officers Council Restructuring**

We have taken steps to reorganize the CFO Council into committees with missions related to the five government-wide initiatives of the President's Management Agenda. Because the interests of the CFO Council lie chiefly with issues of financial management, there are two committees of the CFO Council that will address the initiative of the President's Management Agenda dealing with improved financial performance, Financial Statement Acceleration and Erroneous Payments. I note that the Erroneous Payments Committee is conducting an initiative jointly with the President's Council on Integrity and Efficiency, the council of Inspectors General, to assist agencies in identifying and reducing erroneous payments. Other committees dealing with the remaining government-wide initiatives of the President's Management Agenda include Human Capital, Systems/E-Government, and Budget and Performance.

These are the steps we are taking to address many of the problems you have identified throughout your congressional career, Mr. Chairman. As you can see, we are focusing on the problem regularly and consistently. With your help, we can make real progress in the near term.

### **Budgeting for Results**

Consistent with our emphasis on increased transparency, the President's FY 2003 Budget proposes to charge all employee costs, including those related to retirement, to the programs themselves. By recording the accruing costs as employees earn benefits, managers can get a better sense of the true costs of operations. The proposal would bring budgeting for Federal employees in the Civil Service Retirement System (and several smaller retirement systems) in line with budgeting for employees in the Federal Employees Retirement System and the Military Retirement System. The proposal would have no effect on total budget outlays.

We have proposed the necessary statutory changes to ensure that appropriations charge employee costs to the agency accounts where the individuals are employed. This is part of the Managerial Flexibility Act, which the President sent to Congress on October 1, 2001. Like the changes to the President's budget, this proposal would have no effect on the amount of money we allocate for employee benefits, nor would it lessen any payment to retirees. Federal employees have earned the benefits we are talking about. The President's proposal simply makes a change in the way those benefits are accounted for so that we can get a more accurate sense of the full cost of government programs.

The accounting changes called for in the Managerial Flexibility Act have been supported by a broad coalition in the government accounting world. As the Joint Financial Management Improvement Program (JFMIP) recently stated, "*A key element of financial planning and evaluations is clear measurement of the full costs of agencies' activities during each fiscal year. Including these costs in data used for budgetary decision-making would enhance both the planning process and the evaluation of the cost of operations. It would also provide for enhanced consistency and transparency relating to presentation of this information and greater accountability for results.*" The American Institute of Certified Public Accountants has stated similar support: "*We support providing for the full costs of agencies' activities, including*

*Federal employee retirement costs, in individual agency budgets. This would enhance the evaluation of the true costs of operations within each Federal agency, and more closely align the Federal government's budgetary process with its financial accounting and reporting processes." The 18,000 member Association of Government Accountants (AGA) has indicated: "AGA supports the integration of accounting and budgeting concepts proposed by OMB with respect to Federal post-employment benefits."*

This accounting proposal is consistent with our efforts to provide increased transparency over the government's finances. The accrual-based financial statements, which generally provide a more comprehensive picture of government operations and obligations than traditional budget information alone, show that for the first time, future employee and veterans benefits payable in the amount of \$3.4 trillion exceed the debt held by the public of \$3.3 trillion. As our obligation to Federal employees grows, greater transparency will help us ensure that our responsibilities are met.

The time is right for this full cost accounting improvement, especially given the heightened sensitivity to the need for accuracy and transparency in accounting. We welcome this strong support from the professional community, which adds momentum to making this improvement this year. I hope, Mr. Chairman, that we can count on your leadership and strong support for this common sense change in the law.

Thank you.



Mr. HORN. Let me ask the first question here.

If the three of you were to be available to the President on other assignments and the three Cabinet officers have been stuck with malaria, the lepers and everything else, and they can't get back to their agency for a couple of years, and the President says, I want you three to go over to those offices, what would be—given what you are testifying on—what would you say to your staff in the—that you are now a Cabinet officer and you were really very concerned about the fiscal situation. What would you tell them? And how would you face that?

We will start with you, Mr. Everson, because you know what the executive branch is like.

Mr. EVERSON. Yes, thank you.

Mr. HORN. So do you other two. So what would you say and what would you have them do?

Mr. EVERSON. I think that the division that has been articulated by the JFMIP, it is thanks largely to the leadership that GAO has demonstrated over the years, is that financial information has to be useful to support day-to-day operating decisions. What I am struck by, returning to government, is the total split between staff functions in government and operating functions in government.

In industry, there are two things that happen. First, the staff functions generally tend to hang together, if you will, where the CFO and the CIO and the procurement officer and the H.R. officer all work together and frequently they battle it out with the operators.

What is the problem you have here and gets back to this issue is you—one of the questions I have about—there are many benefits to the CFO Act, but we seem to have moved forward with a real splitting of those functions now. I am not sure that they are cooperating the way they should be.

So the first thing I would try to do is get my staff functions to be aligned and to work together. Because you are not going to fix your financial issues until you get all of the staff functions to work together.

Then the second step is to get the operating people, the program managers to work with the staff functions. It is a two-step process, if you will.

Mr. HORN. Mr. Hammond, you have been around here a long time.

Mr. HAMMOND. Building on what Mr. Everson said, I think the important thing from my standpoint would be to identify within the organization that there be only one source of financial information on program data.

I think one of the things that I found in my experience is when you talk to program managers within an agency they come up with financial information that is totally distinct from the financial information that may be found in any central system or central reporting. If you can put in place a methodology and a discipline to look to only one source of data, and that being the agency's own central data, I think that goes lockstep with what Mark was saying, that you integrated then the staff functions into the program people.

Today the amount of time and effort that is spent in program operations, developing and tracking their own financial information and measuring it their own ways and slicing it in their own fashion is huge; and it results in them looking at the staff functions and, quite frankly, saying they are not value added to me.

That is not the right outcome. The right outcome is for the staff functions to provide the data that the program needs, for that not only to be value added but for them to be a critical part of the discussion.

Mr. HORN. What is the role of your Assistant Secretary for Administration in Treasury? Does he have any—he or she—is he the fiscal financial officer?

Mr. HAMMOND. He has actually got somewhat of a unique role, as I understand it, across agencies, in that Assistant Secretary position is not only the Chief Financial Officer for Treasury but it is also the Chief Operating Officer, essentially, for the agency. He sits on the President's Management Council. So he has a unique perspective on—his involvement not only deals with finance, but it deals with the fundamental operations and systems reforms throughout the department, and the CIO reports to that position as well.

So I think it—in Treasury, you have a very strong integration of those staff functions, bringing them together at an operating level. You still, however, because of the decentralized nature of the bureau operations, have program information which, you know, is not under, you know, the same type of review, I guess I would say.

Mr. WALKER. Can I take a shot?

Mr. HORN. Go ahead.

Mr. WALKER. I would characterize your question as why should we care about this? And the response that I would give to that is that accounting is how you keep score and how you keep score counts.

Second, if you don't have timely, accurate and useful financial, budget and management information available, you will never maximize the economy, the efficiency and the effectiveness of government and you will never adequately ensure the accountability of government to the taxpayers.

Third, if you can't do that, then you are not going to attain and maintain the public's respect for and confidence in their government.

And, last, given our long-range fiscal challenges which are being pushed by known demographic trends and in rising healthcare costs, we have to make some tough choices. You need to have that timely, accurate, useful information in order to be able to make tough choices about where you ought to allocate resources, what is working, what is not working, who should be rewarded, who should be held accountable, etc.

Mr. HORN. One of the things that has bothered me for 5 years on this thing was the Treasury; the Administrative Secretary there was putting all of these things to his particular bailiwick.

Now, when Congress put together saying, you know, they have got to face up to CFOs, we meant a full-time CFO, not just pushed into the administrative thing. I think part of Treasury's problems has been, over the years, with the Internal Revenue group, et al,

which had a real mess on its hands, and I don't know the degree to which—we are going to have the Commissioner in here in a couple of weeks, as we do every year. Then when Congress said, you know, most of those people down there really don't know what they are talking about when you get to a Chief Information Officer—so that is thrown in there, and it seems to me you need to get a few first-rate people to hold one of those positions. The Deputy Secretary in Treasury and the under secretaries of many other departments, it just seems to me that they don't fully use their opportunities for talent to come into the administration and to provide some leadership there.

And you say, Mr. Hammond, that you don't agree with that. That is fine. Let's hear it.

Mr. HAMMOND. Well, it is certainly a little bit out of my area of expertise with regard to the Treasury's overall operations. But I would speak to the fact that over the past 4 or 5 years the role of the Assistant Secretary for Management at Treasury has been very carefully refined, trying to balance the needs for management of a very large decentralized organization and bringing in some very, very top-notch people.

We have been fortunate to have people such as Nancy Killefer as well as the incumbent, Ed Kingman, hold that position. I think they bring a vast amount of private sector experience and have made a lot of changes in the way that office interacts with its—you know, its appropriate functions within the department.

I know that from my other hat, I sit on top of the Financial Management Service in the Bureau of the Public Debt, two operating bureaus at Treasury that I deal with, the Assistant Secretary for Management on a range of budget issues and operational issues for those two bureaus, I find them to be very engaged and very involved in not only the financial management but the overall program management from the standpoint of how it relates to consistent Treasury policy.

Mr. EVERSON. Could I weigh-in on this one?

Mr. HORN. Yes.

Mr. EVERSON. Secretary O'Neil is not a bashful fellow—

Mr. HORN. I have noticed that.

Mr. EVERSON [continuing]. And he totally, totally supports both the governmentwide efforts that we have all been speaking to, but dramatic reform efforts at Treasury. He has tasked Ed Kingman—and, as Don is saying, I chair the President's Management Council. Ed is a frequent participant in the substance there and also chairs one of our CFO committees. Just as Don chairs the financial acceleration, Ed chairs another. He has the total support of the Secretary.

You can set up any boxes you want. But, if the leadership, meaning the Secretary and the Deputy, doesn't empower these people and drive them to change, nothing will happen.

Changes are happening at Treasury. They are moving to the 3-day close, very aggressive programs to eliminate the two remaining material weaknesses.

So I think that even though it is a very hard department to manage, because, as Don indicated, everything from the IRS to international trade elements, tracking to the ATF, this administration

through those players I know is tackling those tasks that you are concerned about.

Mr. HORN. Well, the other one told us that, too, and that is when I started getting upset and—back in, as I say, 5 years ago—and I never saw much happening. Well, a little bit is happening now, and they are in the category of improvement, and that is a clean-bit on there for a while.

But it just seems to me that—and that is what I said way back during the Clinton administration, what are you doing? I mean, for heaven's sake, can't you focus on something and not just have a position and overwhelm one person and not take advantage of the CFO and the CIO?

Mr. EVERSON. Yes.

Mr. HORN. That bothers me. I guess it is going to continue to bother me. But until they really get the job done, I don't know how you can do anything else. That is part of your problem.

You are right about saying, get the staff to start moving. That is what a staff is supposed to be for. I think there has been some progress to improve the financial management, but I think it has a long way to go.

What role do you see your agency—or under your jurisdiction taking in developing strategies for addressing the problems that continue to prevent the government from preparing auditable consolidated financial statements? That group is going to stay out there in malaria-land until you three get there, because you are the only ones left practically. And what would you do? How would you keep after them? They just smile at you.

I mean, I know what the bureaucracy does. I have been in it. And I was bothered then. That was the Eisenhower administration. I am still thinking about it.

Yes.

Mr. WALKER. Mr. Chairman, I think you have to start at the top, and there are a lot of other things that have to happen. But let me touch on a few things. First things first.

As I noted in my testimony, the President has identified financial management as one of his top five management priorities. Now, frankly, the last President did, too. This President has a CFO Council. You know, the last President did, too. But, the fact of the matter is that there are some things that are fundamentally different that cause some hope.

First, this President has been personally engaged on occasion in dealing with some of these management issues. That is unusual, if not unprecedented, at least in modern times.

Second, most of the Cabinet-level officials—or at least many if not most of the Cabinet-level officials—in the administration have some private sector experience and have a better understanding of the need for timely, accurate and useful information, because of some of the reasons I have articulated.

Third, the JFMIP principals, which comprise the individuals that I talked about, have never been more active in identifying what are the problems, what the barriers are, and determining an action plan that can be implemented by the staff who are critically important to getting us to where we need to be. And all are fully committed.

I have got to tell you, Secretary O'Neil has been at every JFMIP principals meeting. Director Daniels would have been at every meeting but for a last-minute meeting with the President that he was called to before our last one. Director James has also been involved in every meeting. We are all confirmed for the next meeting.

So there are a lot of things that have to happen. But I am hopeful that if we can sustain this momentum we will see much more progress over the next year or two than we have seen in a number of years.

Let me mention one other thing. I think one of the things we have to deal with is that, while we have a lot of capable and committed players at the present point in time, I think we have to recognize that not only in the financial management area but also in the human capital area, in the information technology area, in the strategic planning area and a variety of others, we are talking about a fundamental transformation of how the government does business.

We are talking about looking longer range. We are talking about looking more integrated. We are talking about changing some fundamental things. That takes years.

I think one of the things the government is going to have to face is whether it is well organized? Does it have the right kind of people responsible and accountable who over a period of time, will transcend presidents, political secretaries, and assistant secretaries in different areas to try to make sure that the infrastructure issues get dealt with and dealt with effectively over time? I have concerns about that.

Mr. HORN. Any other thoughts on that?

Mr. HAMMOND. Well, just one. I think I wanted to reemphasize something that is apparent to me but I think isn't also necessarily apparent to the public, which is the level of involvement that Secretary O'Neil brings and commitment to those areas. He has demonstrated a focus and an interest that I have not seen during my tenure at Treasury on financial management from the secretaries. Bob Rubin had a strong interest but not the level of detailed interest that Paul O'Neil brings to this.

For example, this year with regards to the management representation letters across government, he was involved in the preparation for the governmentwide management representation letter. As you can imagine, there a number of weaknesses noted in that.

Mr. HORN. Now, Secretary Rubin was committed to getting at the debt, and I just haven't followed it yet. But what about Secretary O'Neil? Is he pushing the agencies to get the debt turned over for the credit and the debits and the—getting rid of the debt?

Mr. HAMMOND. Very definitely. There is a great example of a program, once it gets high-level attention and focus, that every agency comes on board, participates cooperatively, and we have got a whole range of success stories. Debt collection is a great example of when you bring the kind of high-level focus and commitment, you can get some very, very strong results.

I am encouraged that after the Secretary this year went through the agency rep letters, for example, that he is going to followup with some of the agencies. Because I think it is very eye-opening, when you see a three-inch binder of disclaimers from various agen-

cy officials about the state of their financial systems, someone with our Secretary's experience looks at that and immediately understands that this is a bigger issue than it may appear, you know, at first glance.

Mr. HORN. Well, it is especially important when we are trying to get a balanced budget again; and one way to do it is to take care of the debt situation all over the executive branch. I do hope the administration will ask the Ways and Means Committee that we get at the tax debt. Right now, everybody says, oh, well, that really isn't in the law. Well, if you are sitting there, you got to have a little energy and do what is needed to be caught up. And it has not been very well caught up except for Rubin's pushing on that. His successor didn't do a thing, so I am glad that Secretary O'Neil wants to do it.

Because it is—I think for the average citizen, when they say, hey, I pay my taxes, what is wrong with these jokers? And getting away time after time after time in terms—just saying, oh, you know, I am going into bankruptcy. And we shouldn't allow that. We shouldn't have that kind of thing.

Constantly the same old gang is the one that is just—is thieving away at the Treasury. And that gets me, and it gets everybody else when you pay your taxes.

Mr. HAMMOND. I do have some encouraging news with regard to the collection of delinquent tax debt, which is that the tax levy offset system is now fully operational. So we are in the process of working with the IRS to get those debts certified so—the only thing worse than not collecting debt is collecting the wrong debt. So we are wanting to make sure that those numbers are good and that the debts are validly owed. Once those are loaded in the system we will have another tool to collect the—exactly those delinquent obligations.

Mr. HORN. Are we going to get tax collectors in the private sector or are we going to continue to let the bureaucracy continue to do it in IRS?

Mr. HAMMOND. With regard to the private collection agencies, that at this point is still an IRS operational issue.

Mr. HORN. That is why we haven't collected the debt, and we knew that from day 1. They phoned us up here when they said, oh, we have got this great bit for you to have a little pilot of this. Well, it was a 5-year-old debt, and you never get anywhere with a 5-year debt.

I was shocked because I have a great opinion of Commissioner Rossotti. But I was shocked last year that he hadn't taken some really moving ahead action.

You can't just take one phone call or one letter. You have got to keep after it. The Commissioner before Mr. Rossotti said, we can't do that, that is the privacy law.

That is nonsense. Just give them the address, say they owe us \$10,000. If they are griping about that, fine, then you turn them over to the IRS and say, well, now is this right or wrong?

So, again, we just let the money go down the drain, and that bothers me.

I don't know. What does the General Accounting Office think about that?

Mr. WALKER. Clearly, we think there are more aggressive steps that need to be taken with regard to debt collection. I think, as Secretary Hammond noted, it is important, though, to make sure that when people are aggressively attempting to collect valid debt.

That leads us back to the problem with the basic financial systems. We don't have timely, accurate and useful information. So I think we need to keep that in mind in determining what type of safeguards might need to be in place, so that as you pointed out, Mr. Chairman, if somebody believes that they don't owe anything, there is some type of mechanism whereby the validity of the debt can be verified one way or the other and not have people aggressively going after debts when there could be some real legitimate dispute about whether or not the amount is owed.

But once that has been decided, I think we need to consider some experimental alternative ways of collecting that debt, because you want to have incentives for people to do the right thing. If they don't do the right thing, then you have to have appropriate accountability. Otherwise, that creates pervasive incentives not to comply.

Mr. HORN. Any other comments on that?

Mr. EVERSON. I agree with both of those remarks, sir.

Mr. HORN. Good. Well, maybe we can get something done, particularly on the private collections. I just don't understand why that can't be done.

I realize they have got a union in the Treasury and all that. But we said, hey, you can have the first crack at it in 3 months. If you haven't collected it, turn it over to collectors that know what they are doing. So that is what bothers me. Because I don't know—they talk a good game, but let's see what happens. When you are after money and we are waging a war, we need to find every dollar we can find to get it into the Treasury.

Now the administration and the executive branch has done a fine job with your management scorecard to highlight the agencies progress in achieving the management and performance improvements. I just wonder, how do you plan to measure agencies progress? What are you primarily thinking about? Is it just dollars or it is accomplishments and results of what you were given the power by Congress to do it? So how are we going about that?

Mr. EVERSON. In each case, as you will recall from our earlier discussions, we did a baseline evaluation as of the end of the last fiscal year, the end of 2001, against the standards for success. The standards for success were articulated for each of the five agenda initiatives. In the case of the financial standards for success, we developed them at OMB. We had them commented upon by the agencies. And then we took them to the JFMIP, so that the JFMIP staffs and then the principals reviewed and adjusted the standards. So you have the vision that is articulated in each of those areas for what is success.

And I would tell you that is a first and significant step. In financial management, for years the administration, the government has been responding to GAO high-risk lists or your own interventions from the Congress for investigations. And that, frankly, is the wrong way to do it. It is reactive as opposed to having a set of standards that you are driving to and always, of course, being at-

tentive to the events or to areas that come up from time to time. But you should have standards. We have got that now.

As we made those evaluations, we went back and asked each agency to develop plans to improve their status. They have done that now. There was a series of negotiations that took place. Some have just only been completed. They all differ. Because each agency's situation is unique, of course.

We have been talking about the Treasury Department. But the Treasury Department, with all of its disparate functions, is different from the Social Security Administration, which is sort of a more of a single-purpose entity, if you will.

We have worked with the agencies, and they have established a set of deliverables and timetables. We will measure progress, once having accepted the plans by how they are adhering to the deliverables and the timetables that they agreed to with us. Each quarter we will sit down with them.

I am going to be sitting down with the leads on each of the five agenda items actually later this month to review where the agencies—what they got done in this first calendar quarter of 2002, and we will assess the progress that way. If they are making progress in accordance with the established deliverables and the timetables, that would be green on the progress side for the agenda item. If they are showing some slippage, which calls into question the timing or maybe some elements of the deliverable, that would be a yellow. If, on the other hand, they are at risk of achieving the objective absent strong intervention, meaning that they are headed toward not achieving the objective, that is going to be a red on the progress side.

We are just starting that. We are going to do our first evaluations at the end of March. So we are sort of tweaking that process and tightening it up as we go.

Mr. HORN. Well, I will stick with you for a minute. The preparation of reliable financial statements is only the first step to financial management improvement. In the testimony the General Accounting Office stated that many agencies resort to extraordinary efforts to prepare financial statements.

What's being done to address the internal control and systems weaknesses that are preventing agencies from having reliable financial information for day-to-day management?

Mr. EVERSON. I think there are—there are three things. First, we are—on a governmentwide basis Don spoke about the efforts he is leading to look at, let's say, certain governmentwide standards and issues on reporting and fund balances and transactions that Treasury has the lead on. We're trying to, from a policy point of view, cleanup things and make them better governmentwide. Joe Cul, my deputy, Don, and I got a group of people who have worked very closely on that.

But second, the two other areas which are internal to the agencies are really related to two things; one, systems, and there are any number of important systems projects under way, where I mentioned just a moment ago the start of something very significant at DOD where they're doing the enterprise architecture. So they'll have a coherent systems approach and they will rationalize over 600 different systems that they have that feed into the finan-



cial statement information. That clearly is a major thrust and if you look almost at any government agency now there's a lot of systems work under way.

But it goes beyond that, I would say, to include looking at your business processes independent of systems. It's not only about money and new systems. It's also about doing things like looking at your unliquidated obligations on a regular basis instead of doing some sort of an analysis just 4 or 5 months after the close of the fiscal year, a lot of things that companies do on a monthly or quarterly basis that government doesn't bother to do except at the end of the year, and clearly one of our clear intentions by forcing acceleration of the statements is that there will be a rupture, there will be a change in practices and that will have two benefits. It will provide for the more timely information itself, but it will also get to the issue of actually making information useful internally.

Mr. HORN. When will that happen on what you're doing with the agencies and the systems they have and how they can generate financial statements to meet the dates? What will happen?

Mr. EVERSON. I think that's all going to happen on a case-by-case basis. What we've done now is we—the due date for the 2001 statements was February 27. We've done two things for the 2002 cycle. First, we've mandated joint or combined performance and accountability reports. Up until now, although some departments and agencies did it, there is no requirement to link your GPRA reporting to your accountability reports which has the financial statement information. That's nuts because the whole intention of GPRA is to have that kind of a linkage. So we're requiring that linkage. We're going to accelerate the due date to February 1, but then after a lot of internal discussion we decided to have a pause so that the 2002 date will be the same date in 2003 and then accelerate it from February 1 to November 15 in 2004 because we recognize that these issues and some of the systematic changes will take time. We want the agencies to plan correctly to do this because there are a lot of technical issues.

Mr. HORN. Comptroller General.

Mr. WALKER. Mr. Chairman, I think there are three things that hopefully can help significantly to make progress in this area and avoid what we have referred to in the past as heroic efforts where people spend millions of dollars and thousands of person-hours trying to get a clean opinion but at the same time they have material control weaknesses, substantial compliance problems, and don't have timely and accurate, useful information to make decisions. No. 1, change how you keep score, change the definition of what is success in financial management.

The last administration did a number of positive things; however, one of the things that I was always concerned about is that they tended to measure success based upon whether they achieved a clean opinion or not. That creates perverse incentives. GAO has said for some period of time that's the wrong measure. The JFMIP principals have now agreed. OMB has now adopted it for their "getting to green" efforts. And so we've got different measures of success to deal with the root causes.

Second, the acceleration of the due dates of the financial statement reporting will serve to further discourage heroic efforts be-

cause people won't have time to be able to do a lot of things they've been doing and still hit the date. So you give them an incentive from the standpoint of how you keep score. You end up undercutting their ability to do it by accelerating the due dates. And the third thing which I hope is happening, and I'm sure that they will followup on if it's not, is one of the things that Mark just talked about—is linking performance and accountability, linking budget with management, and focusing on results and outcomes.

So hopefully one of the things that is happening through the budget process is that OMB is integrating what the management plans are with the resource allocation decisions and they are funding things that are dealing with the root-causes and denying things that are superficial and that aren't ending up actually making substantive improvements that can be sustained over time. I think that's another critical element and one of the reasons why you really do need to link that M with that B in order to get the desired results.

Mr. HORN. Let's take one example of Treasury Customs. When Commissioner Kelly was there, he recognized, and he had a software to produce it, that he looked at the East Coast versus the West Coast on the type of personnel that they needed in both places because of containers and the whole business of trade coming into the United States and so forth. So he was out at the end of that, and I don't know that the new Commissioner is doing anything about it. But it sure needs it and in order to do it, as we know, in a bureaucracy, you can't just take it from the New York crowd and put it in the two largest ports in the United States or the Long Beach Port and the Los Angeles Port, and together they are No. 1 right behind Singapore, and yet they don't have the people to check the containers and all the rest and you've got—some of the containers have people from this gang in Shanghai that charge \$30,000 to get each of those persons into the United States, and we try to get them on the high seas and the Coast Guard has done a terrific job in doing that, and then you also have the problem of just a plain bunch of fouled-up invoices, and they need to deal with that. And I think Customs has a great opportunity but we've got to do that and you can't take it away. So let's do it for more where it's needed, and that was what Kelly's approach was to that and he was right.

Mr. HAMMOND. I'm not all that familiar with the operations of the Customs Service obviously, but I can tell you from conversations that I've been part of that container inspections in particular, the way they're approached, the methodology, the data supporting how that development, how that inspection is done is something that Secretary O'Neil has personally expressed a lot of interest in. It is something that he understands and the—obviously the events of September 11th have focused a lot of attention on issues related to container security as well as other forms of port of entry. It is something that I can tell you that he is personally engaged in and I suspect that Judge Bonner, the new Customs Commissioner, is equally engaged in that same sort of very disciplined review of those practices.

Mr. HORN. What they have now is they say, well, we check 1 percent. This was 1 year ago. We get 1 percent of the containers com-

ing through. That's sort of laughable. So they got it up to 2 percent, and every 4th month or so 1.6 million containers go through the ports of Long Beach and Los Angeles and that moves to all over the United States, and we're about to realize this coming week that the Alameda Corridor is opened and that will move trade even faster in terms of trains moving 24-hours a day right up to the cargo and off it goes, and if they are suspicious about one they take it up 20 miles, unload all of the container and they take it apart, and sometimes they get a good hit and there's narcotics or whatever there and it just—but we need some more people power to really have any of this moving.

So I would hope that we can get it in a fairer way so the West isn't constantly losing a lot of people and then not being able to hire others because it's on the East Coast. We had that on frequencies, by the way, on these terrorism things. Most of them are on the East Coast and we need to get frequencies for communication throughout the executive branch, and that's a real problem. And we shouldn't be having private sector things when the government needs the frequencies. And in our first hearing in Nashville we had a problem with the helicopters of the bases in Tennessee versus the civilian helicopters that bring people into hospitals from far away places, and again they can't talk to each other because they aren't on the right frequencies. So we need to do something with that, and that ought to be going fast.

So in the results approach, a good bipartisan bill we had, and the Majority Leader Armev was pushing that for everybody just as I was and we need to get the results timed with the financial side and, as you say, the scoring and if it isn't of any use to making decisions, then we shouldn't even waste our time on it, but if decisions can be better and more effectively used, that would be important, it seems to me, for all of us to take a look at that, what is it and how do you know that this cabinet department really is doing something effective or just writing checks. Well, there's more to that than just writing checks.

So what kind of penalty will the executive branch do if people sort of fail on the reporting deadlines? What kind of penalty is it? Do you take a few million dollars out of their budget? That would get their attention.

Mr. EVERSON. On the deadlines itself, I haven't contemplated yet what would be the ramification of that. As you indicated earlier, all 24 of the CFO Act reports were timely this year. I don't yet have any indications—Don and I haven't talked about it but—that we'll have a problem next year with the 1-month acceleration. I believe that we will meet that uniformly in the sense that nobody's yet squawked and said they can't do it. It's too early to say, sir, where we'll be on the 45-day deadline. That's 2½ years out.

We set a very high bar. I fully hope that we will achieve that across the board of all 24 agencies. That is what we're going to drive to. I can't tell you yet what the consequence would be if we fail in one or more instances, but I will certainly consider it. And all I want to just do is reiterate, as Dave said a few minutes ago, on the scorecards themselves the President has been using these. I don't know what more consequences or focus you could want than to have the chief executive of the land using the scorecard when

he sits down, and it was mentioned—Ari Fleischer was talking about it last week, when the Social Security Administrator was in with her deputy—they went through the scorecard and they talked about it afterwards in the press. So I think there will clearly be consequences as time goes on because of the accountability and the focus and the thrust that the administration all the way through is bringing to these things.

Mr. WALKER. Mr. Chairman, can I jump in there?

Mr. HORN. Certainly.

Mr. WALKER. I think we need to look at it from the standpoint of both individual and institutional perspectives. You've got to have appropriate accountability mechanisms if things aren't done, and obviously it depends upon how significant the slip is and the item. But obviously something that should be looked at is, you know, to what extent is this affecting the individual's compensation, including whether or not they will receive a bonus. It should also affect their opportunities for promotions or different level increases to the extent they're in the SES, whatever level they are at. It should also affect in appropriate circumstances whether or not they continue to be retained in their position. So I think you have to look at it both individually as well as institutionally.

Unfortunately, what has happened all too frequently in the past—and I'm not talking about this administration, I'm just talking generically—is that entities who get more of the money are the entities who have failed in the past, and so we need to have an incentive to make sure that we understand where we're going and we've got a game plan. We've got to get people focused on appropriate accountability mechanisms and try to get the money to these people who are really making a difference, both institutionally and individually, in achieving progress.

Last thing, as Mark mentioned, the administration has decided to accelerate the due date for agency financial reports up to February 1st next year. Our statutory reporting timeframe for the consolidated financial statements, as you know, was March 31st. The Social Security and Medicare trustees' statutory reporting deadline is April 1. I can tell you if past is prologue we are going to have a problem next year in that this year we had about 3 days to be able to look at the Social Security and Medicare projections, which is absurd, especially given the fact that GAO has access to top secret information, special compartmentalized information, and yet the staff don't want to provide information on the Social Security and Medicare reports. Something has got to be done to make sure that information is accelerated and to make sure that type of information is included in not only the agency financial statements but the consolidated financial statements. Otherwise the government just looks foolish.

Mr. EVERSON. We would agree with that. There are a host of sequencing issues that you get to when you start to do the acceleration, and those are the kinds of things we're grappling with right now.

Mr. HORN. On the Results law Mr. Armev in particular likes that. He has told the chairs of the authorization committees and the appropriations subcommittees that you ought to be able to sit down with members of the executive branch and just talk and not

just have the staff of both parties do it but the people that are selected by the President and the people that are elected by the people. And I don't know if any of them have ever sat in this last year. Has anybody ever said, hey, let's talk about some of this? And maybe they all want to run in opposite directions. I don't know.

Mr. EVERSON. In terms of—you're speaking, sir, of the GPRA reporting and—

Mr. HORN. Right.

Mr. EVERSON. I think that my perspective on this, and it goes back to what we were speaking about just a minute ago, the Comptroller General was talking about, what is really the fifth initiative, budget and performance integration. I see very serious efforts taking place at the departments to try and rationalize that continuum of establishing objectives, strategic objectives, which my impression from the discussions I've had with other administration officials is that by-and-large coming in our people tend to believe that the strategic—the broad strategic objectives, what's the mission of the Interior Department at broadest level, has been pretty well articulated and we accept in many instances those overall mission statements.

It's when you get down to the second and then the third level of what you might consider more tactical objectives that you get into trouble, where outputs rather than outcomes have been defined. Let's get 100,000 new cops; that's an output as opposed to is crime down and why is crime down. Let's get more teachers; that's an output as opposed to are kids reading better. Let's write more grants for diabetes; that's an output as opposed to is diabetes being reduced. We're trying to, through that initiative, focus on that continuum so that you're getting the right things measured because what you measure will change behaviors, and I think that through that initiative we're starting to see some progress.

Mr. WALKER. If I could add to that real quick, Mr. Chairman, I think part of that goes back to what we talked about earlier, which is how do you define success? We've redefined what success is in the area of financial management. The President's Management Agenda has taken a shot at redefining success in the other five major areas. Departments and agencies need to look beyond what historically they viewed in their mission and say, well, how are we going to define success, how are we going to know whether or not we are being successful or, if we're not, are we making progress toward achieving the desired outcomes? That is part of this fundamental transformation process. That is a multiyear effort, but is beginning and it is important that it continue.

Mr. HORN. Well, I think that's you're absolutely right on that, and I'm delighted you're pushing it in that way and challenging the bureaucracy and the political appointees and the career appointees that you're serious.

Mr. EVERSON. Could I make one additional point on this? I'm the vice chair and the acting chair of the President's Management Council and we've just recently made a change there based on our—we had a retreat at the beginning of March and wanted to figure out how we would do things better because it's been about a year, and what we've done is we've reconstituted the Council to include three committees. One is human capital and that's chaired by

OPM Director Kay James. Another is on e-government because that is a particularly challenging initiative because it requires coordination across agencies, and that is chaired by Cam Findley, who is the Deputy at Labor. Bill Hansen, who is the Deputy Secretary of Education, is chairing the third group, which is on budget and performance integration because we recognize that unless we get buy-in from the cabinet departments and the agencies and they help us define what this has to look like, it won't help just having the Comptroller General and the Director of OMB and a few other people talking about it. It's got to be—this club has to be picked up and carried by the operators that run those departments. So we think that this will help do that.

Mr. HORN. Good. So let me just close with a few things here. Does the Congress need to impose any additional legislative requirements to assist the agencies improve financial performance? Is there something that we can do that will help you manage the executive branch?

Mr. EVERSON. I'd like to think about that, sir. We've had a series of conversations about very preliminary and very general—there are a lot of things that interact here. There have been some statutes that have been established over the last 10 or 12 years. They aren't always totally connected, and you've had evolution in duties and responsibilities of IGs and other areas. There are a lot of things to look at that could be considered in terms of defining a slightly better working model.

I'm not suggesting the model that we have is a barrier. I think that certainly the burden is upon us to work with that model and there is a lot we can do with the existing model, but I want to reserve judgment before I would make any specific suggestions.

Mr. HORN. The kind of thing I'm thinking of is in the Debt Collection Act back in 1996 we provided that the agency that collected the debt, to help it along because they needed computing and take part of that and let the agency improve their computer situation; in other words, we're given a little carrot out there.

Mr. EVERSON. No. I'm going to back up and I'm going to reverse myself here. I think that the erroneous payments area, I'll tell you something that's pending before the Congress right now that I'm concerned about. In the farm bill the quality control program is being weakened rather than strengthened and as we go—one of the vexing things is not just our systems but in a lot of cases this \$20 odd billion or so dollars that GAO reports on as erroneous payments. A lot of times these are moneys—these are programs that are conducted by States or counties or other officials on behalf of the Federal Government. There needs to be clear accountability on the part of the third parties. It's not just the fact that Treasury or Ag or somebody is not running the program correctly. I would watch—I would take a look at that farm bill if you could.

Mr. HORN. I'm going to be in Iowa in a month or two; so we might ask that question.

Mr. WALKER. Mr. Chairman, I think it's appropriate for the JFMIP principals to talk about this issue. We already have identified a couple of areas where we know there are problems that need to get resolved. They may be able to be handled administratively

but to the extent they can't be handled administratively, we won't be shy about letting you know.

Mr. HORN. Well, any other thoughts you have?

Mr. EVERSON. No. I'm just thankful that you have this continued interest and, as I said at the top of the hour, I think that we have an unusual alignment right now of people who are really trying to get some things done. Your continual poking and prodding and corraling us is very helpful because it makes sure that we get centered correctly from time to time and aren't only talking to each other.

Mr. HORN. Well, I agree with you on that, and anything we can do to be helpful we'll be glad to do it, at least up through December, or part of December.

I want to thank the people that put this hearing together. J. Russell George is our very distinguished staff director and chief counsel right back there. And Bonnie Heald, deputy staff director, next to him. And then Henry Wray, senior counsel, right behind me here, and we're delighted to have Rosa Harris, who's done a terrific job as professional staff on loan from the General Accounting Office. Don't hold anything against her. Just hold it against me. Give her a raise. Detailee. She's done a terrific job. I've seen the best questions and so forth, and I haven't given her justice because I haven't used all her questions. Justin Paulhamus, the majority clerk, he's gone with us now all over America. He'll see America. And Michael Sazonov, the subcommittee intern. And the minority staff here is David McMillen, professional staff for the minority, and Jean Gosa, for the minority clerk, and without her we couldn't use this place. The court reporters, Mark Stuart and Lori Chetakian. And we thank you all, and I'd like to thank the inspectors general of the 24 departments and agencies for their invaluable contributions to our financial management grades this year and we thank you. You're moving in the right direction and if we can help you, we'll be glad to. With that we're adjourned.

[Whereupon, at 11:29 a.m., the subcommittee was adjourned.]

