THE FINANCIAL REPORT OF THE U.S. GOVERNMENT FOR FISCAL YEAR 2004

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, FINANCE, AND ACCOUNTABILITY

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

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CONTENTS

THE FINANCIAL REPORT OF THE U.S. GOVERNMENT FOR FISCAL YEAR 2004

WEDNESDAY, FEBRUARY 9, 2005

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
FINANCE, AND ACCOUNTABILITY,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:04 p.m., in room 2247, Rayburn House Office Building, Hon. Todd Russell Platts (chairman of the subcommittee) presiding.

Present: Representatives Platts, Towns, Dent, Marchant, Westmoreland, Duncan, and Foxx.

Staff present: Mike Hettinger, staff director; Dan Daly, counsel; Tabetha Mueller, professional staff member; Jessica Friedman, legislative assistant; Nathaniel Berry, clerk; Adam Bordes, minority professional staff member; and Jean Gosa, minority assistant clerk.

Mr. PLATTS. A quorum being present, this hearing of the Committee on Government Reform will come to order.

As we begin the 109th session, it is great to be serving again with my ranking member, Mr. Towns from New York, as well as our other colleagues on the majority and minority side. I look forward to an active and productive 2-year session as we go forward from this hearing of the committee today.

As stewards of taxpayer dollars, we owe our citizens no less than full accountability. At the very least, we need to ensure that assets are protected from loss or misuse. Ideally, we need to ensure that every dollar is spent wisely and for its intended purpose. We should also understand fully the cost of the Government's operations and the implications of our financial commitments.

To fulfill these important responsibilities, Congress began requiring that the Federal Government would produce audited financial statements beginning in fiscal year 1997. The 2004 financial report of the United States and accompanying audit performed by the Government Accountability Office were released on December 15th of last year. This deadline represents an important milestone. It is a huge improvement over the days not too long ago when agencies took nearly 6 months to close their books. Timely financial information is necessary for responsible budget decisions, and in times of fiscal constraint, as many Federal agencies are required to do more with less, real time financial data becomes a critically important tool.

For the 8th straight year, unfortunately, GAO was unable to provide assurance as to the reliability of the information that underlies the Federal Government's financial statements. As has been the case year after year, GAO reported significant material deficiencies. Additionally, this year a new issue came to light that warrants consideration. Eleven agencies restated their financial information for the previous fiscal year. Frequent restatements can undermine the credibility of our financial reports.

During this hearing we will discuss the possible reasons for these restatements and ways that we can improve the process going forward to ensure that information is reliable as well as timely.

Perhaps the most important benefit of the audit process is learning how to correct systemic weaknesses. We have seen improvement since the inception of the Government-wide audit in 1997, but until we can be assured that the reporting information is reliable and GAO can issue a clean opinion, we will not benefit from the full value of this report.

The Government Reform Committee has a responsibility to ensure sound financial management through appropriate oversight, and this hearing will establish the basis for our work in the 109th Congress.

Our witnesses today will provide the subcommittee with insight on the audit findings of the consolidated financial statements and discuss areas that need improvement.

Today we are pleased to have the Honorable David Walker, Comptroller General of the United States; the Honorable Jack Martin, who will represent the Office of Federal Financial Management at the Office of Management and Budget, and who is CFO at the Department of Education; and Donald Hammond, Fiscal Assistant Secretary at the Department of Treasury. We will certainly look forward to the testimony of each of our witnesses.

[The prepared statement of Hon. Todd Russell Platts follows:]

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON GOVERNMENT REFORM
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, FINANCE AND ACCOUNTABILITY

Oversight Hearing: Audit of the Consolidated Financial Statements of the U.S. Government for Fiscal Year 2004

OPENING STATEMENT OF
REP. TODD R. PLATTS
FEBRUARY 9, 2005

As stewards of taxpayer dollars, we owe our citizens no less than full accountability. At the very least, we need to ensure that assets are protected from loss or misuse. Ideally, we need to ensure that every dollar is spent wisely and for its intended purpose. We should also understand fully the cost of the government's operations and the implications of our financial commitments. To fulfill these important responsibilities, Congress began requiring that the Federal government produce audited financial statements beginning in fiscal year 1997.

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Mr. PLATTS. I now yield to our ranking member, the gentleman from New York, for the purpose of making an opening statement. Mr. Towns.

Mr. TOWNS. Thank you, Mr. Chairman.

Let me begin by saying I really thank you for your leadership. I look forward to working with you to make Government more responsible. It is good to be back here with you.

I look forward to continuing our good work on improving the performance and efficiency of the agencies and programs that so many Americans depend on every day. While I am pleased to see that the agency community is continuing to make progress in meeting their imposed deadlines for annual auditing requirements, these results seem to indicate that efforts to achieve a clean Government-wide audit are stagnant.

As in previous years, a vast majority of agencies are meeting their goals of achieving an unqualified audit opinion, leaving us to focus our attention on a select few. Nevertheless, there is noteworthy decline in the number of agencies receiving clean audits when compared to last year's results. For fiscal year 2004, only 18 out of 23 agencies received a clean audit opinion, down from the 20 agencies receiving clean audits for fiscal year 2003.

Furthermore, we are witnessing a sharp increase in the number of agencies restating their results from the previous year. According to GAO, there are 11 agencies that offered restatements for fiscal year 2003 compared to only 4 agencies during the previous cycle.

While the underlying reason for these restatements remains unclear, it certainly merits our scrutiny. Publicly traded entities that restated its prior results would face harsh scrutiny from the FCC and its investors, so why shouldn't our agencies be scrutinized the same way by Congress and the taxpayers?

Perhaps it is too early to tell if our efforts to improve agency financial management over the past decade have been adequate or if the system and practices for managing our Federal agencies are faltering. That said, the 2004 statements remain troubling to me and merit a thorough review from the Government Accountability Office.

There is no question that the road to sound financial management and program efficiency within our Government runs through the achievement of a clean Government-wide audit; thus, it is imperative for us to continue with adequate oversight of agency efforts if we are ever to bring our Government's chronic budget deficit and debt burden under control.

I look forward to hearing from the witnesses and gaining their perspectives for making our Government a more effective and accountable institution.

On that note, Mr. Chairman, I yield back.

Mr. PLATTS. Thank you, Mr. Towns.

[The prepared statement of Hon. Edolphus Towns follows:]

Congressman Ed Towns
Committee on Government Reform
Consolidated Financial Statements of the Federal Government
February 9, 2005

Thank you, Mr. Chairman. Let me begin by thanking you for your leadership. I look forward to working with you to make our government more responsible, and continuing our good work on improving the performance and efficiency of the agencies and programs that so many Americans depend on every day.

While I'm pleased to see that the agency community is continuing to make progress in meeting their imposed deadlines for annual auditing requirements, the results seem to indicate that efforts to achieve a clean government wide audit are stagnant. As in previous years, a vast majority of agencies are meeting their goals of achieving an unqualified

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I look forward to hearing from our witnesses and gaining their perspectives for making our government a more effective and accountable institution.

Mr. PLATTS. Thank you for your kind words. Again, I look forward to working with you. We have taken a great team approach in the past 2 years. It worked so well. I was delighted that we got to stay in the same chairs that we are in as chairman and ranking member.

Mr. TOWNS. Mr. Chairman, I must admit I agree with everything you said but that.

Mr. PLATTS. We will proceed to our witnesses. We appreciate all three of you and your staff for your preparation for today's hearing and your appearance here today. As is a practice, if I could ask our witnesses to stand and any staff who will be assisting them, as well, to take the oath with them.

[Witnesses sworn.]

Mr. PLATTS. Thank you. The clerk will note that all witnesses affirmed the oath.

We appreciate the written testimonies and we will proceed. We are going to use a rough framework of about 8 minutes each. We won't be real close to that, but if we are able to we will have more time for questions and more of that give-and-take.

Mr. Walker, we are going to start with you. In advance—I think you said 6 years and 3 months in your position—I thank you for your service and your true and clear dedication to the fiscal integrity of the operations of the Federal Government. That name change is appropriate. The Federal Government is accountable to the people of our great Nation.

If you would like to proceed?

STATEMENT OF DAVID M. WALKER, COMPTROLLER GENERAL, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. WALKER. Thank you, Mr. Chairman and Mr. Towns. I appreciate my statement being entered into the record in its entirety, and therefore I will try to summarize the highlights and the lowlights for this subcommittee.

I am pleased to be here again to be able to talk about the results of the U.S. Government's consolidated financial statement audit for the fiscal year ended 2004. I would like to thank this subcommittee for continuing its tradition of holding annual hearings. I think it is very, very important that you do that, and I would note that because of your interest and efforts I think it has helped to make faster progress. I do think we have made progress over the last several years in a number of different ways. I think that has to be acknowledged.

As you mentioned, Mr. Chairman, one of the aspects of the good news is that for the first time in its history the Federal Government issued its annual report, which included audited financial statements, on December 15, 2004, clearly a much expedited schedule from what has been the case in the past. I think that is clearly a positive action that we should all be pleased with and proud of.

At the same point in time, for the same basic reasons as we have for the last 7 years, the Government Accountability Office has not been able to express an opinion on the consolidated financial statements for three primary reasons.

No. 1, the Department of Defense. The Department of Defense is the tail on the dog. We will not be able to express an opinion on the consolidated financial statements, in my view, until the Department of Defense gets its act together.

There are two other reasons: one, because of certain intra-governmental transactions; and, second, because of certain activities dealing with actually preparing the consolidated financial statements. My personal view is we will solve those issues well in advance of solving the challenges associated with the Department of Defense, which I am happy to get into during the question and answer period.

While it is good news that we achieved this record reporting date, one area of concern that you mentioned is the fact that there was a significant increase in the number of restatements of prior year agency financial statements. These statements primarily relate to the reconciliation of the budget results with the financial statement results, which is a fairly new statement and one that people, I think, are still trying to get comfortable with. But the fact of the matter is that when you have restatements of financial statements, that is a very serious matter and would be taken very seriously in the private sector.

The fact of the matter is that it is important that we not trade improved timeliness for decreased reliability. I believe over time we won't do that, and I think it serves to reinforce the importance of making sure that agencies have the right types of systems and effective controls in order to be able to get this done in a timely and reliable manner. That is critically important, not just to be able to generate audited financial statements at the end of the year, but in order to be able to have timely, accurate, and useful information to be able to make informed management decisions on a day-by-day basis.

I would also note, as you are aware, that the principals of the Joint Financial Management Improvement Program, the three primary ones dealing with financial management matters being the Secretary of the Treasury, the Director of OMB, and myself as Comptroller General of the United States, agreed several years ago that success in financial management was not merely a clean opinion on the financial statements, but you also had to be able to achieve no material control weaknesses, no major compliance problems, and have systems that provided timely, accurate, useful information to make informed decisions on a day-to-day basis.

Based on that criteria, only 4 of 24 major departments and agencies meet that test, up from 3 last year. As the chart shows, 18 of the major 24 Federal agencies received clean opinions this year, the same as last year. But keep in mind this: when somebody has restated their financial statements, that means they didn't deserve a clean opinion in the prior year and they shouldn't be stating, "We got a clean opinion last year and we got a clean opinion this year," because by definition if their financial statements were restated, other than for a change in accounting principle, it means they should not have received a clean opinion in the prior year.

In fact, one of the things that we are looking at is to determine what, if any, modifications should be made to generally accepted governmental auditing standards to make sure the auditors point out what the effect of that restatement would have been had they known about it in the prior year. I think it is also something that

OMB needs to consider in determining the criteria for when you get to green in the financial management area, because if you have restatements something is wrong. We need to make sure that people are held accountable when they have that type of situation happen.

If I can, in the balance of my time I just want to reinforce with this subcommittee something that I have been talking to many committees of the Congress about on both ends of the Hill, and that is if you look at the consolidated financial statements of the U.S. Government you will find that since the beginning of the republic in 1789 we have run up a net negative position of about $7.7 trillion. Worked out a little differently, right now total debt is about $7.6 trillion, another way of looking at it.

But if you look at these financial statements and also the management discussion analysis section, the footnotes, etc., you will find there are a lot of other very big numbers in there, many of which are not on the balance sheet of the U.S. Government. For example, you will find that we have made significant promises through Social Security, through Medicare, and other programs that, in current dollar terms, represent huge mismatches between what we have promised and what dedicated revenues are there to be able to deliver on those promises.

In fact, if you were to take current liabilities and add on top of that the present value dollar difference between what we have been promised and what dedicated revenues are there in the form of payroll taxes or premiums or whatever else to deliver on those promises, then our current burden is about $43 trillion and rising every day. That is about $350,000 for every full-time worker. It is $145,000 per American. The total estimated net worth of all individuals in the United States combined, including Bill Gates, is $47 trillion, and yet we are already committed to $43 trillion.

That reinforces the point that we need to continue to provide enhanced transparency through our annual financial reporting as to where we are and where we are headed.

By the way, these bonds that are in the so-called "trust funds," you won't find them as a liability on the balance sheet of the U.S. Government. The reason being, under current accounting and reporting treatment the right hand owes the left hand; yet, nonetheless, we took the people's money, we spent the people's money in operating expenses, we replaced it with an IOU, and I think we need to reconsider the accounting treatment for that and other areas, as well.

Last, we are on an unsustainable long-term fiscal path. Due to known demographic trends and rising health care costs, we face a sea of mounting red ink. We are not going to be able to grow our way out of this problem. It is going to be critically important that we engage in a fundamental baseline review of discretionary spending, mandatory spending, entitlement programs, and tax policy. It may take up to a generation to be able to deal with this gap, but the sooner we get started the better.

For the benefit of this committee, on February 16th, before a full committee hearing of Senate Homeland Security and Governmental Affairs, GAO will release an unprecedented 21st Century Challenges report which will summarize where we are and where we are headed. This report will raise a number of key questions that need to be asked—and hopefully answered—about the base of existing Government programs, policies, functions, and activities, and offer some possible alternatives for a way forward, because our country, our children, and our grandchildren are counting on us to deal with this problem. And in order to deal with it we need timely, accurate, useful financial reporting and we also need performance reporting that is results based so we can understand what is working and what is not working and where we are generating a return on investment and where we need to reconsider our current position and plan.

Thank you, Mr. Chairman.

Mr. PLATTS. Thank you, Mr. Walker.

[The prepared statement of Mr. Walker follows:]

United States Government Accountability Office

GAO

Testimony

Before the Committee on Government Reform, House of Representatives

For Release on Delivery
Expected at 2:00 p.m.
Wednesday, February 9, 2005

FISCAL YEAR 2004 U.S. GOVERNMENT FINANCIAL STATEMENTS

Sustained Improvement in Federal Financial Management Is Crucial to Addressing Our Nation's Future Fiscal Challenges

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

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Accountability * Integrity * Reliability

GAO-05-284T

February 9, 2005

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Accountability·Integrity·Reliability

Highlights

Highlights of GAO-05-284T, testimony before the Committee on Government Reform, House of Representatives

Why GAO Did This Study

GAO is required by law to annually audit the consolidated financial statements of the U.S. government. Proper accounting and reporting practices are essential in the public sector. The U.S. government is the largest, most complex, and most diverse entity on earth today. Its services—homeland security, national defense, Social Security, health care, mail delivery, and food inspection, to name a few—directly affect the well-being of almost every American. Sound decisions on the current results and future direction of vital federal government programs and policies are made more difficult without timely, reliable, and useful financial and performance information.

Until the problems discussed in GAO's audit report on the U.S. government's consolidated financial statements are adequately addressed, they will continue to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other information; (2) affect the federal government's ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs; (3) impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and (4) prevent the federal government from having reliable financial information to operate in an economical, efficient, and effective manner.

www.gao.gov/cgi-bin/getrpt?GAO-05-284T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Jeffrey C. Steinhoff or Gary T. Engel at (202) 512-2600.

FISCAL YEAR 2004 U.S. GOVERNMENT FINANCIAL STATEMENTS

Sustained Improvement in Federal Financial Management Is Crucial to Addressing Our Nation's Future Fiscal Challenges

What GAO Found

The federal government completed its consolidated financial statements on December 15, 2004. This is just 76 days after the end of the fiscal year—a record for timeliness. However, as in the previous 7 fiscal years, certain material weaknesses in internal control and in selected accounting and financial reporting practices resulted in conditions that continued to prevent GAO from being able to provide the Congress and American citizens an opinion as to whether the consolidated financial statements of the U.S. government are fairly stated in conformity with U.S. generally accepted accounting principles. Three major impediments to an opinion on the consolidated financial statements continue to be (1) serious financial management problems at the Department of Defense, (2) the federal government's ineffective process for preparing the consolidated financial statements, and (3) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies. Further, in our opinion, the federal government did not maintain effective internal control over financial reporting and compliance due to numerous material weaknesses.

While GAO was unable to express an opinion on the consolidated financial statements of the U.S. government, several key items deserve emphasis in order to put the information contained in the financial statements and Management's Discussion and Analysis in perspective. First, the federal government reported a $412.3 billion unified budget deficit and a $568 billion on-budget deficit in fiscal year 2004, representing approximately 3.6 percent and 4.9 percent of gross domestic product (GDP), respectively. Second, the U.S. government's reported liabilities, commitments, and other obligations grew by over $13 trillion in fiscal year 2004, primarily due to enactment of the new Medicare prescription drug benefit, and now surpass $43 trillion, representing close to four times current GDP. In addition, while the size of the nation's long-term fiscal imbalance grew significantly during the fiscal year, the retirement of the "baby boom" generation is closer to becoming a reality. Given these and other factors, it seems clear that the nation's current fiscal path is unsustainable and that tough choices by the President and the Congress will be necessary in order to address the nation's large and growing fiscal imbalance.

An emerging issue during fiscal year 2004 that merits concern and close scrutiny was the growing number of Chief Financial Officers (CFO) Act agencies that restated certain of their financial statements for fiscal year 2003 to correct errors. Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. The material internal control weaknesses discussed in this testimony serve to increase the risk that additional errors may occur and not be identified on a timely basis by management or the auditors, resulting in further restatements.

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 2004 and 2003. Both the consolidated financial statements and our report are included in the fiscal year 2004 *Financial Report of the United States Government*, which was issued by the Department of the Treasury (Treasury) in mid-December, 2004, and is available through GAO's Internet site, at www.gao.gov, and Treasury's Internet site, at www.fms.treas.gov/fr/index.html.

I would like to thank you for continuing the annual tradition of oversight hearings on this important subject. The involvement of your subcommittee remains critical to ultimately assuring continued progress in the financial management area while enhancing public confidence in the federal government as a financial steward that is accountable for its finances.

The federal government completed its consolidated financial statements on December 15, 2004. This is just 76 days after the end of the fiscal year—a record for timeliness. However, as in the 7 previous fiscal years, certain material weaknesses[1] in internal control and in selected accounting and financial reporting practices resulted in conditions that continued to prevent us from being able to provide the Congress and American citizens an opinion as to whether the consolidated financial statements of the U.S. government were fairly stated in conformity with U.S. generally accepted accounting principles (GAAP). Until the problems discussed in our report are adequately addressed, they will continue to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; (2) affect the federal government's ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs; (3) impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and (4) prevent the federal government from having reliable financial information to operate in an economical, efficient, and effective manner. Sound decisions on the current results and future direction of vital federal programs and policies are made

[1]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.

more difficult without timely, reliable, and useful financial and performance information.

While the federal government has not yet been able to prepare auditable financial statements, the requirement to do so at the consolidated level, as well as at the agency level, has already yielded important results. We see continuous movement toward the ultimate goals of annual accountability and, more importantly, of development of the day-to-day financial information that the federal government will need to best address today's budgetary challenges and the looming longer-term fiscal imbalance driven by, among other things, demographic trends, rising health care costs, and new homeland security and defense commitments. Across government, financial management improvement initiatives are under way, and if effectively implemented, have the potential to appreciably improve the quality of the federal government's financial management and reporting. Individual federal agencies continue to make some progress in their efforts to modernize their financial management systems and improve financial management performance as called for in the President's Management Agenda.[2]

The Office of Management and Budget (OMB) accelerated the fiscal year 2004 financial statements reporting date for agencies to November 15, 2004, as compared with January 30, 2004, for fiscal year 2003. Twenty-two of 23 Chief Financial Officers (CFO) Act agencies[3] were able to issue their fiscal year 2004 financial statements by the accelerated reporting date and the last one was issued during the first week of December. These reporting dates represent a significant improvement over fiscal year 2003 in the timeliness of CFO Act agencies' issuance of their financial statements.

[2]The President's Management Agenda is the administration's strategy for improving the management and performance of the federal government. Its purpose is to identify and address the most significant problems facing the federal government. It contains five governmentwide and nine agency-specific goals to improve federal management and deliver results to the American people.

[3]The Federal Emergency Management Agency (FEMA) was transferred to the new Department of Homeland Security (DHS) effective March 1, 2003. With this transfer, FEMA is no longer required to prepare and have audited stand-alone financial statements under the CFO Act, leaving 23 CFO Act agencies for fiscal year 2004. DHS, along with most other executive branch agencies, is required to prepare and have audited financial statements under the Accountability of Tax Dollars Act of 2002, Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002). The DHS Financial Accountability Act, Pub. L. No. 108-330, 118 Stat. 1275 (Oct. 16, 2004), added DHS to the list of CFO Act agencies and deleted FEMA, increasing the number of CFO Act agencies again to 24 for fiscal year 2005.

As shown in appendix I, for fiscal year 2004, 18 of 23 CFO Act agencies were able to attain unqualified audit opinions on their financial statements from inspectors general and their contract auditors responsible for those audits. With accelerated reporting, which we support in concept, it is even more imperative that federal agency management continue to work toward fully resolving the pervasive and generally long-standing material weaknesses that have been reported at the agency level for the past 9 fiscal years. Otherwise, federal agencies may risk incurring additional costs while at the same time sacrificing reliability to achieve accelerated reporting.

In identifying improved financial performance as one of its five governmentwide initiatives, the President's Management Agenda recognized that a clean (unqualified) financial audit opinion is a basic prescription for any well-managed organization. The Principals of the Joint Financial Management Improvement Program (JFMIP)[4] defined certain measures, in addition to receiving an unqualified financial statement opinion, for achieving financial management success. These additional measures include being able to routinely provide timely, accurate, and useful financial and performance information and having no material internal control weaknesses or material noncompliance with laws and regulations and the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).[5] As shown in appendix II, while the severity and magnitude of the problems identified vary greatly, our analysis of audit reports of inspectors general and their contract auditors showed that for fiscal year 2004 only 4 of the 23 CFO Act agencies had neither a material weakness in internal control, an issue involving compliance with applicable laws and regulations, nor an instance of lack of substantial compliance with the requirements of FFMIA.

In this testimony, I will discuss why sound financial management today and in the future is central to meeting our nation's large and growing long-term

[4]JFMIP was a joint and cooperative undertaking of the Department of the Treasury, GAO, OMB, and the Office of Personnel Management working in cooperation with each other and other federal agencies to improve financial management practices in the federal government. Leadership and program guidance were provided by the four Principals of JFMIP—the Comptroller General of the United States, the Secretary of the Treasury, and the Directors of OMB and the Office of Personnel Management. Although JFMIP ceased to exist as a stand-alone organization as of December 1, 2004, the JFMIP Principals will continue to meet at their discretion.

[5]FFMIA of 1996, Pub. L. No. 104-208, div. A, § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996)

fiscal imbalance. I will also discuss the growing number of CFO Act agencies that restated certain of their financial statements for fiscal year 2003 to correct errors—an emerging issue that merits concern and close scrutiny. I will then highlight the major issues relating to the consolidated financial statements for fiscal years 2004 and 2003, discuss systems problems that continue to hinder federal agency accountability, and describe progress that has been made toward addressing major impediments to an opinion on the consolidated financial statements.

The Nation's Fiscal Imbalance

First, I would like to spend a few minutes discussing our nation's worsening financial condition and long-range fiscal outlook. Last week, I spoke on this issue at the National Press Club as part of the Outlook 2005 Conference, which was attended by government, corporate, and nonprofit executives from around the country. I have attached a copy of my remarks at that conference to my testimony today as appendix III.

While we are unable to express an opinion on the U.S. government's consolidated financial statements, several key items deserve emphasis in order to put the information contained in the financial statements and the Management's Discussion and Analysis section of the *Financial Report of the United States Government* into context.

First, the federal government reported a $412.3 billion unified budget deficit and a $568 billion on-budget deficit in fiscal year 2004, representing approximately 3.6 percent and 4.9 percent of gross domestic product (GDP), respectively.[6] Second, the U.S. government's reported liabilities, commitments, and other obligations grew by over $13 trillion in fiscal year 2004, primarily due to the enactment of the new Medicare prescription drug benefit, and now surpass $43 trillion, representing close to four times current GDP.[7]

In March 2004, the Trustees of the Social Security and Medicare trust funds issued their respective 2004 annual reports on the current and projected

[6]The transactions of the Postal Service and the Social Security trust funds are classified as off-budget. As such, their reported surpluses—$4 billion for the Postal Service and $151 billion for the Social Security trust funds—are excluded from the on-budget deficit but included in the unified budget deficit.

[7]This represents the sum of selected fiscal exposures net of certain revenues (e.g., payroll taxes, beneficiary premiums) that fund some of these exposures.

status of these two programs. Once again, the trustees' reports confirmed that both the Social Security and Medicare programs are unsustainable in their present form. The trustees also noted that Medicare's financial difficulties are much more severe than those confronting Social Security. Furthermore, the new prescription drug benefit has significantly increased the federal government's commitments associated with the Medicare program. Specifically, in their 2004 report, the trustees estimated the present value cost to the federal government of this new benefit over the next 75 years to be $8.1 trillion as of January 1, 2004. The trustees reiterated the message contained in their previous reports that action to address the financial difficulties facing Social Security and Medicare should be taken in a timely manner and that the sooner these financial challenges are addressed, the more varied and less disruptive the solutions can be.

The federal government's gross debt[8] as of September 2004 was about $7.4 trillion, or about $25,000 for every man, woman, and child in the country. But that number excludes such items as the gap between promised and funded Social Security and Medicare benefits, veterans' health care, and a range of other liabilities, commitments, and contingencies that the federal government has pledged to support. If these items are factored in, the current dollar burden for every American rises to about $145,000 per person, or about $350,000 per full-time worker.

Current financial reporting does not clearly and transparently show the wide range of responsibilities, programs, and activities that may either obligate the federal government to future spending or create an expectation for such spending. Thus, it provides an unrealistic and even misleading picture of the federal government's overall performance, financial condition, and future fiscal outlook. Few federal agencies adequately show the results they are getting with the taxpayer dollars they spend. In addition, too many significant federal government revenues—as well as commitments and obligations such as those associated with Social Security and Medicare—are not adequately and consistently disclosed in the federal government's consolidated financial statements and budget, and current federal financial reporting standards do not require such disclosure. The Federal Accounting Standards Advisory Board recently completed a project on accounting and reporting of earmarked funds,

[8]The federal government's gross debt consists of debt held by the public and intragovernmental debt holdings

which include the Social Security and Medicare trust funds, and has a project underway to consider recognition, measurement, and display of social insurance obligations.

Figure 1 shows some selected fiscal exposures. The spectrum of these exposures ranges from explicit liabilities shown on the consolidated financial statements to implicit promises embedded in current policy or public expectations.[9] These liabilities, commitments, and promises have created a fiscal imbalance that will put unprecedented strains on the nation's future spending and tax policies. Although economic growth can help, the projected fiscal gap is now so large that the federal government will not be able to simply grow its way out of the problem. Tough choices by the President and the Congress are inevitable.

Figure 1: Selected Fiscal Exposures: Sources and Examples[a]

Type	Example (dollars in billions)
Explicit liabilities	Publicly held debt ($4,297) Military and civilian pension and postretirement health ($3,059) Veterans benefits payable ($925) Environmental and disposal liabilities ($249) Loan guarantees ($43)
Explicit financial commitments	Undelivered orders ($596) Long-term leases ($39)
Financial contingencies	Unadjudicated claims ($4) Pension Benefit Guaranty Corporation ($96) Other national insurance programs ($1) Government corporations e.g., Ginnie Mae
Exposures implied by current policies or the public's expectations about the role of government	Debt held by government accounts ($3 071)[b] Future Social Security benefit payments ($3 699)[c] Future Medicare Part A benefit payments ($8,236)[c] Future Medicare Part B benefit payments ($11,416)[c] Future Medicare Part D benefit payments ($8,119)[c] Life-cycle cost including deferred and future maintenance and operating costs (amount unknown) Government Sponsored Enterprises e.g., Fannie Mae and Freddie Mac

Source: GAO analysis of data from the Department of the Treasury, the Office of the Chief Actuary, Social Security Administration, and the Office of the Actuary, Centers for Medicare and Medicaid Services.

[a]All figures are for end of fiscal year 2004, except Social Security and Medicare estimates, which are as of January 1, 2004.

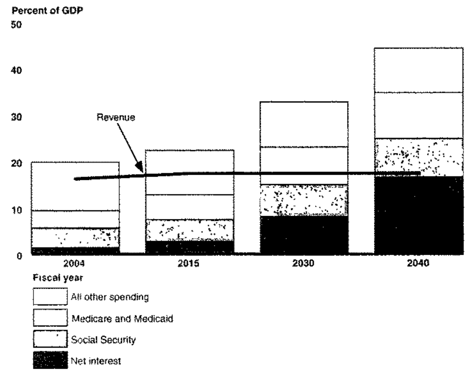
[9]While the selected fiscal exposures list provides some perspective on the range and magnitude of exposures facing the federal government, it is neither meant to be comprehensive nor to represent a universally agreed-upon list. A broader discussion of fiscal exposures can be found in GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

[b]This amount includes $845 billion held by military and civilian pension and postretirement health funds that would offset the explicit liabilities reported by those funds.

[c]Figures for Social Security and Medicare are net of debt held by the trust funds ($1,531 billion for Social Security, $256 billion for Medicare Part A, and $24 billion for Medicare Part B) and represent net present value estimates over a 75-year period. Over an infinite horizon, the estimate for Social Security would be $10.4 trillion, $21.8 trillion for Medicare Part A, $23.2 trillion for Medicare Part B, and $16.5 trillion for Medicare Part D.

GAO's fiscal policy simulations illustrate that the fiscal policies in place today—absent substantive entitlement reform or unprecedented changes in tax and/or spending policies—will result in large, escalating, and persistent deficits that are economically unsustainable over the long term. Assuming that discretionary spending grows with inflation and all existing tax cuts are allowed to expire when scheduled under current law, spending for Social Security and health care programs would grow to consume over three-quarters of federal revenue by 2040. Moreover, if all expiring tax provisions are extended and discretionary spending keeps pace with the economy, by 2040 total federal revenues may be adequate to pay little more than interest on the federal debt. Without reform, known demographic trends, rising health care costs, and projected growth in federal spending for Social Security, Medicare, and Medicaid will result in massive fiscal pressures that, if not effectively addressed, could cripple the economy, threaten our national security, and adversely affect the quality of life of Americans in the future.

Figure 2: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended



Source: GAO's January 2005 analysis.

Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the alternative minimum tax, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

The President and the Congress face the challenge of sorting out the many claims on the federal budget without the budget enforcement mechanisms or fiscal benchmarks that guided the federal government through the years of deficit reduction into a brief period of federal surpluses. While a number of steps will be necessary to address this challenge, as outlined in my February 2, 2005, remarks at the Press Club, truth and transparency in federal government financial reporting and budgeting are essential elements of any attempt to address the nation's long-term fiscal challenges. Further, Congress needs to have access to the long-term cost of selected spending and tax proposals before they enact related laws. The fiscal risks just mentioned can be managed only if they are properly accounted for and publicly disclosed, including the many existing commitments facing the federal government. In addition, new budget control mechanisms will be required, along with effective approaches to successfully engage in a fundamental review, reassessment, and reprioritization of the base of federal government programs and policies. In this regard, we should not assume that all defense and homeland security expenditures are both necessary and prudent. Furthermore, the use of across-the-board adjustments to address the spending imbalance serves to avoid making the necessary difficult choices, is inequitable, and simply will not get the job done.

Potential Impact of Restatements on Agencies' Financial Statements

An emerging issue during fiscal year 2004 that merits concern and close scrutiny was the growing number of CFO Act agencies that restated certain of their financial statements for fiscal year 2003 to correct errors. As shown in appendix II, at least 11[10] of the 23 CFO Act agencies fell into this category as compared with at least 5 CFO Act agencies that had restatements covering their fiscal year 2002 financial statements in fiscal year 2003. At least 3 CFO Act agencies had restatements in both years. For example, in fiscal year 2003, one agency misstated certain of its fiscal year 2002 financial statements by about $1 billion. The following year, this same agency restated certain of its fiscal year 2003 financial statements by over $5 billion. Nonetheless, for both years, the agency received unqualified audit opinions on its financial statements.

Nine of the 11 agencies having restatements for fiscal year 2003 had received unqualified opinions on their originally issued fiscal year 2003 financial statements. Seven of the nine auditors issued unqualified opinions on the restated financial statements, which in substance replace the auditors' opinions on their respective agencies' original fiscal year 2003 financial statements. For two of these nine, the auditors not only withdrew their unqualified opinion on the fiscal year 2003 financial statements but also issued other than unqualified opinions[11] on their respective agencies'

[10]The number of reported restatements in this testimony differs from our audit report dated December 6, 2004, because it includes one additional agency for which audit documentation was not made available to us in time to complete our planned audit procedures as of the date of our audit report.

[11]The auditors for the Department of Justice withdrew the unqualified opinion that had been previously rendered on the department's fiscal year 2003 financial statements and issued a disclaimer of opinion on these restated financial statements, and the auditors for the Nuclear Regulatory Commission withdrew the unqualified opinion on the commission's fiscal year 2003 financial statements and issued a qualified opinion on these restated financial statements.

restated fiscal year 2003 financial statements because they could not determine whether there were any additional misstatements and the effect that such could have on the restated fiscal year 2003 financial statements.

The material internal control weaknesses discussed in this testimony increase the risk that additional misstatements may occur and not be identified on a timely basis by management or the auditors, resulting in further restatements. Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. According to Statement of Federal Financial Accounting Standards (SFFAS) No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, prior period financial statements presented should only be restated for corrections of errors that caused such statements to be materially misstated. Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. The restatements to CFO Act agencies' fiscal year 2003 financial statements ranged from correcting two line items on one agency's balance sheet to numerous line items on several of another agency's financial statements. The amounts of the agencies' restatements ranged from several million dollars to over $91 billion.

As part of our fiscal year 2004 audit, we reviewed certain federal agencies' fiscal year 2003 Statement of Budgetary Resources (SBR)[12] for consistency of (1) certain information reported in the SBR with related information reported in the agencies' other financial statements and notes and (2) the offsetting receipts and net outlays reported in the SBR with published governmentwide reports. We found significant inconsistencies in these areas, which we brought to the attention of these agencies and their auditors prior to completion of their fiscal year fiscal year 2004 audits. For example, we notified a federal agency that the net outlays reported in its fiscal year 2003 SBR were overstated by about $91 billion due to certain offsetting receipts that were not reported in the SBR as offsets to outlays, as required by OMB guidance. In fiscal year 2004, this agency's fiscal year 2003 SBR was restated, reducing its previously reported net outlays from $596 billion to $505 billion. At least four of the nine agencies that received

[12]The Statement of Budgetary Resources provides information about how the resources available to the agencies were obtained (appropriations, other receipts, etc.) and used (obligations incurred and status of unobligated resources), and also reports the agencies' net outlays.

unqualified opinions on their fiscal year 2003 financial statements restated certain of these financial statements in fiscal year 2004 to address some of the significant inconsistencies we identified in the SBR.

The transparency of the restatements in the agency auditors' reports and the agencies' financial statements is also a concern of ours.[13] We believe that the auditor's report should clearly inform the reader about the correction of a material misstatement. In our view, the reader of the financial statements and auditor's report should be able to readily understand that the financial statements originally issued by management in the previous year and the opinion thereon should no longer be relied on and instead the restated financial statements and the related auditor's opinion should be used. The reader should also be able to gain at least a basic understanding as to why the agency needed to restate its prior year financial statements and the impact of the restatement on the financial statements.

In our preliminary review of the fiscal year 2003 restatements, several issues regarding the inadequate transparency in connection with the reporting on the restatements were readily apparent. First, two of the nine agency auditors that had issued unqualified opinions the previous year on their respective agencies' originally issued fiscal year 2003 financial statements did not include a reference to management's restatement footnote in their audit reports. Second, while our analysis of restatements is just underway, the information included in the auditors' reports along with the agency's financial statements were in some instances not sufficient in our view for a reader of the financial statements to clearly understand the error that occurred and the effects it had on the financial statements. Third, while U.S. generally accepted accounting principles do not expressly require financial statements to be labeled as restated, 9 of the 11 agencies having fiscal year 2003 restatements did so, which we support. However, 2 of the 11 did not label their prior year restated financial statements as restated, which we believe also demonstrates a lack of transparency. As I highlighted earlier, in keeping with full transparency and accountability, when restatements occur, all readers should be able to understand the ramifications of what happened and that the financial statements originally issued by management, along with the related auditor's opinion, should no longer be relied on. Furthermore, agencies

[13]U.S. auditing standards require, in certain circumstances, that auditors' reports refer to or discuss restatements.

that have to restate their prior year financial statements for material errors should not refer to their prior year opinions as having been unqualified since, by definition, the restatement means they should not have received an unqualified opinion on their prior year's statement(s).

We plan to perform a more detailed review of the nature and causes of the restatements during our audit of the fiscal year 2005 consolidated financial statements, and later this year will report separately on the results of this work.

Highlights of Major Issues Related to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2004 and 2003

As I mentioned earlier, as has been the case for the previous 7 fiscal years, the federal government continues to have a significant number of material weaknesses related to financial systems, fundamental recordkeeping and financial reporting, and incomplete documentation. Several of these material weaknesses, which generally have existed for years, contributed to our disclaimer of opinion on the U.S. government's consolidated financial statements for the fiscal years ended September 30, 2004, and 2003.[14] Appendix IV describes these material deficiencies in more detail and highlights their primary effects on the consolidated financial statements and on the management of federal government operations. There may also be additional issues that could affect the consolidated financial statements that have not been identified. The material deficiencies we identified were the federal government's inability to

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by the Department of Defense (DOD), were properly reported in the consolidated financial statements;
- reasonably estimate or adequately support amounts reported for certain liabilities, such as environmental and disposal liabilities, or determine whether commitments and contingencies were complete and properly reported;

[14] We previously reported that material deficiencies prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2003.

- support significant portions of the total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain agencies;
- ensure that the federal government's consolidated financial statements were consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP;
- adequately account for and reconcile intragovernmental activity and balances between federal agencies; and
- resolve material differences that exist between the total net outlays reported in federal agencies' SBRs and the records used by Treasury to prepare the Statements of Changes in Cash Balance.

In addition to these material deficiencies, we found four other material weaknesses in internal control as of September 30, 2004. These weaknesses are discussed in more detail in appendix V, including their primary effects on the consolidated financial statements and on the management of federal government operations. These material weaknesses were the federal government's inability to

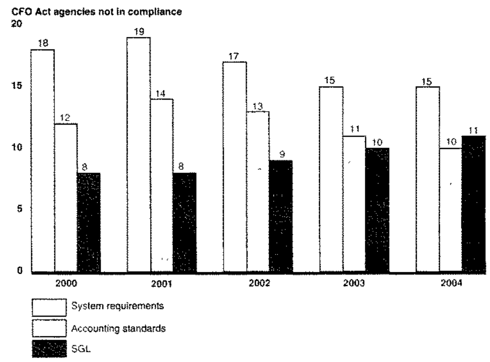
- implement effective processes and procedures for properly estimating the cost of certain lending programs, related loan guarantee liabilities, and value of direct loans;
- determine the extent to which improper payments exist;
- identify and resolve information security control weaknesses and manage information security risks on an ongoing basis; and
- effectively manage its tax collection activities.

Continuing Systems Problems Hinder Accountability

The ability to produce the data needed for efficient and effective management of day-to-day operations in the federal government and provide the necessary accountability to taxpayers and the Congress has been a long-standing challenge at most federal agencies. The results of the fiscal year 2004 assessments performed by agency inspectors general or their contract auditors under FFMIA show that these problems continue to affect financial management systems at most of the 23 CFO Act agencies. While the problems are much more severe at some agencies than at others, the nature and severity of the problems indicate that overall, management at most CFO Act agencies lacks the complete range of information needed for accountability, performance reporting, and decision making. These problems include nonintegrated financial systems, lack of accurate and timely recording of data, inadequate reconciliation procedures, and noncompliance with accounting standards and the U.S. Government Standard General Ledger (SGL).

The inability of agencies to meet federal financial management systems requirements continues to be the major barrier to achieving compliance with FFMIA. Under FFMIA, CFO Act agency auditors are required to report whether agencies' financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the SGL at the transaction level as part of the agencies' financial statement audits. These factors are critical for improving accountability over government operations and routinely producing sound cost and operating performance information. As shown in figure 3, instances of noncompliance with federal financial management systems requirements were the compliance issue most frequently reported by auditors. These instances of noncompliance involved not only core financial systems, but also administrative and programmatic systems.

Figure 3: Auditors' FFMIA Assessments for Fiscal Years 2000 through 2004



Source: Independent auditors' reports for fiscal years 2000 through 2004 prepared by agency inspectors general and contract auditors.

For fiscal year 2004, auditors for 16 of the 23 CFO Act agencies reported that the agencies' financial management systems did not comply substantially with one or more of FFMIA's three requirements. For 6 of the remaining 7 CFO Act agencies, auditors provided negative assurance, meaning that nothing came to their attention indicating that the agencies' financial management systems did not substantially meet FFMIA requirements. The auditors for these 6 agencies did not definitively state whether the agencies' systems substantially complied with FFMIA requirements, as is required under the statute. In contrast, auditors for the Department of Labor provided positive assurance by stating that, in their opinion, the department's financial management systems substantially complied with the requirements of FFMIA. The Department of Homeland Security (DHS) was not subject to the requirements of the CFO Act in fiscal year 2004[15] and, consequently, was not required to comply with FFMIA. Accordingly, DHS's auditors did not report on DHS's compliance with FFMIA. However, the auditors identified and reported deficiencies that related to the aforementioned three requirements of FFMIA. With the recent passage of the Department of Homeland Security Financial Accountability Act,[16] DHS has been designated as a CFO agency. With this designation, DHS is now required to implement and maintain financial management systems that comply with FFMIA, and its auditors will be required to report on the department's financial management systems' compliance beginning with fiscal year 2005.

In an effort to address problems such as nonintegrated systems, inadequate reconciliations, and lack of compliance with the SGL, a number of agencies have efforts underway to implement new financial management systems or to upgrade existing systems. Agencies expect that the new systems will provide reliable, useful, and timely data to support managerial decision making and assist taxpayer and congressional oversight. Whether in government or the private sector, implementing and upgrading systems is a difficult job and brings a degree of new risk. Organizations that follow and effectively implement accepted best practices in systems development and implementation (commonly referred to as disciplined processes) can manage and reduce these risks to acceptable levels. However, our work at DOD,[17] the Department of Health and Human Services (HHS),[18] and the National Aeronautics and Space Administration[19] has shown that these agencies, which all have experienced significant problems in implementing new financial management systems, are not following the necessary

[15]For fiscal year 2004, DHS is required to prepare and have audited financial statements under the Accountability of Tax Dollars Act of 2002, Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002).

[16]Pub. L. No. 108-330, 118 Stat. 1275, 1277 (Oct. 16, 2004).

[17]GAO, *DOD Business Systems Modernization: Billions Continue to Be Invested with Inadequate Management Oversight and Accountability*, GAO-04-615 (Washington, D.C.: May 27, 2004).

[18]GAO, *Financial Management Systems: Lack of Disciplined Processes Puts Implementation of HHS' Financial System at Risk*, GAO-04-1008 (Washington, D.C.: Sept. 23, 2004).

[19]GAO, *National Aeronautics and Space Administration: Significant Actions Needed to Address Long-standing Financial Management Problems*, GAO-04-754T (Washington, D.C.: May 19, 2004).

disciplined processes for efficient and effective development and implementation of such systems. Further, the Department of Veterans Affairs recently halted pilot implementation of its new core financial system, in which it had invested a reported $249 million. The problems cited by the Department of Veterans Affairs Office of Inspector General were similar to those we noted at DOD, HHS, and the National Aeronautics and Space Administration. As the federal government moves forward with ambitious modernization efforts to identify opportunities to eliminate redundant systems and enhance information reliability and availability, adherence to disciplined processes will be a crucial element to reduce risks to acceptable levels. Given the nature and magnitude of the problems facing federal agencies, we recognize that it will take time, investment, and sustained emphasis to successfully modernize agencies' underlying financial management systems.

Addressing Major Impediments to an Opinion on Consolidated Financial Statements

For the past 8 fiscal years, the federal government has been required to prepare, and have its consolidated financial statements audited. Successfully meeting this requirement is closely linked to the requirements for the CFO Act agencies (and now all covered executive agencies) to also have audited financial statements. This has resulted in extensive cooperative efforts and considerable attention by agency chief financial officers, inspectors general, Treasury and OMB officials, and GAO. With the benefit of the past 8 years' experience in having the required financial statements subjected to audit, more intensified attention will be needed on the most serious obstacles to achieving an opinion on the U.S. government's consolidated financial statements. There are three primary ongoing reasons why the consolidated financial statements remained unauditable for fiscal year 2004: (1) serious financial management problems at DOD, (2) the federal government's ineffective process for preparing the consolidated financial statements, and (3) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies.

Financial Management at DOD

Essential to achieving an opinion on the consolidated financial statements is resolution of the serious financial management problems at DOD, which we have designated as high risk[20] since 1995. Overhauling DOD's financial management operations represents a challenge that goes far beyond financial accounting to the very fiber of DOD's range of business operations, management information systems, and culture. DOD's financial management problems 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[21] because of pervasive weaknesses in financial management systems, operations, and controls. The seriousness of the weaknesses in DOD's business operations underscores the importance of no longer condoning the status quo at DOD. Although the Secretary of Defense and several key agency officials have shown commitment to transformation, as evidenced by key initiatives such as the Business Management Modernization Program and the Financial Improvement Initiative, little tangible evidence of significant broad-based and sustainable improvements has been seen in DOD's business operations to date. For example, the department's former comptroller started the Financial Improvement Initiative with the goal of obtaining an unqualified opinion for fiscal year 2007 on DOD's departmentwide financial statements; however, the initiative still lacks a clearly defined, well-documented, and realistic plan to make the stated goal a reality. In particular, the initiative lacks several of the key elements critical to success, including (1) a comprehensive, integrated plan; (2) results-oriented goals and performance measures; and (3) effective oversight and monitoring. For DOD to successfully transform its business operations, it will need a comprehensive and integrated business transformation plan; people with the skills, responsibility, and authority to implement the plan; an effective process and related tools, such as a business enterprise architecture;[22] and results-oriented performance measures that link institutional, unit, and individual personnel goals and expectations to promote accountability for results.

[20]GAO identifies areas at high risk due to either their greater vulnerabilities to waste, fraud, abuse, and mismanagement or major challenges associated with their economy, efficiency, or effectiveness.

[21]Although not major DOD components, the Military Retirement Fund received an unqualified opinion on its fiscal year 2004 financial statements, and the DOD Medicare-Eligible Retiree Health Care Fund received a qualified opinion on its fiscal year 2004 financial statements.

[22]A business enterprise architecture is a well-defined blueprint for operational and technological change.

Preparing the Consolidated Financial Statements

The federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP. During fiscal year 2004, Treasury made progress in laying the foundation to address certain long-standing material deficiencies in preparing the consolidated financial statements. Foremost is the ongoing development of a new system, the Governmentwide Financial Reporting System (GFRS), to collect agency financial statement information directly from federal agencies' audited financial statements rather than using federal agencies' SGL data as Treasury had done in previous years to compile the consolidated financial statements. The goal of the new system is to be able to directly link information from federal agencies' audited financial statements to amounts reported in the consolidated financial statements, a concept that we strongly support. For the fiscal year 2004 reporting process, Treasury's GFRS was able to capture certain agency financial information from agencies' audited financial statements, which is an important first step. The automated system, though, was not yet at the stage of development that it could be used to compile the consolidated financial statements from the information that was captured.

Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. OMB and Treasury require the CFOs of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners.[23] In addition, these agencies are required to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the agencies did not fully perform the required reconciliations for fiscal years 2004 and 2003. For fiscal year 2004, based on trading partner information provided in GFRS, Treasury produced a "Material Difference Report" for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners. After analysis of the material

[23] Trading partners are U.S. government agencies, departments, or other components included in the consolidated financial statements that do business with each other.

differences, a significant number of CFOs cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Many CFOs simply indicated that they were unable to explain the differences with their trading partners. For both fiscal years 2004 and 2003, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. As a result, the federal government's ability to determine the impact of these differences on the amounts reported in the consolidated financial statements is impaired. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a commitment by federal agencies and strong leadership and oversight by OMB.

Closing Comments

The U.S. government is the largest, most complex and most diverse entity on earth today. Its services and programs—homeland security, national defense, Social Security, health care, mail delivery, and food inspection, to name just a few—directly affect the well-being of almost every American. Our nation's large and growing long-term fiscal imbalance, which is driven largely by known demographic trends and rising health care costs—coupled with new homeland security and defense commitments and the recent downward trend in revenue as a share of GDP—continues to sharpen the need to fundamentally review and reexamine basic federal entitlements, as well as other mandatory and discretionary spending and tax policies. Clearly, tough choices will be required to address the resulting structural imbalance.

Sound decisions on the current results and future direction of vital federal programs and policies are made more difficult without timely, reliable, and useful financial and performance information. Proper accounting and financial reporting practices are essential in the public sector. Until the problems discussed in our audit report are adequately addressed, they will continue to present a number of adverse implications for the federal government and the taxpayers, which are outlined in our report. At the same time, the need for timely, reliable, and useful financial and performance information is greater than ever.

There will need to be ongoing and sustained top management attention to business systems transformation at DOD to address what are some of the most difficult financial management challenges in the federal government. As noted in our recent high-risk report, we also believe that the implementation of a new Chief Management Officer position at DOD will be needed in order for the department to succeed in its overall business transformation plan. Further, continued leadership from OMB and Treasury will be important to resolve the issues that have prevented us from expressing an opinion on the consolidated financial statements.

In closing, Mr. Chairman, I want to reiterate the value of sustained congressional interest in these issues, as demonstrated by your subcommittee's hearings. 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.

Contacts

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Appendix I

Fiscal Year 2004 Audit Results

Selected Major Federal Departments and Agencies: Fiscal Year 2004 Audit Results, Principal Auditors, and Number of Other Audit Contractors

23 CFO Act agencies	Audit results	Principal auditor	Number of other audit contractors
Agency for International Development	Unqualified	Inspector General	1
Agriculture	Unqualified	Inspector General	3
Commerce	Unqualified	KPMG LLP	0
Defense	Disclaimer	Inspector General	1
Education	Unqualified	Ernst & Young LLP	0
Energy	Unqualified	KPMG LLP	0
Environmental Protection Agency	Unqualified	Inspector General	0
General Services Administration	Unqualified	PricewaterhouseCoopers LLP	0
Health and Human Services	Unqualified	Ernst & Young LLP	3
Housing and Urban Development	Disclaimer	Inspector General	1
Interior	Unqualified	KPMG LLP	0
Justice	Disclaimer	KPMG LLP	2
Labor	Unqualified	R. Navarro & Associates, Inc.	2
National Aeronautics and Space Administration	Disclaimer	Ernst & Young LLP	0
National Science Foundation	Unqualified	KPMG LLP	0
Nuclear Regulatory Commission	Unqualified	R. Navarro & Associates, Inc.	0
Office of Personnel Management	Unqualified	KPMG LLP	0
Small Business Administration	Qualified[a]	Cotton & Company LLP	0
Social Security Administration	Unqualified	PricewaterhouseCoopers LLP	2
State	Unqualified	Leonard G. Birnbaum and Company, LLP	4
Transportation	Unqualified	Inspector General	2
Treasury	Unqualified	KPMG LLP	5[b]
Veterans Affairs	Unqualified	Deloitte & Touche LLP	0
Other major agency			
Homeland Security	Disclaimer	KPMG LLP	0

Source: GAO.

[a]The Small Business Administration received qualified opinions on its fiscal year 2004 consolidated balance sheet and statements of net cost, changes in net position, and financing, and an unqualified opinion on its fiscal year 2004 combined statement of budgetary resources.

[b]In addition, GAO audited the Internal Revenue Service's financial statements and the Schedules of Federal Debt Managed by the Bureau of the Public Debt.

Appendix II

Fiscal year 2004 and 2003 Agency Results

	Agencies auditors' rendered unqualified opinions		Agencies restated previous year financial statements		Agencies auditors' reported unqualified opinions with no material weaknesses or noncompliance	
Agencies	2004	2003	2004	2003	2004	2003
Agency for International Development	✓	✓				
Agriculture	✓	✓	✓	✓		
Commerce	✓	✓				
Defense			✓			
Education	✓	✓				
Energy	✓	✓			✓	✓
Environmental Protection Agency	✓	✓				
General Services Administration	✓	✓	✓			
Health and Human Services	✓	✓	✓	✓		
Homeland Security						
Housing and Urban Development		✓				
Interior	✓	✓		✓		
Justice		[a]	✓			
Labor	✓	✓			✓	
National Aeronautics and Space Administration						
National Science Foundation	✓	✓	✓		✓	✓
Nuclear Regulatory Commission	✓	[b]	✓			
Office of Personnel Management	✓	✓	✓			
Small Business Administration			✓			
Social Security Administration	✓	✓			✓	✓
State	✓	✓	✓			
Transportation	✓	✓	✓	✓		
Treasury	✓	✓		✓		
Veterans Affairs	✓	✓				
Total	18	18	11	5[c]	4	3

Source: GAO.

[a]The auditors for the Department of Justice withdrew the unqualified opinion that had been previously rendered on the department's fiscal year 2003 financial statements and issued a disclaimer of opinion on these restated financial statements.

[b]The auditors for the Nuclear Regulatory Commission withdrew the unqualified opinion that had been previously rendered on the commission's fiscal year 2003 financial statements and issued a qualified opinion on these restated financial statements.

[c]20 of the agencies listed, including the 5 with restatements, had received unqualified opinions on their originally issued fiscal year 2002 financial statements.

Outlook 2005 Conference The National Press Club February 2, 2005

Saving our Nation's Future: An Intergovernmental Challenge

Keynote Address By the Honorable David M. Walker Comptroller General of the United States

Thank you for that kind introduction and for the opportunity to speak to you today.

As a federal official speaking at this state and local conference, it is important to note at the outset that in today's world governments, institutions, and individuals are increasingly interconnected and interdependent. This trend is occurring both internationally and domestically and among different economic and social sectors. From a federal, state, and local government perspective, this interconnection and interdependence involves a range of issues, including tax policy, education, the environment, health care, homeland security, social welfare, and transportation.

I could talk about any number of intergovernmental challenges, but today I plan to brighten the lights and turn up the heat on an overarching problem that too many people seem content to put on the back burner. That problem is our nation's worsening financial condition and long-range fiscal outlook.

I'm sad to say that since I last spoke on this issue here at the National Press Club back in September of 2003, our nation's long-range fiscal imbalance has deteriorated significantly. Furthermore, as you all know, most state and local governments also have their own fiscal challenges and are having to make increasingly difficult choices.

We now confront three large and interrelated national deficits. The first is a large federal budget deficit. The second is a growing balance-of-payments deficit. And the third is an alarming personal savings deficit.

Frankly, it's easy to dismiss government deficits and debt as someone else's problem. But in my view, every American has both a personal reason and a civic responsibility to become more informed and involved in the coming debate over our collective fiscal future.

The American people need to realize that the fiscal choices being made in Washington today have profound consequences for the future of our country, and our children. In a nutshell, these fiscal choices will directly affect our future national security, economic vitality, and quality of life.

In the past, Americans have shrugged off warnings about the impending deficit and debt crises. Many Americans are too focused on today and aren't thinking enough about tomorrow. As Walter Shapiro pointed out in a recent column in USA Today, low interest rates and modest inflation give many Americans a false sense of security. These false perceptions are reinforced by the government's financial statements, which currently do not provide a full and fair view of our nation's current financial condition and long-term outlook. The simple truth is that our nation's financial condition is much worse than advertised. In addition, due largely to the looming retirement of the baby boomers, surging health care costs, and relatively low federal revenues as a percentage of the economy, we now face decades of red ink.

One aspect of government financial reporting in which I'm directly involved as Comptroller General of the United States is the audit of the federal government's consolidated financial statements. Every year, the federal government is required to issue a comprehensive report on its finances and operations. My agency, the U.S. Government Accountability Office (GAO), has a statutory responsibility to audit these financial statements. As the person who has to sign GAO's audit report, and a CPA, I have an official as well a professional and personal interest in ensuring that the federal government is accountable to the taxpayers. The federal government's fiscal 2004 report was issued in record time. Unfortunately, for the eighth year in a row, GAO was unable to vouch for the accuracy and completeness of the information in the financial statements.

Recent accountability failures in the private sector underscore the importance of accurate and timely financial reporting. The scandals at Enron, Worldcom, and other corporations have led to restatements of financial statements and bankruptcies that have harmed countless shareholders, employees, pensioners, and other stakeholders, including entire communities. Here in Washington, the recently announced restatements at Fannie Mae and Freddie Mac hit uncomfortably close to home. We at GAO are committed to doing our best to ensure that such accountability failures are not repeated in the federal government.

Beyond the financial statement numbers, what does the federal government's annual report say about the results that are being achieved with the taxpayer dollars being spent? The answer is not much! It's bad enough that too few agencies adequately show the results they are getting with the taxpayer dollars they spend, but policymakers also frequently do not focus on the-long-term impact of new spending and tax proposals before taking action on related legislation. Particularly troubling are the enormous commitments that we face in connection with Social Security, Medicare, Medicaid, and veteran's health care. Down the line, we could also be facing potential federal bailouts of several entities like the Pension Benefit Guaranty Corporation.

Over the years, our federal fiscal debates have gone from millions to billions to trillions. Unless you're an economist, a statistician, an actuary, or a CPA, these numbers are mind-boggling. What's a million dollars? When it comes to the federal government, a million dollars is practically pocket change. Last year, the federal government experienced a deficit that averaged more than $1 billion each and every day. That is more than $750,000 a minute.

If you're honest about keeping score and include promised but unfunded Social Security and Medicare benefits along with explicit benefit and other commitments, the federal government's obligations, current liabilities and unfunded fiscal commitments are over $43 trillion and rising. In the last year alone, this amount has risen by more than $13 trillion, largely due to the new Medicare prescription drug benefit. Yes, that's trillions with 12 zeros rather than billions with 9 zeros. To put that number into perspective, even with the recent run up in housing prices, the estimated total net worth of every American, including Bill Gates and other billionaires, is only about $47 trillion. That means that every American would have to fork over more than 90 percent of their net worth to cover the government's current promises. Stated differently, the current burden for every American works out to more than $145,000. The numbers are even worse for full-time workers, whose share now exceeds $350,000. That amount is growing every day and it isn't even tax deductible! Keep in mind that the average family income in this country is around $42,000 a year.

As bad as these numbers are, it's the real-life consequences of unchecked deficits that are truly frightening. For example, if we continue as we have, higher interest rates are inevitable. It's only a matter of when and how high. As government borrows more and more money to finance its debt, less money will be available for companies to invest to stay competitive in today's global economy. Without meaningful changes, long-term economic growth will suffer, and along with it American jobs and purchasing power. And don't forget that high budget deficits can lead to slower growth, higher interest rates and higher inflation, which in many respects is the cruelest tax of all.

By continuing to run huge budget deficits, America is partially ceding control over its own destiny to others. Why? Because America's personal savings rate has reached historic lows. So guess who's been financing much of our spending spree in recent years? The answer is foreign investors. Since 1993 the share of publicly held debt owned by international investors has more than doubled, from 19% to over 40%. Last year, foreign investors purchased nearly $399 billion in Treasury securities—just $13 billion less than the size of the 2004 deficit! If these foreign investors lose confidence in U.S. securities as a safe haven and start to move their money elsewhere, our economy could take a serious and sudden hit. The recent decline in the value of the dollar may be a warning shot in this regard.

Mounting deficits and debt will also eventually imperil many government programs and services that Americans have come to take for granted. The reality is that government functions like national defense, homeland security, education, transportation, and our judicial system fall under the category of "discretionary spending." These programs are facing increasing budget pressures, and our ability to respond to new and emerging needs is also being constrained. If we don't get serious soon, many important programs at the state and local level will also feel the crunch. Right now, state and local governments play a key role in a range of important functions, such as educating our children, housing the poor, delivering health care, and building roads and bridges. But in the future, state and local governments may not be able to count on as much federal help. Furthermore, states may also face additional unfunded federal mandates.

In the past, particularly in the decades since World War II, America was the world's engine of economic growth. We still are, but our long-term fiscal gap is so great today that there's no way we'll be able to grow our way out of the problem. Using plausible assumptions, closing our fiscal gap would require average real growth in double-digits for the next 75 years. By any measure, that's unrealistic. In fact, even during the boom years of the 1990s, the economy grew at an average annual real rate of only 3.2 percent.

If we continue on our present path, we'll see pressure for deep spending cuts or dramatic tax increases. GAO's long-term budget simulations paint a chilling picture. If we do nothing, by 2040 we may have to cut federal spending by more than half or raise federal taxes by more than two and half times to balance the budget. Clearly, the status quo is both unsustainable and difficult choices are unavoidable. And the longer we wait, the more onerous our options will become and the less transition time we will have.

So how do we start to turn things around? At the federal level, a crucial first step is to insist on truth and transparency in government operations, including federal financial reporting. The federal government must provide a fuller and fairer picture of existing budget deficits, the so-called "trust funds," and the growing financial burdens facing every American.

On the budget side, the current 10-year cash-flow projections are an improvement over past practices. But given known demographic trends, even these projections fail to capture the long-term consequences of today's spending and tax policy choices. In my view, elected representatives should have more explicit information on the present value dollar costs of major spending and tax bills—before they vote on them. This was not the case when Congress passed the Medicare prescription drug bill with its $8.1 trillion price tag. The time has also come to reinstate budget controls, such as reasonable spending caps and responsible "pay-go" rules which would require any new spending increases or tax cuts to be paid for by equivalent tax increases and/or spending cuts.

Further reforms to the substance and timing of the current appropriations and authorization processes may also be needed. When considering these reforms, we should look to the states. In some ways, the states are way ahead of the federal government in dealing with fiscal imbalances. They have made hard choices in the past— partly driven by their state constitutions, partly by their inability to print money and partly by their sensitivity to their bond ratings!

From a more strategic and results based perspective, we also need to develop a set of key national performance and outcome-based indicators to measure America's position and progress on a range of economic, security, environmental, and social issues. Key indicators can help to inform strategic planning, enhance performance and accountability reporting, and improve key decision-making. Several countries, states, and localities have already adopted key indicator systems, but I'm sorry to say the United States still lacks such a system at the national level. This has meant that at times our policymakers have been flying blind, not unlike an airplane pilot at night without an instrument panel. Importantly, we are currently looking at how states use performance information to reprioritize their budgets in tight fiscal times. We are also working with the National Academies and the OECD to help make key indicators become a reality in the U.S. and elsewhere.

Think about it. Each year, the federal government spends more than $2 trillion on a wide range of programs and operations, provides hundreds of billions of dollars in tax preferences, and issues thousands of pages of regulations. And it does all this without having enough knowledge about whether federal policies, programs, and activities are making a real difference. Based on where we are headed, we need to engage in a base-line review of the entire federal government that encompasses three key dimensions.

First, we need to undertake a top-to-bottom review of government programs, policies, functions, and activities to ensure their relevance for the 21st century. This includes both discretionary and mandatory spending. Today, many if not most government policies and programs are based on conditions that existed when Harry Truman or Dwight Eisenhower were President. We cannot afford to spend increasingly limited taxpayer dollars on government policies and programs that were designed to deal with the problems of the past or can't show they're that making a meaningful difference today. Congress and the President need to decide which programs and policies remain priorities, which should be overhauled, and which have outlived their usefulness. Importantly, increases in targeted earmark spending combined with across-the-board cuts are not substitutes for making tough and informed choices about the base of government. These trends can result in adding fat and protecting ineffective programs while cutting muscle from high-priority and high-performing programs.

Second, we need to revisit existing tax policy and enforcement efforts. Every year, our government forgoes hundreds of billions of revenue because of existing tax preferences, significant uncollected back taxes, and tax evasion. In fact, in some years, the cost of tax preferences exceeds total discretionary spending. Our complex tax system distorts decisions to work, save, and invest—and that dampens economic growth. Complexity also creates opportunities for tax evasion through vehicles such as tax shelters. All of this raises questions about fairness with taxpayers wondering whether their friends, neighbors and business competitors are paying their fair share. Clearly, comprehensive tax reform is needed. Reform could also better position the United States to compete in today's global economy—one that is increasingly knowledge-based and subject to fast-paced technological change. It's important to recognize that the ripple effects of comprehensive tax reform will be felt at all levels of government.

Third, entitlement reform is essential. We need to put Social Security and Medicare on a sound footing and make them solvent, sustainable, and secure for both current and future generations. Actually, the problems with Social Security are not that difficult to solve. In fact, we now have a window of opportunity to exceed the expectations of all Americans—whether they'll be retiring 30 days or 30 years from now. I'd be happy to tell you more about how we can do this during the question and answer period.

On the other hand, it seems clear that the biggest single domestic challenge is health care, of which Medicare and Medicaid are a big part. Mounting health care costs are a problem for governments, employers, and individuals. Despite repeated efforts to rein in health care spending, costs continue to climb. Between 1990 and 2000, U.S. health care spending rose from $696 billion to $1.3 trillion. Spending on health care is projected to more than double again by the end of this decade. Clearly, such growth is unsustainable, and it's one of the main reasons why both the Medicare and Medicaid programs are on GAO's high-risk list. It's also one of the reasons that Medicaid costs represent the fastest growing and one of the largest budget items—second only to education—for states.

The problems affecting Medicare and Medicaid will be much more difficult to solve than Social Security. More broadly, we need to reconsider how we define, deliver, and finance health care in this country—both in the public and the private sectors. We need to weigh unlimited individual wants against specific societal needs and decide how responsibility for health care should be divided among employers, individuals, and governments.

Despite the huge amounts of money we're spending on medical care, broad access to basic coverage remains an elusive goal. The rising cost of government health care programs increases budget pressures at both the federal and state levels. Rising health care costs are also discouraging additional pension coverage, constraining wage increases, and reducing the tax base because an increasing percentage of employee compensation is coming in the form of nontaxable benefits like health insurance. Some reports suggest that rising health care premiums are also causing companies to move jobs offshore, cut overall employment levels, and hire part-time rather than full-time workers.

As you may have heard about in news stories, GAO recently released its new high-risk report, which deals primarily with the here and now. GAO's high-risk report lists current government programs and functions that need special focus and immediate attention. In addition, yesterday we issued a report on the results of a GAO forum on our long-range fiscal challenges.

In the next couple of weeks, GAO will be issuing its 21st Century Challenges Report, which will discuss where we are and where we're headed as a nation. This report will include a number of illustrative questions that policymakers should consider in examining the base of government. Frankly, it's going to take many years to get us back on a prudent and sustainable long-term fiscal track but the time to start is now.

There's clearly a real payoff for prompt action. By acting now, both America and Americans can minimize the need for drastic measures and give all of us more time to adjust to any changes. By acting now, we can help to ensure that the miracle of compounding eventually works for us rather than against us—as it is today. By acting now, we can also avoid a dangerous upward spiral of deficits and debt that will ultimately harm America and every American family. By acting now, we can enhance our credibility with investors and improve public confidence in the government's ability to deal with large, complex and controversial fiscal issues before a crisis is upon us. Finally, by acting now, we can reduce the burdens that will otherwise be imposed on our children and grandchildren and give them more freedom of choice over what role they would like for government to play in the future.

As a member of the Sons of the American Revolution, I sometimes wonder what the Founding Fathers would think if they came back today. George Washington, Thomas Jefferson, Benjamin Franklin, Alexander Hamilton, and the other founders can seem larger than life, but most of them earned a living as farmers and businessmen. They understood first hand both the value of thrift and the perils of personal and public debt. Theirs was, after all, a world with debtors' prisons. With good reason, Ben Franklin said, "He who goes a borrowing goes a sorrowing."

At the same time, our first Secretary of the Treasury, Alexander Hamilton, was a realist who recognized that adding debt in times of war or economic recession may be a temporary necessity. It seems clear, however, that our Founding Fathers did not believe that adding debt in the normal course of events was either prudent or appropriate.

No less than the father of our country, George Washington felt that the most important personal value was courage and the most important institutional value was fiscal responsibility. His views are particularly timely at this point in our nation's history.

Somehow, in the last 200 years we seem to have forgotten the sound advice from Washington, Hamilton and Franklin. If the Founding Fathers were to return today, I have no doubt they'd be justifiably proud of many things our nation has accomplished, as we are. But I suspect many of them would be shocked and saddened by our willingness to forgo fiscal discipline and pile on both personal and public debt. It's likely that our Founding Fathers would see our mounting debt as a violation of our stewardship responsibility to future generations of Americans.

This is at the heart of my message. For the debate about our fiscal future is, ultimately, not about numbers but about values. The debate we are really having is about the kind of world we're prepared to pass on to our children and grandchildren. The time has come for responsible public officials to heed George Washington's words by demonstrating more individual courage and recommitting to institutional fiscal responsibility.

It's very important to emphasize here that the nation's fiscal imbalance is not a partisan issue. There are many players we could blame for our current financial situation. After all, it's been many years in the making. The point is that while we can't change the past, we can and must do something about our future.

Overcoming our fiscal challenges will take the combined efforts of both sides of the aisle in Washington and in every state capital. Right now, what we need are leaders who will acknowledge that we have a problem and are willing do something about it. In this regard, actions speak louder than words.

In my judgment, the worst thing that could happen is to continue on our present path and do nothing. Because once a crisis is upon us, we face terrible choices. And while it's true that other nations also have long-range fiscal challenges, who wants to be the best looking horse in the glue factory?

Although my message is sobering and I want you to take our situation seriously, I don't want you to go away thinking that things are hopeless or that I am pessimistic. That's far from true and those who know me will attest to the fact that I am a results oriented optimistic by nature. After all, America has overcome much more serious challenges in the past. Furthermore, in America, anything is possible with leadership, vision, commitment, and persistence. But we need to get serious and we need to act soon. Keep in mind, the passengers on the Titanic had a smooth ride and a great time until the very moment the ship hit the iceberg.

Today, every American needs to be part of the solution. In my view, our best hope for change is for people who live on Main Street to recognize the magnitude of our challenge and appreciate the risks posed by these deficits to them, their children and their grandchildren.

If the folks who live on Main Street remain silent, significant and sustainable change is unlikely. After all, why should any elected official stick his or her neck out on a complex and controversial issue if no one cares? Younger Americans especially need to become active in this discussion because they and their children will bear the heaviest burden if today's leaders fail to act.

State and local governments need to play a strong role in our fiscal challenge debate, because in the end, every government entity and public servant, myself included, is in the same boat. After all, bad news eventually flows down hill. This means we've got to start paddling together, or we'll surely sink separately.

My hope is that when you leave here today, you will spread the word among your friends and colleagues at the state and local level. We have to start doing something about America's triple deficits. Everyone from governors and mayors to rank-and-file state and local employees have a stake in this cause, and they need to become more informed and involved in demanding change and suggesting constructive and realistic solutions.

In closing, one of my favorite Presidents is Theodore Roosevelt. As a person of strong character who was trustbuster, environmentalist, internationalist and a winner of both the Medal of Honor and the Nobel Peace Prize, he showed that if you put your mind to something, anything is possible. TR said, "Fighting for the right [cause] is the noblest sport the world affords." When it comes to our current fiscal challenges, I hope you'll join me in working together as modern-day patriots to insist on the facts, speak the truth, and help save our nation's future.

Thank you for your time and attention. I'd be happy to answer any questions that you may have.

Appendix IV

Material Deficiencies

The federal government did not maintain adequate systems or have sufficient, reliable evidence to support information reported in the consolidated financial statements, as described below. These material deficiencies contributed to our disclaimer of opinion on the federal government's consolidated financial statements and also constitute material weaknesses in internal control.

Property, Plant, and Equipment and Inventories and Related Property

The federal government could not satisfactorily determine that property, plant, and equipment (PP&E) and inventories and related property were properly reported in the consolidated financial statements. Most of the PP&E and inventories and related property are the responsibility of the Department of Defense (DOD). As in past years, DOD did not maintain adequate systems or have sufficient records to provide reliable information on these assets. Other agencies, most notably the National Aeronautics and Space Administration, reported continued weaknesses in internal control procedures and processes related to PP&E.

Without reliable asset information, the federal government does not fully know the assets it owns and their location and condition and cannot effectively (1) safeguard assets from physical deterioration, theft, or loss; (2) account for acquisitions and disposals of such assets; (3) ensure that the assets are available for use when needed; (4) prevent unnecessary storage and maintenance costs or purchase of assets already on hand; and (5) determine the full costs of programs that use these assets.

Liabilities and Commitments and Contingencies

The federal government could not reasonably estimate or adequately support amounts reported for certain liabilities. For example, DOD was not able to estimate with assurance key components of its environmental and disposal liabilities. In addition, DOD could not support a significant amount of its estimated military postretirement health benefits liabilities included in federal employee and veteran benefits payable. These unsupported amounts related to the cost of direct health care provided by DOD-managed military treatment facilities. Further, the federal government could not determine whether commitments and contingencies, including those related to treaties and other international agreements entered into to further the U.S. government's interests, were complete and properly reported.

Problems in accounting for liabilities affect the determination of the full cost of the federal government's current operations and the extent of its liabilities. Also, improperly stated environmental and disposal liabilities and weak internal control supporting the process for their estimation affect the federal government's ability to determine priorities for cleanup and disposal activities and to appropriately consider future budgetary resources needed to carry out these activities. In addition, when disclosures of commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government's obligations.

Cost of Government Operations and Disbursement Activity

The previously discussed material deficiencies in reporting assets and liabilities, material deficiencies in financial statement preparation, as discussed below, and the lack of adequate disbursement reconciliations at certain federal agencies affect reported net costs. As a result, the federal government was unable to support significant portions of the total net cost of operations, most notably related to DOD.

With respect to disbursements, DOD and certain other federal agencies reported continued weaknesses in reconciling disbursement activity. For fiscal years 2004 and 2003, there was unreconciled disbursement activity, including unreconciled differences between federal agencies' and the Department of the Treasury's (Treasury) records of disbursements and unsupported federal agency adjustments, totaling billions of dollars, which could also affect the balance sheet.

Unreliable cost information affects the federal government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by federal agencies for inclusion in the President's budget concerning obligations and outlays.

Preparation of Consolidated Financial Statements

During fiscal year 2004, Treasury made progress in laying the foundation to address certain long-standing material deficiencies in preparing the consolidated financial statements. Foremost is the ongoing development of a new system, the Governmentwide Financial Reporting System (GFRS), to collect agency financial statement information directly from federal agencies' audited financial statements rather than using federal agencies'

Standard General Ledger data as Treasury had done in previous years to compile the consolidated financial statements. The goal of the new system is to be able to directly link information from federal agencies' audited financial statements to amounts reported in the consolidated financial statements, a concept that we strongly support. Once Treasury is able to achieve this, it would eliminate a major impediment to our being able to audit the consolidated financial statements.

For the fiscal year 2004 reporting process, Treasury's GFRS was able to capture certain agency financial information from agencies' audited financial statements, which is an important first step. The automated system, though, was not yet at the stage of development that it could be used to compile the consolidated financial statements from the information that was captured. Therefore, for fiscal year 2004, Treasury had to rely primarily on Excel spreadsheets and extensive manual procedures to prepare the consolidated financial statements. As discussed in our scope limitation section of our audit report, the federal government could not produce the fiscal year 2004 consolidated financial statements in time for us to complete all of our planned auditing procedures. In addition, for fiscal year 2004, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with U.S. generally accepted accounting principles (GAAP). Specifically, during our fiscal year 2004 audit, we found the following:[1]

- Treasury's process for compiling the consolidated financial statements did not ensure that the information in these statements was fully consistent with the underlying information in federal agencies' audited financial statements and other financial data.

- Treasury's ability to timely prepare a complete set of consolidated financial statements was greatly impaired because in some cases the financial information provided by federal agencies to Treasury did not agree to the agencies' audited financial statements, causing Treasury to

[1]Most of the issues we identified in fiscal year 2004 existed in fiscal year 2003, and some have existed for a number of years. In September 2004, we reported in greater detail on the issues we identified, in GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Further Improvement*, GAO-04-866 (Washington, D.C.: Sept. 10, 2004). This report includes about 140 recommendations to the federal government.

have to resort to last-minute, alternative methods to gather the needed information. These problems were compounded by Treasury's reliance on internal controls that were dependent on procedures that would attempt to identify any errors after they were made by an agency (detective controls) rather than implementation of internal controls that may have prevented or minimized the errors from occurring (preventive controls).

- Other internal control weaknesses existed in Treasury's process for preparing the consolidated financial statements, involving a lack of (1) segregation of duties, (2) appropriate documentation of certain policies and procedures for preparing the consolidated financial statements, (3) adequate support for adjustments made to the consolidated financial statements, and (4) required management reviews.

- Information system weaknesses existed within the segments of GFRS that were used during the fiscal year 2004 reporting process. We found that inappropriate access to GFRS was granted to certain Treasury personnel and that the GFRS database was not configured to prevent the alteration of data submitted by federal agencies and was used for both production and testing during the fiscal year 2004 reporting process.

- Treasury did not have the infrastructure to address the magnitude of the fiscal year 2004 financial reporting challenges it was faced with, such as an incomplete financial reporting system, compressed time frames for compiling the financial information, and inaccurate and incomplete information provided by certain federal agencies. We found that personnel at Treasury's Financial Management Service had excessive workloads that required an extraordinary amount of effort and dedication to compile the consolidated financial statements; however, there were not enough personnel with specialized financial reporting experience to ensure accurate and reliable financial reporting by the accelerated reporting date. Nevertheless, a foundation for the future was put into place and a number of lessons were learned.

- To make the fiscal years 2004 and 2003 consolidated financial statements balance, Treasury recorded a net $3.4 billion increase and a net $24.5 billion decrease, respectively, to net operating cost on the Statements of Operations and Changes in Net Position, which it labeled "Unreconciled Transactions Affecting the Change in Net Position."[2] An additional net $1.2 billion and $11.3 billion of unreconciled transactions were recorded in the Statement of Net Cost for fiscal years 2004 and 2003, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.

- Treasury eliminated many intragovernmental activity and balances through accounting entries for fiscal year 2004 rather than "dropping" or "offsetting" the amounts as it has done in the past, which is a positive step. However, as discussed below, amounts reported for federal agency trading partners[3] for certain intragovernmental accounts were significantly out of balance, resulting in the need for unsupported intragovernmental elimination entries in order to force the Statement of Operations and Changes in Net Position into balance. Treasury's ability to eliminate certain intragovernmental activity and balances continues to be impaired by the federal agencies' problems in handling their intragovernmental transactions, which are noted below. In addition, significant differences in other intragovernmental accounts, primarily related to appropriations, have not been reconciled and still remain unresolved. Therefore, the federal government continues to be unable to determine the impact of unreconciled intragovernmental activity and balances to the consolidated financial statements.

- The federal government did not have an adequate process to identify and report items needed to reconcile the operating results, which for fiscal year 2004 showed a net operating cost of $615.6 billion, to the budget results, which for the same period showed a unified budget deficit of $412.3 billion. In addition, a net $23.2 billion "net amount of all other differences" was needed to force this statement into balance.

- The consolidated financial statements include certain financial information for the executive, legislative, and judicial branches, to the extent that federal agencies within those branches have provided Treasury such information. However, there are undetermined amounts of assets, liabilities, costs, and revenues that are not included, and the federal government did not provide evidence or disclose in the

[2] Although Treasury 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 cost in the consolidated financial statements.

[3] Trading partners are U.S. government agencies, departments, or other components included in the consolidated financial statements that do business with each other.

consolidated financial statements that such excluded financial information was immaterial.

- Treasury did not have an adequate process to ensure that the financial statements, related notes, Stewardship Information, and Supplemental Information are presented in conformity with GAAP. For example, we found that certain financial information required by GAAP was not disclosed in the consolidated financial statements. Treasury did not provide us with documentation of its rationale for excluding this information. As a result of this and certain of the material deficiencies noted above, we were unable to determine if the missing information was material to the consolidated financial statements. In an effort to begin addressing this issue, we found that Treasury collected certain additional financial information required by GAAP in its new process for fiscal year 2004. However, due to the compressed time frames to compile the consolidated financial statements and because GFRS is still being developed, Treasury plans to analyze this information in fiscal year 2005 and determine how or whether to disclose this information in future years' consolidated financial statements.

Accounting for and Reconciliation of Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. The Office of Management and Budget (OMB) and Treasury require the chief financial officers (CFO) of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these agencies are required to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the agencies did not fully perform the required reconciliations for fiscal years 2004 and 2003. For fiscal year 2004, based on trading partner information provided in GFRS, Treasury produced a "Material Difference Report" for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners. After analysis of the material differences, a significant number of CFOs cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Many CFOs simply indicated that they were unable to explain the differences with their trading partners. For both fiscal years 2004 and 2003, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. As a result, the federal government's ability to determine the impact of these differences on the amounts reported in the consolidated financial statements is impaired. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a commitment by federal agencies and strong leadership and oversight by OMB.

Net Outlays—A Component of the Budget Deficit

OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, states that outlays in federal agencies' Statement of Budgetary Resources (SBR) should agree with the net outlays reported in the budget of the U.S. government. In addition, Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requires explanation of any material differences between the information required to be disclosed (including net outlays) in the financial statements and the amounts described as "actual" in the budget of the U.S. government.

The federal government reported in the Statement of Changes in Cash Balance from Unified Budget and Other Activities (Statement of Changes in Cash Balance) a budget deficit for fiscal year 2004 of $412.3 billion. The budget deficit is calculated by subtracting actual budget outlays from actual budget receipts.[4] In previous years, the Statement of Changes in Cash Balance reported actual budget outlays and actual budget receipts; however, for fiscal year 2004, the federal government chose not to disclose budget outlays and budget receipts in this financial statement and only included the budget deficit. As we reported for fiscal year 2003, we found $140 billion in differences between the total net outlays reported in selected federal agencies' audited SBRs and Treasury's central accounting records, which it uses to prepare the Statement of Changes in Cash Balance. Treasury again chose for fiscal year 2004 to use its central accounting records to prepare the Statement of Changes in Cash Balance without a process for identifying and resolving the differences between its

[4]Receipts and net outlays (unified budget amounts) are also reported in governmentwide reports-specifically, in the President's Budget (annually); Treasury's Final Monthly Treasury Statement, as part of leading economic indicators on federal finances (quarterly); and Treasury's Annual Combined Statement of Receipts, Outlays, and Balances of the United States Government.

central accounting records and net outlay amounts reported in the agencies' audited SBRs. For fiscal year 2004, while Treasury no longer disclosed this information in the Statement of Changes in Cash Balance, we again found material differences between the total net outlays reported in certain federal agencies' audited SBRs and the records Treasury used to prepare the Statement of Changes in Cash Balance totaling about $69 billion. In addition, we also noted reported internal control weaknesses regarding certain agencies' SBRs.

OMB's efforts in working with the agencies resulted in some notable improvements in reducing the approximately $140 billion of differences that we reported in fiscal year 2003 between the total net outlays reported in the federal agencies' SBRs and the Statement of Changes in Cash Balance. As we reported, two agencies, Treasury and HHS, accounted for about 83 percent of these differences. We found that the major cause of the differences for the two agencies for fiscal year 2003 was the treatment of offsetting receipts.[5] Some offsetting receipts for these two agencies had not been included in the agencies' SBRs, which would have reduced the agencies' net outlays and made the amounts more consistent with Treasury's records used to prepare the Statement of Changes in Cash Balance. In fiscal year 2004, a major component of HHS restated its fiscal year 2003 net outlays in its SBR, and Treasury obtained a waiver from OMB exempting it from reporting certain offsetting receipts in its SBR totaling about $16.9 billion until further research is performed. However, about $75 billion of differences we found for fiscal year 2003 still remained unreconciled as of September 30, 2004.

Until the material differences between the total net outlays reported in the federal agencies' SBRs and the records used to prepare the Statement of Changes in Cash Balance are timely reconciled, the effect of these differences on the U.S. government's consolidated financial statements will be unknown.

[5]Offsetting receipts are collections that are credited to general fund, special fund, or trust fund receipt accounts and that offset gross outlays at the agency or governmentwide level.

Other Material Weaknesses

The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations as of September 30, 2004. In addition to the material deficiencies discussed in appendix IV, we found the following four other material weaknesses in internal control.

Loans Receivable and Loan Guarantee Liabilities

Federal agencies continue to have material weaknesses and reportable conditions related to their lending activities. In fiscal year 2004, significant deficiencies in the processes and procedures used to estimate the costs of certain lending programs and value of loans receivable increased. While the Small Business Administration (SBA) made noteworthy progress to improve its cost estimation processes, additional improvements are still needed at SBA to fully resolve the deficiencies in the area so that reasonable estimates can be produced and audited in a timely manner. Further, this year at the Department of Housing and Urban Development (HUD), a new material weakness was reported. HUD lacked adequate management reviews of underlying data and cost estimation methodologies that resulted in material errors being undetected, and significant adjustments were needed. These material weaknesses at SBA and HUD, plus deficiencies at the Department of Agriculture and the Department of Education relating to the processes and procedures for estimating credit program costs, continue to adversely affect the federal government's ability to support annual budget requests for these programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities. Further, these weaknesses and the complexities associated with estimating the costs of lending activities greatly increase the risk that significant errors in agency and governmentwide financial statements could occur and go undetected.

Improper Payments

Across the federal 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.[1] Many improper payments occur in federal programs that are administered by entities other than the federal government, such as states and municipalities. Generally,

[1]Improper payments include inadvertent errors, such as duplicate payments and miscalculations, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from fraud and abuse by program participants and/or federal employees.

improper payments result from a lack of or an inadequate system of internal control, but some result from program design issues. Federal agencies' estimates of improper payments based on available information for fiscal year 2004 exceeded $45 billion. This estimate could increase significantly over the next several years as agencies become more effective at estimating and reporting improper payment amounts for programs and activities that are susceptible to significant improper payments.[2]

Fiscal year 2004 represents the first full year that federal agencies were required to include the reports required by the Improper Payments Information Act of 2002 (IPIA)[3] in their Performance and Accountability Reports (PAR). IPIA raised improper payments to a new level of importance by requiring federal agencies to annually review all programs and activities and identify those that may be susceptible to significant improper payments. Federal agencies are to then estimate the annual amount of improper payments for those programs and activities identified as susceptible to significant improper payments. The law further requires federal agencies to report to the Congress the improper payment estimates and information on the actions the agency is taking to reduce the improper payments. The Office of Management and Budget (OMB) implementation guidance required that estimates and, if applicable, the corrective action report, be included in federal agencies' PARs beginning with fiscal year 2004.[4]

The OMB guidance also required 44 programs of 14 CFO Act agencies to report improper payment information in their fiscal year 2003 PARs. Last year, we reported that those 14 CFO Act agencies reported the required improper payment amounts for 29 of the 44 programs,[5] suggesting that despite the enhanced emphasis on improper payments and legislative reporting requirements, those agencies appeared to be struggling with

[2]OMB defines the term "significant improper payments" as "annual erroneous payments in the program exceeding both 2.5 percent of program payments and $10 million."

[3]Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002).

[4]OMB Memorandum M-03-13, *Improper Payments Information Act of 2002 (Public Law 107-300)* (Washington, D.C.: May 21, 2003).

[5]GAO, *Financial Management: Fiscal Year 2003 Performance and Accountability Reports Provide Limited Information on Governmentwide Improper Payments*, GAO-04-631T (Washington, D.C.: Apr. 15, 2004).

estimating improper payment amounts for about one-third of their programs.

Our preliminary reviews of 29 federal agencies' fiscal year 2004 PARs further suggest that a number of agencies were not well positioned to meet the reporting requirements of IPIA. For example, while most agencies acknowledged the IPIA reporting requirements in their PARs, 8 of the 44 programs with previous reporting requirements as noted above indicated that they would be able to estimate and report on improper payments sometime within the next 4 years but could not do so now. Another 5 programs in 2 agencies with previous reporting requirements determined that improper payment amounts were insignificant for their programs. Further, 4 additional programs in 4 agencies with prior reporting requirements did not estimate improper payment amounts for their programs and were silent as to whether they would report estimates in future reports. Therefore, 32 of the 44 programs with previous reporting requirements reported estimates or reported that their improper payment amounts were insignificant in their fiscal year 2004 PARs.

Until all agencies develop and implement a systematic measurement of the extent of improper payments, the federal government cannot determine (1) the extent to which improper payments exist, (2) mitigation strategies and the appropriate amount of investments to reduce them, and (3) the success of efforts implemented to reduce improper payments.

Information Security

Although progress has been made, serious and widespread information security control weaknesses continue to place federal 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. GAO has reported information security as a high-risk area across government since February 1997. Such information security control weaknesses could result in compromising the reliability and availability of data that are recorded in or transmitted by federal financial management systems. A primary reason for these weaknesses is that federal agencies have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security control weaknesses, resolving information security problems, and managing information security risks on an ongoing basis. The Congress has shown continuing interest in addressing these risks, as evidenced by hearings on information security and enactment of the Federal Information Security Management

Act of 2002[6] and the Cyber Security Research and Development Act.[7] In addition, the administration has taken important actions to improve information security, such as integrating information security into the Executive Branch Management Scorecard.[8]

Tax Collection Activities

Material internal control weaknesses and systems deficiencies continue to affect the federal government's ability to effectively manage its tax collection activities,[9] an issue that has been reported in our financial statement audit reports for the past 7 years. Due to errors and delays in recording activity in taxpayer accounts, taxpayers were not always credited for payments made on their taxes owed, which could result in undue taxpayer burden. In addition, the federal 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.

Weaknesses in controls over tax collection activities continue to affect the federal government's ability to efficiently and effectively account for and collect revenue. Additionally, weaknesses in financial reporting of revenues affect the federal government's ability to make informed decisions about collection efforts. As a result, the federal government is vulnerable to loss of tax revenue and exposed to potentially billions of dollars in losses due to inappropriate refund disbursements.

[6]Title III of the E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2899, 2946 (Dec. 17, 2002).

[7]Pub. L. No. 107-305, 116 Stat. 2367 (Nov. 27, 2002).

[8]The Executive Branch Management Scorecard highlights agencies' progress in achieving management and performance improvements embodied in the President's Management Agenda.

[9]GAO, *Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements*, GAO-05-103 (Washington, D.C.: Nov. 10, 2004).

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Mr. PLATTS. You hit on the things that we want to focus on: timely, transparent, reliable, useful information that will benefit all aspects of the Federal Government as we try to achieve those goals that we are all after.

Next we have Mr. Jack Martin, CFO of the Department of Education. As you are hitting your third anniversary at the Department coming up here later this month, we appreciate your service and also again thank you for your service in the past as a U.S. Marine and your service in uniform.

STATEMENT OF JACK MARTIN, CHIEF FINANCIAL OFFICER, U.S. DEPARTMENT OF EDUCATION

Mr. MARTIN. Thank you, Mr. Chairman and members of the committee.

As the Chief Financial Officer at the Department of Education I am very pleased to be here today to provide some perspective on the Federal financial reporting process for fiscal year 2004. I look forward to sharing with you some observations on the Government Accountability Office's report on the financial report of the U.S. Government, as well as the significant progress made by Federal agencies during the past fiscal year.

During this past fiscal year the Federal Government achieved a significant milestone in the area of Federal financial reporting. For fiscal year 2004, 22 of 24 major agencies issued audited financial statements in their performance and accountability reports just 45 days after the end of the fiscal year. Prior to this year, agencies generally took up to 5 months to produce these same reports.

Complying with an administration requirement that took effect this past year, agencies have now significantly reduced the reporting delay that had been typical in the past. As a member of the CFO Council, where I have had the opportunity to work with other agency CFOs and their deputies, I can tell you the entire CFO community is pleased and proud to have played a role in this major accomplishment.

The Department of Education was 1 of the 22 agencies that met the 45-day reporting deadline in fiscal year 2004. In fact, Education met this accelerated deadline for the second year in a row, since we issued our 2003 in mid-November the previous year, a year ahead of the requirement. Our success was certainly not attained overnight; rather, the work done over the previous fiscal years, with careful planning and efficient execution, enabled us to reach this milestone.

The financial reporting efforts at the agency level enabled the Department of Treasury to issue the governmentwide financial report on December 15th for the first time. In previous years, the Government-wide financial report was typically not issued until March.

With the accelerated reporting deadline taking effect this past year, agencies faced a 1-year fiscal period in which there was less time to prepare audited financial statements compared to previous years. Despite this shorter reporting timeframe, a comparable number of CFO Act agencies received unqualified audit opinions on their financial statements in fiscal year 2004 as in the prior year. Of the 24 major Federal agencies, 18 received unqualified audit opinions in fiscal year 2004. This result in the face of a more rigorous audit schedule is especially noteworthy since greater financial discipline and reliance on internal controls was needed to successfully meet the 45-day reporting timeframe. Accelerated schedule demanded good planning and timely reconciliations, and we are pleased with these efforts.

For fiscal year 2004 I am pleased to report that the Department of Education was 1 of 18 agencies that received an unqualified audit opinion. Education has received an unqualified opinion for the last 3 fiscal years, and we look forward to continuing our fiscal vigilance in the coming years.

Some have questioned the accelerated reporting requirement, asserting that the earlier date may result in poor-quality data. From our perspective at Education, this is certainly not the case. Education has met the accelerated deadline for the past 2 years, receiving unqualified audit opinions each time. An unqualified opinion we have received has required a more rigorous financial reporting and audit schedule compared to the previous fiscal years.

Further, the early reporting date has allowed our department and others the benefit of having financial information throughout the year on which daily management decisions can be made on a routine basis. The accelerated reporting requirement has driven process and control improvements that have laid a foundation for management reports such as Education's Fast Facts report.

Fast Facts is a monthly reporting tool that highlights key financial and performance data in a consolidated and user-friendly format. Managers at the Department use Fast Facts to monitor performance and derive improved results in a variety of areas including grants administration, financial matrix, and educational outcomes.

In the Government-wide financial report, GAO identified three main impediments to rendering an opinion: financial management problems at the Department of Defense, ineffective processes for preparing the consolidated financial statements, and deficiencies in accounting for intra-governmental transactions.

These three items were reported by GAO as material weaknesses in its report. All these issues are complex, long-term challenges and will take sustained efforts to resolve. DOD is addressing specific weaknesses and progress is being made. It is important to recognize that longstanding issues in a department that has over 300 sub-entities are not easily fixed. In some cases, eliminating DOD material weaknesses depends on the implementation of new financial management systems. In other cases, material weaknesses require an incremental approach to transforming business processes, which involves focusing on one component at a time or one financial statement line item at a time.

For fiscal year 2004 the auditors determined that three significant financial statement items at the DOD-wide level—appropriations received, investments, and Federal Employment Compensation Act liabilities—passed audit scrutiny. In addition, six components, up from five the previous year, earned an unqualified opinion on the fiscal year 2004 financial statement.

During this fiscal year 2004 reporting cycle, significant progress was made in implementing a new process for preparing the financial report. The new process facilitates a stronger, more direct link to agency financial statements, something that has been a concern of GAO. While the new process was successful in producing Government-wide financial statements within the new accelerated reporting timeframe, there are issues that need to be refined and improved during fiscal year 2005. The CFO Council looks forward to working with OMB, Treasury, and the other agencies to improve this process.

It is my understanding that the inability to balance significant amounts of intra-governmental transactions is being addressed on several fronts by OMB and Treasury. Process enhancements such as more-frequent reporting and reconciliations and new tools like the intra-governmental reporting and analysis system will support the efforts to eliminate reporting errors. These new analytical tools have helped to better focus corrective actions.

In December 2004, OMB issued the revised Circular A–123, Management's Responsibility for Internal Control. Circular A–123 defines management's responsibility for maintaining effective internal control and requires management to adhere to broadly accepted internal control standards and undertake a strengthened process when assessing internal control effectiveness. The strengthened assessment process is similar to the process that public corporations must follow under the financial reforms of the Sarbanes-Oxley Act of 2002.

The policies contained in Circular A–123 further emphasize a foundation of disciplined accounting processes and good internal control for providing timely and reliable information and demonstrating financial accountability.

Eleven agencies restated their fiscal year 2003 financial statements when issuing their fiscal year 2004 reports. These restatements relate to a period prior to the implementation of the November 15th accelerated reporting requirement. Overall, the restatements reflect the greater scrutiny and attention the financial reporting process has received in recent years. Process and control improvements resulting from accelerating reporting and material weakness monitoring under the PMA scorecard, as well as recent revisions to OMB Circular A–123 emphasizing internal control over financial reporting, will likely serve to reduce restatements in the future.

One of my goals as CFO is to produce more timely and reliable financial information and to use this information in a daily decisionmaking to reduce costs and better manage programs. These efforts are currently tracked by OMB as part of the improved financial performance initiative of the President's management agenda.

I am pleased to report that the Department of Education has been in green status in the improved financial performance initiative for just over a year. Education was the fourth Federal agency and the first Cabinet agency to reach this milestone, and several other agencies have joined us since then. Today a total of eight Federal agencies have received a green score on the PMA improved financial performance scorecard. With the recent additions of the Departments of Commerce and State, eight agencies have an overall green status indicating that they have demonstrated they are using financial management information to manage their programs.

I am further pleased to report that the Department of Education received three prestigious financial management awards during the last year: The President's Quality Award for Improved Financial Performance; a Certificate of Excellence in Accountability Reporting from the Association of Government Accountants; the Alexander Hamilton Award for Technology, the Silver Award from the magazine "Treasury and Risk Management," an award that normally goes to private sector corporations.

Conclusion: the outlook for the Federal Government to improve the quality and timeliness of financial reporting to the American citizen is positive. While many challenges remain, others that appeared similarly insurmountable just a few years ago are being solved.

The Department of Education looks forward to working with OMB and the other agencies to improve Federal financial management in the months and years ahead.

Thank you for listening. I am happy to answer your questions.

Mr. PLATTS. Thank you, Mr. Martin.

[The prepared statement of Mr. Martin follows:]

Testimony of
The Honorable Jack Martin
Chief Financial Officer, Department of Education,
before the
Committee on Government Reform
United States House of Representatives

February 9, 2005

Financial Report of the United States Government for Fiscal Year 2004

Thank you, Mr. Chairman and Members of the Committee.

As the Chief Financial Officer (CFO) at the Department of Education, I am pleased to be here today to provide some perspective on the federal financial reporting process for fiscal year (FY) 2004. I look forward to sharing with you some observations on the Government Accountability Office's (GAO) report on the *Financial Report of the United States Government* ("Financial Report"), as well as the significant progress made by federal agencies during the past fiscal year.

Accelerated Financial Reporting

During this past fiscal year, the Federal Government achieved a significant milestone in the area of federal financial reporting. For FY 2004, 22 of 24 major agencies issued audited financial statements in their Performance and Accountability Reports (PARs) just 45 days after the end of the fiscal year. Prior to this year, agencies generally took up to five months to produce these same reports. Complying with an Administration requirement that took effect this past year, agencies have now significantly reduced the reporting delay that had been typical in the past. As a member of the CFO Council, where I have the opportunity to work with other agency CFOs and their deputies, I can tell you the entire CFO community is pleased and proud to have played a role in this major accomplishment.

The Department of Education was one of the 22 agencies that met the 45-day reporting deadline in FY 2004. In fact, Education met this accelerated deadline for the second year in a row, since we issued our 2003 PAR in mid-November the previous fiscal year – a year ahead of the requirement. Our success was certainly not attained overnight. Rather, the work done over the previous fiscal years, through careful planning and efficient execution, enabled us to reach this milestone.

For the two agencies that did not meet the 45-day accelerated deadline, the Department of Homeland Security (DHS) issued its PAR only four days after the 45-day period, while the Department of Health and Human Services (HHS) followed soon after in early December. The submissions by DHS and HHS should still be considered an accomplishment, as they came months earlier than was the norm in previous years.

The financial reporting efforts at the agency level enabled the Department of the Treasury (Treasury) to issue the government-wide *Financial Report* on December 15 for the first time. In previous years, the government-wide Financial Report was typically not issued until March. This accomplishment places the Federal Government financial reporting cycle on par with private-sector reporting.

With the accelerated reporting deadline taking effect this past year, agencies faced a one-year fiscal period in which there was less time to prepare audited financial statements compared to previous years. Despite this shorter reporting timeframe, a comparable number of Chief Financial Officers Act ("CFO Act") agencies received unqualified audit opinions on their financial statements in FY 2004 as in the prior year. Of the 24 major federal agencies, 18 received unqualified audit opinions in FY 2004. This result, in the face of a more rigorous audit schedule, is especially noteworthy since greater financial discipline and reliance on internal controls was needed to successfully meet the 45-day reporting timeframe. The accelerated schedule demanded good planning and timely reconciliations, and we are pleased with these efforts.

For FY 2004, I am pleased to report that the Department of Education was one of the 18 agencies that received an unqualified audit opinion. Education has received an unqualified opinion for each of the last three fiscal years, and we look forward to continuing this streak this year.

Some have questioned the accelerated reporting requirement, asserting that the earlier date may result in poorer quality data. From our perspective at Education, this is certainly not the case. Education has met this accelerated deadline for the past two years, receiving an unqualified audit opinion each time. And the unqualified opinion we have received has required a more rigorous financial reporting and audit schedule compared to previous years.

Further, the earlier reporting date has allowed our department and others the benefit of having financial information throughout the year in which daily management decisions can be made on a routine basis. The accelerated reporting requirement has driven process and control improvements that have laid the foundation for management reports such as Education's "Fast Facts." Fast Facts is a monthly reporting tool that highlights key financial and performance data in a consolidated and user-friendly format. Managers at the Department use Fast Facts to monitor performance and drive improved results in a variety of areas, including grants administration, financial metrics, and educational outcomes.

Among the agencies not receiving unqualified opinions, one agency – the Small Business Administration (SBA) – received a qualified opinion in FY 2004. Noteworthy progress is being made at SBA, as shown by its qualified opinion compared to its FY 2003 disclaimer of opinion. SBA's improvements over the past year have positioned it well for receiving an unqualified opinion in the future.

The remaining five agencies received disclaimers on their statements – DHS; the Departments of Defense, Housing and Urban Development and Justice; and the National Aeronautics and Space Administration. For several of these agencies, issues surfaced that could not be resolved in time to meet the accelerated reporting deadline.

(For additional information on federal financial reporting and financial management issues, please refer to the 2005 Federal Financial Management Report, which can be found at http://www.whitehouse.gov/omb/financial.)

Financial Report of the United States Government

In the government-wide *Financial Report*, GAO identified three main impediments to rendering an opinion:

- financial management problems at the Department of Defense (DoD);
- ineffective processes for preparing the consolidated financial statements; and
- deficiencies in accounting for intragovernmental transactions.

These three items were reported by GAO as material weaknesses in its report. All of these issues are complex long-term challenges and will take sustained efforts to resolve.

DoD is addressing specific weaknesses, and progress is being made. It is important to recognize that long-standing issues in a department that has over 300 sub-entities are not easily fixed. In some cases, eliminating DoD material weaknesses depends on the implementation of new financial management systems. In other cases, material weaknesses require an incremental approach to transforming business processes, which involves focusing on one component at a time or one financial statement line item at a time. Once a component entity determines that sufficient progress has been made, an independent auditor performs an assessment to ensure that the component is ready for audit.

For fiscal year 2004, the auditors determined that three significant financial statement items at the DoD-wide level – appropriations received, investments, and Federal Employment Compensation Act liabilities – passed audit scrutiny. In addition, six components, up from five the previous year, earned an unqualified opinion on their FY 2004 financial statements.

During this FY 2004 reporting cycle, significant progress was made in implementing a new process for preparing the *Financial Report*. The new process facilitates a stronger and more direct link to agency financial statements, something that has been a concern of GAO. While the new process was successful in producing government-wide financial statements within the new accelerated reporting time frame, there are issues that need to be refined and improved during FY 2005. The CFO Council looks forward to working with OMB, Treasury, and the other agencies to improve this process.

It is my understanding that the inability to balance significant amounts of intragovernmental transactions is being addressed on several fronts by OMB and Treasury. Process enhancements, such as more frequent reporting and reconciliation, and new tools like the Intragovernmental Reporting and Analysis System (IRAS), will support the efforts to eliminate reporting errors. These new analytical tools have helped to better focus corrective actions.

Internal Control

In December 2004, OMB issued the revised Circular A-123, *Management's Responsibility for Internal Control.* Circular A-123 defines management's responsibility for maintaining effective internal control and requires management to adhere to broadly accepted internal control standards and undertake a strengthened process when assessing internal control effectiveness. The strengthened assessment process is similar to the process that public corporations must follow under the financial reforms of the Sarbanes-Oxley Act of 2002. The policies contained in Circular A-123 further emphasize a foundation of disciplined accounting processes and good internal control for providing timely and reliable information and demonstrating financial accountability.

Eleven agencies restated their FY 2003 financial statements when issuing their FY 2004 reports. These restatements relate to a period prior to the implementation of the November 15 accelerated reporting requirement. Overall, the restatements reflect the greater scrutiny and attention the financial reporting process has received in recent years. Process and control improvements resulting from accelerated reporting and material weakness monitoring under the PMA scorecard, as well as the recent revisions to OMB Circular A-123 emphasizing internal control over financial reporting, will likely serve to reduce restatements in the future.

President's Management Agenda

One of my goals as a CFO is to produce more timely and reliable financial information, and to use this information in daily decision-making to reduce costs and better manage programs. These efforts are currently tracked by OMB as part of the Improved Financial Performance initiative of the President's Management Agenda (PMA).

I am pleased to report that the Department of Education has been in "green" status in the Improved Financial Performance initiative for just over a year. Education was the fourth federal agency – and the first cabinet agency – to reach this milestone, and several other agencies have joined us since then. Today, a total of eight federal agencies have received a green score on the PMA Improved Financial Performance scorecard. With the recent addition of the Departments of Commerce and State, eight agencies have an overall green status score – indicating that they have demonstrated they are using financial management information to manage their programs. I am further very pleased to report that the Department of Education received three prestigious financial management awards during the last year: the President's Quality Award for Improved Financial Performance; the Certificate for Excellence in Accountability Reporting from the Association of Government Accountants; and the Alexander Hamilton Award for Technology (Silver) from the magazine "Treasury and Risk Management".

The Department of Education's success under the PMA and other financial management efforts is also shown by our receiving the Presidential Award for Management Excellence in 2004. I am pleased to report that the department was one of six agencies (selected from 61 nominations) to receive this award, which is the highest recognition bestowed by the government to federal agencies for management excellence.

A new program initiative of the PMA this fiscal year is the Eliminating Improper Payments initiative. Under this new PMA initiative, Education and 13 other federal agencies are taking steps to measure and eliminate their improper payments. These efforts include, but are not limited to, payments made in an incorrect amount, to an ineligible recipient, for a service not received, or for improper use of federal funds. FY 2004 began the first year of reporting under the Improper Payments Information Act (IPIA), and this information was included in the Department of Education's 2004 PAR.

From our perspective at the Department of Education, this first year of reporting is a vital step in meeting the objectives of the IPIA in that it establishes the baseline from which short- and long-term program-improvement strategies and priorities will be based. A focus of many of our strategies will be to improve the internal control surrounding these programs.

For information on the improper-payment-elimination efforts at other agencies, I would direct you to the OMB report, *Improving the Accuracy and Integrity of Government Payments*, which was issued in late January. (This report can be found at http://www.whitehouse.gov/omb/financial/fia_improper.html.) The OMB report provides an overview of what the CFO Act agencies reported in their PARs on their efforts to comply with the IPIA.

Conclusion

The outlook for the Federal Government to improve the quality and timeliness of financial reporting to the American citizen is positive. While many challenges remain, others that appeared similarly insurmountable just a few years ago are being solved. The Department of Education looks forward to working with OMB and the other agencies to improve federal financial management in the months and years ahead.

Thank you for listening. I am happy to answer any questions you may have.

Mr. PLATTS. Your example of the Fast Facts is a perfect example of that—the internal controls and process, that you have responded to the accelerated deadline in getting that timeline information that your managers have to really act on. A great example for other agencies to follow.

Next we have our Fiscal Assistant Secretary at the Department of the Treasury, Don Hammond.

We appreciate your being with us. I think you and the Comptroller General started in your positions about the same time, so a good tag team as we here try to get our arms around the financial challenges of the Federal Government.

Mr. HAMMOND. Thank you, Mr. Chairman.

Mr. PLATTS. Actually, Mr. Hammond, before you start, I did want to recognize we have been joined by three other members of the subcommittee: Charlie Dent from Pennsylvania, who is on the subcommittee, and two other full committee members, Mr. Marchant from Texas, and Mr. Westmoreland from Georgia. We appreciate your participating here today. Go ahead, Don.

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

Mr. HAMMOND. Thank you very much, Mr. Chairman, Ranking Member Towns, members of the committee. It is my privilege and pleasure to represent the Treasury Department today to discuss the state of reporting on the finances of the Federal Government. Your continued interest in this important subject is much appreciated.

I would ask that my full statement be included in the record.

Mr. PLATTS. Without objection.

Mr. HAMMOND. Thank you.

The financial report of the U.S. Government incorporating the consolidated Government-wide financial statements is designed to report on the financial condition of the Government using the accrual basis of accounting employed and understood worldwide for financial reporting. The report for fiscal year 2004 was the eighth time that Treasury has prepared and issued this report. We have learned a lot over these past 8 years, and considerable progress has been made toward producing a timely, accurate, and useful financial report.

Perhaps even more importantly, the efforts to provide effective financial reporting have led to significant improvements Government-wide in the underlying financial management practices and processes.

We are pleased this year to have completed the fiscal year 2004 report on December 15, meeting the objective the administration set out 3 years ago. Every agency met Treasury's November 18th deadline for data input into our new report preparation system. These were significant accomplishments, considering that we also concurrently launched a new consolidation process. I am extremely proud of the considerable effort that was expended across Government to make these results happen.

The financial report has been an important addition to Federal financial reporting. The timely availability of this additional information can more fully inform the budget process. The standardized reporting framework promotes comparability and consistency in reporting across years, among agencies, and increasingly among countries.

The report goes beyond simple reporting of results as it displays the effects of all significant assets, liabilities, stewardship responsibilities, and other commitments and responsibilities, including social insurance. While the appropriate accounting treatment in the future for these social insurance programs is a topic of discussion at the Federal Accounting Standards Advisory Board, the existing standard does provide for comprehensive disclosure.

We think this year's financial report shows significant improvement from the first one we prepared for fiscal year 1997. Many enhancements have been made over these past 8 years. Additional information has been added, the presentation improved over the years, increasing the usefulness of the report for the reader. Less visible but no less important, the discipline and rigor associated with the production of regular financial statements have resulted in improvements in basic financial operating activities. All of these improvements have helped us hone in on those areas that need further attention on and will be the focus of our activities this year.

GAO's audit enhances the reports credibility and highlights areas for improvement. Through this rigorous and continuous process, we will improve our financial management environment and achieve more credibility in our financial reporting. Once we have achieved a level of credibility, we will have created the solid foundation for a better public understanding of the Government's finances.

In order to pass audit scrutiny, we must address three major areas: serious management control issues at the Department of Defense, the Government's inability to properly eliminate transactions between agencies, and deficiencies in the report preparation process.

Defense continues to make progress, but much work remains. They are such a significant portion of the total financial picture that it is extremely unlikely that improvement in the audit opinion will occur without significant further improvement in DOD reporting.

Two new initiatives were included in the 2004 report process that were designed to reduce the out-of-balance conditions that exist between agency transactions with other agencies. While it is too early to assess these initiatives, preliminary results are, indeed, very encouraging. Our new report preparation system is a work in progress. We met our first phase objective for agencies to be able to fully utilize the data collection portion of the system to submit their financial statement data. We plan to complete the consolidating portion of the system in 2005, which will aid us in demonstrating consistency with the agency's financial statements and greatly streamline the preparation process. That being said, a comprehensive draft of the financial report was produced this year in less than 2 weeks.

Accounting standards require some disclosures that are not currently included in the Government-wide financial report. For the fiscal year 2004 reporting cycle, we asked agencies for data that relate to these particular disclosures, and we are in the process of analyzing that data to determine its materiality to the statements.

The Federal Accounting Standards Advisory Board has also launched a project to determine which of the currently required disclosures would not be necessary in a Government-wide financial report.

We continue to make progress on the problems of imbalances in intra-governmental transactions and are devoting increased attention to help agencies fully reconcile these differences. Treasury's Financial Management Service has added a new tool to help agencies properly identify and record these intra-governmental transactions. Treasury and OMB now require agencies to report and reconcile intra-government activity quarterly instead of just at the end of the year, which has led to significant reductions in differences in agency reporting.

Supporting the accelerated reporting efforts have been our internal efforts to accelerate our reporting of monthly agency data to financial managers. The monthly Treasury statement, the public source of budgetary results, has been accelerated in issuance from the 17th work day to the 8th work day each month, facilitating agency efforts to verify and use the data in their reports.

As I have mentioned in the past, we continue with our plans to improve the routine outlay and receipt process by replacing the current two-step classification process with a single classification. We have a pilot scheduled for this coming fall. If that goes as expected, we will be implementing this new feature in the coming years to the dramatic benefit of every single agency.

In summary, we continue to make substantial progress in reaching our objective of effective financial reporting and sound financial management. Through the efforts to date, numerous issues have been identified, corrective actions instituted, and processes changed. Serious challenges remain before we reach our objective, but we understand our tasks and our commitment to resolving them is firm. Improved financial reporting leads to the ultimate benefit of effective financial management. As the stewards of taxpayer funds, our responsibility is to meet those highest standards of financial management.

Thank you, Mr. Chairman. That concludes my prepared remarks. I will be happy to answer any questions the committee may have.

Mr. PLATTS. Thank you, Mr. Hammond.

[The prepared statement of Mr. Hammond follows:]

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

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Statement of Donald V. Hammond
Fiscal Assistant Secretary, U.S. Department of the Treasury
Before the House Committee on Government Reform
Financial Report of the United States Government Improves Government Accountability

Mr. Chairman and Members of the Subcommittee, it is my privilege and pleasure to represent the Treasury Department today to discuss the state of reporting on the finances of the federal government. Your continued interest in this important subject is appreciated. The Financial Report of the United States Government, incorporating the consolidated government-wide financial statements, is designed to report on the financial condition of the Federal government using the accrual basis of accounting employed and understood worldwide for financial reporting. The report for fiscal year 2004 was the eighth time that Treasury has prepared and issued this report pursuant to the requirements of the Government Management Reform Act of 1994. We have learned a lot over these past eight years and, while not always apparent, considerable progress has been made towards producing a timely, accurate and useful financial report. Perhaps even more importantly, the efforts to provide effective financial reporting have led to significant improvements government-wide in the underlying financial management practices and processes.

We are pleased this year to have issued the fiscal year 2004 Financial Report on December 15 meeting the objective the Administration set out three years ago. This is two and a half months after year end and a full three and one half months before the statutory due date of March 31. Much of the credit goes to the agencies whose data is the backbone of the report. Almost all the agencies met their November 15 deadline for the issuance of audited financial reports and every agency met Treasury's November 18 deadline for data input into our new report preparation system. At Treasury, we have been planning for this date and in particular the Treasury bureau, the Financial Management Service (FMS), worked extraordinarily hard to make this a reality.

This was a significant accomplishment considering that we also concurrently launched the first part of a new consolidation process which was designed to ensure that the agencies' financial statements are consistently included in the government-wide Financial Report. Further development work to complete the system is scheduled for 2005, which should make preparation of the report more efficient and allow us to resolve some longstanding audit findings.

Importance of the Report

The Financial Report has been an important addition to federal financial reporting. Prepared in accordance with accrual accounting standards established by generally accepted accounting principles (GAAP), the report presents a picture of government-wide finances that complements the traditional information in the budget and helps to assess the long-term impact of the government's policy decisions. The timely availability of this additional information can more fully inform the budget process.

The standardized reporting framework promotes comparability and consistency in reporting across years, among agencies and increasingly among countries using accounting conventions generally common to financial reporting. The report goes beyond simple reporting of results as it displays the effects of all significant assets, liabilities, stewardship responsibilities and other commitments and responsibilities. For example, the considerable financial implications of the government's social insurance programs (principally Social Security and Medicare) are reported in the stewardship accounting for these programs and discussed in Management's Discussion and Analysis. These future program responsibilities do not fit neatly into current accounting classifications. While the appropriate accounting treatment in the future for these social insurance programs is a current topic of discussion at the Federal Accounting Standards Advisory Board (FASAB), the existing standard provides for comprehensive disclosure.

Major Improvements to the Financial Report

We think this year's Financial Report shows significant improvement from the first one we prepared for fiscal year 1997. Many enhancements have been made over the last eight years. Additional information has been added and the presentation improved over the years which has increased the usefulness of the report to the reader. The report is presented showing both current and prior years. This comparative presentation provides additional context to the reader as one can see the change in an account from year to year. The Statement of Net Cost is presented showing cost by agency instead of by budget function. This provides a critical link to the presentation of the budget. It also makes it easier for us to ensure that the report is consistent with agencies' financial statements from which it is built and also gives agencies a feeling of ownership in the report.

We worked with the FASAB to add two new basic financial statements, 1.) a Reconciliation of Net Operating Cost and the Unified Budget Deficit and 2.) a Statement of Changes in Cash Balance from Unified Budget and Other Activities. The reconciliation statement ties our accrual results to the more widely recognized budget results and the cash statement reconciles the budget results to the change in cash during the year. We have made other additions to the report as required by FASAB, such as additional reporting on social insurance and the presentation of the Department of Defense's military equipment on the balance sheet.

Less visible but no less important, the discipline and rigor associated with the production of regular financial statements have resulted in improvements in basic financial operating activities. For example, the report that identifies differences between the agencies' and Treasury's records for fund balance with Treasury were reduced by 54 percent in FY 2004 alone. For fiscal year 1999, I testified that agencies were out of balance by $401.3 million for differences greater than five months old. Today, for fiscal year 2004, those same differences are $178.1 million using a more aggressive three month aging standard. In another area, eight years ago the details of the problems with intragovernmental transactions were more unknown than known. We can now break out intragovernmental differences by functional categories so key areas that need attention can be identified and addressed. Finally, the synchronization of budget and proprietary figures was greatly improved when FACTS II became operational in the last quarter of fiscal year 1999. The Statements of Budgetary Resources in agencies' financial statements are also an important link between the budget and proprietary areas. All of these improvements have helped us hone in on those areas that need further attention and will be the focus of our activities this year.

Challenges

In order to pass audit scrutiny, we must address three major areas:

- Serious management control issues at DoD
- The government's inability to properly eliminate transactions between agencies
- Deficiencies in the report preparation process

DoD is making progress but much work remains. They are such a significant portion of the total financial picture that it is extremely unlikely that improvement in the audit opinion will occur without significant improvement in DoD reporting.

Two new initiatives were included in the 2004 report process that were designed to reduce the out of balance conditions that exist between agency transactions with other agencies. First we required significantly greater detail in the agency submissions so that we are better able to analyze the data. Second, we required agency auditors to review the out of balance conditions between the audited agencies and their trading partners in the hopes that greater auditor involvement would encourage agency management to accurately record and correct these balances. While it is too early to assess these initiatives, preliminary results are very encouraging.

The new report preparation system is a work in progress. We met our first phase objective for agencies to be able to fully utilize the data collection portion of the system to submit their financial statement data, but we still used a series of off-line processes to produce the final report. We plan to complete the consolidating portion of the system in 2005, which will aid us in demonstrating that the data used is consistent with the agencies' financial statements and greatly streamline the preparation process. That being said, a comprehensive draft of the Financial Report was produced in less than two weeks.

Progress in Addressing GAO Recommendations

GAO's audit enhances the report's credibility and highlights areas for improvement. The existing weaknesses in federal financial management have prevented GAO from being able to fully audit the report resulting in the issuance of a disclaimer of opinion. The preparation and audit of the past eight reports have revealed many deficiencies and areas for attention. This has resulted in improvements in the quality of the underlying financial information and the financial reporting systems and processes. It has also led to a better understanding of the government's financial operations. Through this rigorous and continuous process, we will improve our financial management environment and achieve more credibility in our financial reporting. Once we have achieved this level of credibility, we will have created the solid foundation for a better public understanding of the government's finances.

The new process we implemented for the FY 2004 reporting cycle used the agency financial statements to produce the Financial Report. Agencies use the Government-wide Financial Reports System (GFRS) to reclassify their financial statement line items to the corresponding line items required for the government-wide consolidated statements and provide additional information. While further enhancements to GFRS are needed, Treasury has laid the foundation for ensuring that the government-wide consolidated statements contain the same information as the agency financial statements. As our edits of agency data improve, we believe this aspect of the problem can be resolved in future years.

FASAB requires some disclosures that are not currently included in the government-wide financial report. For the fiscal 2004 reporting cycle, FMS asked agencies for data in the new report preparation system that relate to these particular FASAB-required disclosures. We are in the process of analyzing the 2004 footnote disclosure data submitted by the agencies to determine where the information is material to the financial statements or for evidence that the disclosure is unnecessary due to immateriality. FASAB has also launched a project to determine which FASAB-required disclosures would not be necessary in a government-wide financial report. We are working closely with FASAB staff on this effort.

We continue to make progress on the problem of imbalances in intragovernmental transactions and are devoting increased attention to help agencies fully reconcile these differences. As I testified in July before the Senate Committee on Governmental Affairs, FMS has added a new tool to help agencies properly identify and record these intragovernmental transactions. The Intragovernmental Reporting and Analysis System (IRAS) is instrumental in classifying inter-agency activity and balances. It identifies different ways agencies describe the same transaction (one agency records an expense while the other capitalizes it). Additionally, IRAS provides information for agencies to help correct reporting errors, and assists them in reconciling major differences. IRAS offers a database solution for tracking quarterly accounting errors and timing differences and a systematic documentation of the different accounting methods used by agencies. Treasury and OMB now require agencies to report and reconcile intragovernmental activity quarterly instead of just at the end of the year. These more frequent reconciliations have already led to significant reductions in differences in agency reporting.

Other Improvements

Supporting the acceleration efforts has been our internal efforts to accelerate our reporting of monthly agency data to agency financial managers. The Monthly Treasury Statement, the monthly public source of budgetary results, has been accelerated in issuance from the seventeenth workday to the eighth workday facilitating agency efforts to verify and use the data in their reports.

As I have mentioned in the past, we continue with our plans to improve the routine outlay and receipt process. Presently we employ a two step process for these budgetary transactions. The first step relates to the transactions that record the collection of funds or the disbursement of funds. The second step takes those banking transactions and classifies them according to the appropriations authorized by Congress. Obviously if these two steps could be combined savings would result. In this case the savings would be significant. Estimates are that several thousand financial management staff members across government are involved in this classification process. On the outlay side the classification is known when the disbursement is requested. To have to go back later and classify these transactions is extremely inefficient. The sooner we can eliminate this step the sooner savings and process efficiencies can occur. We have a pilot scheduled for this coming fall. If that goes as planned we will be implementing this new feature in the coming years to the benefit of every single agency across government.

Conclusion

We continue to make substantial progress on reaching our objective of effective financial reporting and sound financial management. Through the efforts to date, numerous issues have been identified, corrective actions instituted and processes changed. Serious challenges remain before we reach our objective but we understand our tasks and our commitment to resolving them is firm. As I have previously stated, improved financial reporting leads to the ultimate benefit of effective financial management. As the stewards of taxpayer funds, our responsibility is to meet the highest standards of financial management.

In conclusion, we have come a long way, our upcoming challenges are significant but manageable, and I am confident that we will continue to see real progress. Thank you, Mr. Chairman. This concludes my formal remarks.

Mr. PLATTS. We are going to go to the Q and A, and we will begin with about 5 minutes for each Member and have as many rounds. Good news or perhaps bad news—meaning we will have more time for a Q and A—is our next series of votes apparently won't be until about 5 p.m. now, so we don't have that crunch coming up at 3 p.m. we thought we may have.

There are a number of issues I want to get into. I think I will start where all of you have touched on up front, the issue of the timeframe. While we are pleased to have the information in a more time-sensitive manner, the November 15th and then December 15th for the consolidated statements, the issue of the pros and cons of that. The one that seems to be an example is the HUD situation where HUD's auditor put their pencils down November 15th. The Department expressed that they believe they would have gotten a clean opinion if the auditor could have finished the audit and not stopped then. One result of that is HUD will have to re-audit their 2004 statement when we come back next year and there is another expense here.

Should there be more flexibility? While we are pushing for this time, should we have some more flexibility built into that date of November 15th? I will throw that out to all three of you.

Mr. HAMMOND. I would be happy to start.

Mr. PLATTS. Sure.

Mr. HAMMOND. I think once you establish deadlines such as these, the objective should be to hold firm to them. Our experience has found that, while there is a difficult transition to getting to the accelerated reporting, once you achieve them the benefits of consistently making those dates or even further acceleration voluntarily before that really benefits the agency.

I will give you one practical example of a benefit. Getting the management letter report from the auditor in a timely fashion early in the fiscal year allows the agency to be able to address those issues within the current year, as opposed to if they were reporting in March, not getting that feedback until midway through the fiscal year or beyond and then, in essence, being a whole year behind cycle in being able to fix those identified areas.

Mr. PLATTS. So focusing more on things that the Department of Education has done internally to make sure you meet that deadline, as opposed to knowing you may have some window of flexibility if you support those internal changes to meet the deadline?

Mr. HAMMOND. Absolutely.

Mr. PLATTS. Yes. Mr. Walker or Mr. Martin?

Mr. MARTIN. I think that we need to stay with the November 15 reporting date. I think the over-arching goal should be for us to get timely financial information so that our managers can use this information to make decisions throughout the year and at year end. Receiving a clean audit 5 or 6 months after the end of the fiscal year, it is great to say you have a clean audit opinion, but it really doesn't do anything to manage the Federal dollars that we collect from our taxpayers. So I think we need to stay with that date. I think that the agencies that have difficulties making the date once they improve their internal control structure and perhaps start their audit in February or March as opposed to June or July, I think they will be able to make it.

Mr. PLATTS. OK. Mr. Walker.

Mr. WALKER. Two points. One, I see nothing wrong with the November 15 date. The fact of the matter is that people have to end up having the right processes, systems, and controls in place no matter what the date is, especially if it is an accelerated date. They also need to start the audits earlier rather than what they have been doing in past years.

The second aspect is whether or not, you have the date of November 15, whether there might be a circumstance in which you might allow a particular agency on a business case-by-case basis, a little bit of extra time if it would make any difference on the opinion they might otherwise receive.

So my view is that you ought to stick with November 15, but that shouldn't preclude the ability of OMB, if it so desires, to provide a little bit more flexibility on a case-by-case basis where a little bit more time might make a difference, and they have the ability to do that now. That is a policy decision.

Mr. PLATTS. The issue that may be related to this next year when we see the audits—that was a big issue this time. We dropped from 20 clean opinions to 18, but if we add in the restatements and we knock out 7—we actually drop down to, I think, 10 maybe clean opinions, maybe about 13 or so; 18 minus 11 is 7; we have 7. Let me get my math right here. So we drop down to seven. So in appearance we actually went up dramatically if we say they were not clean last year and this year we have 18. We really won't know that, because how many restatements will we see next year.

But that broad issue of restatements, I mean, clearly the fact that 11 departments had restatements tells us there is something wrong with what we saw from last year.

If we want to start with what you think the major cause of that number of restatements and how do we avoid that next time around?

Mr. WALKER. I would speculate two things, and I would ask my co-panelists to add their remarks.

First, it is my understanding that a disproportionate amount of the restatements have to do with the reconciliation of the budget to the financial statements, and that is a relatively new statement. Some people are still having some difficulty in trying to deal with it, so one would hope that this situation would improve with time.

Second, not all agencies have the type of systems, processes, and controls in place to be able to deal with accelerated reporting dates as effectively as they should be able to.

I would say those are probably the two biggest contributing factors, but I would also like to hear the opinion of my co-panelists.

Mr. MARTIN. Well, I believe that internal control material weaknesses contribute, the failure to reconcile accounts in a timely manner. Heroic efforts, as we have talked about, I think, at previous hearings, where the opinions are developed based on brute force, I think those lead to restatements. So to the extent that we can implement the financial management systems implemented, clean up our material weaknesses, which OMB has programs to monitor, then I think you will see the number of restatements declining.

I don't think it is a trend, and I think that they will continue for a variety of reasons, but I don't think it is a trend and I think that as we can get our arms around internal control issues we will see a steady decline.

Mr. HAMMOND. Just to add to that, I would agree with both my colleagues. I think it really does highlight an issue that is going to be one of continuing focus, which is the need to seamlessly manage both budgetary data as well as proprietary—what we characterize as proprietary or financial accounting information, because to the extent that those restatements do stem from the budgetary area, it means that the controls leaping back and forth between those two sources of data need to be very solid.

Mr. PLATTS. Thank you. We are going to move to the ranking member, but I want to recognize we have been joined by Mr. Duncan from Tennessee. Thanks for being with us.

Mr. DUNCAN. Thank you very much, Mr. Chairman.

Mr. PLATTS. Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman.

Let me again welcome all the new members to the committee. I am looking forward to serving with you.

Mr. Martin, let me begin with you. From your perspective, what reforms are actually necessary to improve the longstanding financial management problems across the executive branch? What is the status of the reforms currently in place?

Mr. MARTIN. I think there are a number of initiatives taking place right now within OMB that are focusing on providing greater consistency between the various Federal agencies with respect to the systems that they use, and I think that long-term these OMB initiatives, not tomorrow, but long-term I think we will see significant improvement across Government based on systems improvements, internal control improvements.

I think back to where the Federal Government was 15 or 20 years ago, I think most of us would never think we would be at a point now where most agencies are receiving clean opinions.

Mr. TOWNS. Thank you.

Mr. Hammond, can you update us on the developments and efforts underway of recovering improper payments referred to you for collection? Are there any hindrances or anything that we should do here to sort of assist you in being able to recoup that money?

Mr. HAMMOND. Our efforts to collect the delinquent debt owed the Government, whatever its source, whether it is from improper payments or from credit-related programs, are really moving along very nicely, in part attributable to the wonderful leadership that has come from this subcommittee over the years.

Last year we collected over $3 billion on behalf of the Federal Government through delinquent debt collection activity. That is a significant source of repayment, primarily coming from the offset of tax refunds. This year the President's budget has two legislative proposals contained in it that would help us to further enhance and refine our debt collection activities, and I would look to you all for your acknowledgement and support of those two important additions to our debt collection program.

Mr. WALKER. Mr. Towns, if I may add a point on that?

Mr. TOWNS. Sure.

Mr. WALKER. There is one area that I don't believe Congress has addressed yet that I would put back on the table. Under the

Prompt Payment Act, it is my understanding that if the Federal Government doesn't pay certain amounts within a certain timeframe they incur certain additional costs and penalties. At the same point in time, if the Federal Government happens to pay twice for a particular item, the individual who received duplicate payment not only does not have to notify the Federal Government, but, in fact, they never have to pay interest or penalty if down the road it is found out that a double payment occurred. I think we need to think about leveling that playing field in this area.

Mr. TOWNS. Excellent point. I mean, especially when I think about the fact that you mentioned the $7.6 trillion and then the $43 trillion. I mean, I think that we need to do everything we can.

Let me just go to you, Mr. Walker. In your view, what is GAO's continuing role in taking to accelerate progress in financial management reform and in developing short- and long-term strategies for addressing problems that continue to prevent the U.S. Government from preparing auditable consolidated financial statements?

Mr. WALKER. There is no doubt in my mind that the key players are committed to making continued progress in this area. There is also no doubt in my mind that the key players are looking for substantive wins, not pyrrhic victories.

The biggest concern that I have, quite frankly, Mr. Towns, is, of the three big areas that are preventing us from being able to express an opinion on the consolidated financial statements, the one I have by far the most concern about is the Department of Defense, and I am happy to come back to that if you want. That is the one that I still have very significant concerns about.

Mr. TOWNS. Thank you, Mr. Walker.

Mr. Martin, back to you. This year the Government celebrated their timeframe for the submission of financial statements from agencies to November 15th. Is this perhaps an over-aggressive schedule for agencies to meet? Could this be a fact in the decline of the number of agencies that received clean audits for the year?

Mr. MARTIN. I think that the November 15 date is an appropriate date, an appropriate target for all agencies to meet. I think one element that we haven't talked about that I haven't read much about in terms of meeting that accelerated date is the importance of having all individuals in the agency or department onboard, working toward a common goal of meeting that date. That means not only the people in the CFO office, but the Inspector General, the auditors, the program people, everybody in the entire department. I think at the Department of Education that is pretty much how we get it. So it is not a solo run for myself and my staff. Everybody has to say, "We are going to work together. If we have to work 14 to 16 hours a day for a period to make that deadline, that is what we are going to do. If we have to work weekends to make the deadlines, that is what we are going to do."

I received a commitment from our IG. We talked and we said, "We are going to do this. We are not going to cut any corners. We are going to cross T's and dot the I's. We are going to do it right and we are going to have our people work to make that goal.

Mr. TOWNS. All right. Thank you very much.

Thank you, Mr. Chairman. I have used up my time.

Mr. PLATTS. OK. We will come back around. Thank you, Mr. Towns.

Mr. Duncan.

Mr. DUNCAN. Thank you very much, Mr. Chairman.

Mr. Walker, a few months ago I heard a talk by Charley Cook, a very respected political analyst, and he made a very interesting statement. He said that people could relate to and get upset about $600 hammers and $900 toilet seats and things like that, but he said he had never seen a figure over $1 billion that anybody could really comprehend. That made some sense to me.

And then I read in this one article that I was given here. It says, "Agencies reported $35.7 billion worth of improper payments in fiscal year 2003, according to the testimony of Mr. McCoy Williams of the GAO." And then I read a few days ago that the Defense Department couldn't account for about $9 billion over in Iraq. I guess there are two or three questions there.

First of all, how do we get people to understand how much a billion dollars is? I mean, everybody in this room should be shocked or horrified by that $35 billion worth of improper payments or the $9 billion that couldn't be accounted for in Iraq. We should be horrified by that, but we aren't.

And then I guess second, how does that happen? How are we not able to account for $9 billion? I mean, maybe you could understand a much, much smaller figure, but we are talking about huge, huge sums here, just staggering amount.

Mr. WALKER. First, Mr. Duncan, the bad news is the $35 trillion is $45 trillion for this year, and that is not all the numbers yet because not all the agencies have reported yet, but that is an accurate number for 2003.

Mr. DUNCAN. You said trillion twice there.

Mr. WALKER. I am sorry. I am sorry, Mr. Duncan. I am dealing in trillions now. I apologize.

Mr. DUNCAN. I thought my gosh.

Mr. WALKER. Let me clarify.

Mr. DUNCAN. A trillion, a billion.

Mr. WALKER. The number for fiscal year 2003 for improper payments was about $35 billion or $36 billion. The number for fiscal year 2004 was about $45 billion, and that is not everything because not all agencies have reported.

Second, you are correct that even when you deal with billions, much less than trillions, it is hard for people to relate to it. One of the challenges you have is to try to convert that number into something that people can relate to.

You mentioned, for example, the Department of Defense. A billion dollars for the Department of Defense would fund roughly 10,000 Army troops. So for every billion we waste, we don't have the ability to fund 10,000 Army troops. So you have to take these numbers and convert it in terms that I think people can relate to. The $43 trillion number which I mentioned is about $350,000 per full-time worker when the average family income in the United States is $42,000. It compares to $47 trillion, which is the total accumulated net worth of all Americans, including their home equity. So we need to put these numbers in terms that people can understand them.

But we have large and growing structural deficits and we have to get serious now. We can't afford to waste anything, although waste will never be zero in the world's largest enterprise, which is the U.S. Government.

Mr. DUNCAN. Well, it will never be zero, but we sure have to do a lot better than what we are doing or we are going to run into some terrible, terrible problems. I mean, we are already—you know, the Congress voted to raise the national debt to $8.5 trillion a few months ago. Now they tell us that the deficit for this year is going to be $427 billion, and it is going to be more than it was last year. It just keeps going.

At any rate, do you know about this $9 billion that they were talking about a few days ago, how that happened?

Mr. WALKER. Mr. Duncan, GAO right now is doing work to get a handle on where the money went for the supplemental, because I have zero doubt that it was spent. I do however have serious concerns on what it was spent on. We haven't finished our work, but there are serious issues being raised. I believe it comes back to what I said before: the biggest problem agency in the Federal Government by far—nobody is even close—on financial management and accountability is the Department of Defense.

Mr. DUNCAN. Well, when you finish that report I would like to see it. May I respectfully suggest, Mr. Chairman, that might be something that we need to have another hearing about.

I especially like your suggestion that these complaints that get double payments, they should have to pay penalties and interest when that is discovered. You said they are not having to do that now, but I think that would be some good legislation that we could hopefully bring out of this subcommittee.

Mr. MARTIN. Mr. Duncan, let me add to that.

Mr. DUNCAN. Yes, either one of you.

Mr. MARTIN. With the proper internal control structure and elimination of many of those material weaknesses that have been identified at DOD, we would know where that $9 million is.

Mr. DUNCAN. No, billion.

Mr. MARTIN. Billion. He wants to go one way and I will go the other way.

Mr. PLATTS. Mr. Duncan, your point is very well taken. In fact, one of our priorities in our agenda for this session this year is coming back to the Federal Financial Management Improvement Act, which is really to focus on internal controls which will lead us to either improper payments or unaccountable payments, so we do plan on getting into that issue, and that most recent example is yet one more that will relate right on point.

Mr. DUNCAN. You know, I mentioned the hammers and the toilet seats, but I remember several years ago people all over the country got upset over $500,000 they were going to spend on the Lawrence Welk Home in South Dakota, and then in your State there was an outhouse that the Interior Department built in some park, and I think they spent $260,000 on it or something like that, and everybody got upset about that. But we need to get upset about this $35.7 billion worth of improper payments and this $9 billion that was lost in Iraq. As Mr. Walker said, he said he has zero doubt that it was spent, but apparently spent improperly.

Thank you very much.

Mr. PLATTS. We definitely are going to be following up on that issue, and your interest and passion on the issue is welcomed with the subcommittee. We will look forward to working with you.

I am going to pick up a little bit out of the order that I was looking at because I want to come back to the restatement issue, but on the improper payments, Mr. Walker, you touched on it, that the latest numbers are $45 billion with many agencies, and my understanding is the Department of Defense, some parts of the Department of Defense programs have done an improper payments assessment but not in total, given the size of that budget over there we expect to see.

Do you or either of our guests, our panelists, have any guess of where you think we will end up? You know, the $45 million is where we start at now for 2004, but I said when you used the word "trillion," when we add DOD in completely we might be at trillion. We have heard numbers of $75 billion or $80 billion as maybe accurate. Any idea?

Mr. WALKER. Since the executive branch has the primary responsibility to be able to come up with those numbers, I will let one of my co-panelists answer that.

Mr. HAMMOND. To try to attempt to answer your question, I think, from my understanding, I don't have the information to be able to estimate where it will go beyond that which is reported. I think clearly, as you are looking at where improper payments are likely to come from, what you want to look at is programs that have either entitlement design or certain forms of eligibility criteria, because they become prone to various forms of practice which may result in improper payments. And recognize that an improper payment may be a double payment. It may also be an under-payment.

Mr. PLATTS. Mr. Martin.

Mr. MARTIN. I think our difficulty is actually trying to identify improper payments. At the Department of Education we have initiated a couple of projects, data mining projects where we look at large programs attempting to identify data anomalies. But even with those exercises, I am not satisfied that we are really getting close to being able to identify accurately improper payments.

So going down the road, what we are doing at Education right now is looking at techniques and procedures to try to get our arms around just what is the level of improper payments. Right now we don't know. I think it is an area where we are just getting started. It is going to require a lot of work going forward, and it is a real front-burner issue with OMB now. You know it is on the scorecard. So the short-term challenge for me, and I think for many other agencies, is to try to identify what that number is. We are just estimating, and I am not happy with the estimating techniques so far. I think we can do a much better job.

Mr. PLATTS. I think of the $45 billion, maybe to have an accurate statement, my understanding is $40 billion is over-payments and the other $5 billion is under, for a net loss of improper over-payments of $35 billion. But we want to not pay too much, but we also want to pay what we owe, and we are missing it in a substantial way.

Mr. Martin, you are CFO of the Department of Education, but also on behalf of OMB and a message to OMB is the continued focus on the improper payments and that it just ties in to the broad issue of internal controls. If we have those internal controls we can get to the issue of these improper payments.

I put in perspective Mr. Duncan's question how do we put these terms. When we did the Medicare bill in late 2003, the prescription drug plan, the estimates, I used the number of about $45 billion per year over 10 years, because we had numbers of 400. We had over $500 billion over 10 years, what the cost would be, including the transition years. But if you say $45 billion a year, we are talking $450 billion every 10 years. The improper payments for 2004, $45 billion equals the entire cost of the new prescription drug plan for that year. That puts it in perspective for citizens to say yes, that is one heck of a lot of money when we talk about funding that entire program. To your fellow CFOs and to OMB in specific, that continued focus is important.

Mr. MARTIN. Mr. Chairman, I want to say one other thing.

Mr. PLATTS. Yes?

Mr. MARTIN. Going back to our data mining project, I would say, you know, we talk about estimates, but in terms of actual erroneous payments where we paid a vendor, say, the wrong amount of money, I think what we identified was less than $100,000 where there were actual—out of millions, billions. So from that standpoint it is good, but still I say we have a lot of work to do.

Mr. PLATTS. It is one of the I will say legacies of my predecessor, Chairman Steve Horn, on this subcommittee in pushing that legislation through in his final term here in Congress that I think long-term is going to really go a long way to cleaning up our financial house.

I am going to yield to Mr. Towns if you have other questions.

Mr. TOWNS. Thank you, Mr. Chairman.

Mr. Walker, what impact does information security weaknesses have on Federal operations and safeguarding Federal assets? And why is it important for agencies to establish a comprehensive security management program? Can you provide us with any specific examples of an agency making progress in strengthening their internal controls for financial management systems, because this seems to be a problem.

Mr. WALKER. First, like anything in life, if you don't have a plan you are going nowhere fast and you are not going to be able to solve your problem, so it is important to be able to have a comprehensive and integrated plan in order to make progress. In the absence of having a plan and effectively implementing a plan, you have Government assets that are at risk of inadvertent or deliberate misuse or loss. You have financial information that could be modified or destroyed. You have sensitive information that could be inappropriately disclosed. And you have critical Government operations that could be subject to disruption. So there are a lot of significant adverse consequences, some of which can be quantified in dollar terms and some of which don't lend themselves to being qualified in dollar terms.

Mr. TOWNS. I have also concerns actually relating to the lending and credit activities within many of our Federal agencies, particularly in light of your findings. Efficiencies in determining the costs of certain lending programs and the value of related loans—can you speak to the material problems facing the agency community and how to adequately determine credit programs' cost?

Mr. WALKER. I will mention something briefly, but I might have to provide something more for the record.

The issue of credit cost is to properly analyzing that, properly accounting for that, is a matter of increasing concern, one in which we are continuing to do work on. It is one that we have done some reporting on in the past, and if it is OK with you, I would like to be able to provide something for the record on that.

Mr. PLATTS. Without objection.

Mr. WALKER. Thank you.

[The information referred to follows:]

GAO Work on Credit Program Costs

Export-Import Bank: OMB's Method for Estimating Bank's Loss Rates Involves Challenges and Lacks Transparency, GAO-04-531, September 30, 2004.

Student Consolidation Loans: Further Analysis Could Lead to Enhanced Default Assumptions for Budgetary Cost Estimates, GAO-04-843, August 20, 2004.

Small Business Administration: Model for 7(a) Program Subsidy Had Reasonable Equations, but Inadequate Documentation Hampered External Review, GAO-04-9, March 31, 2004.

Department of Education's Federal Direct Loan Program: Status of Recommendations to Improve Cost Estimates and Presentation of Updated Cash Flow Information, GAO-04-567R, March 29, 2004.

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Maritime Administration: Weaknesses Identified in Management of the Title XI Loan Guarantee Program, GAO-03-657, June 30, 2003.

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Multifamily Housing Finance: Funding FHA's Subsidized Credit Programs, GAO-02-323R, February 1, 2002.

Small Business Administration: Section 7(a) General Business Loans Credit Subsidy Estimates, GAO-01-1095R, August 21, 2001.

Department of Education: Key Aspects of the Federal Direct Loan Program's Cost Estimates, GAO-01-197, January 12, 2001.

Department of Veterans Affairs: Credit Costs and Risks of Proposed VA Small Business Loan Guarantee Program, GAO/GGD-00-158, June 30, 2000.

Small Business Administration: A Review of SBA's Estimate of Impact of Legislative Proposals for the 7(a) Loan Guarantee Program, GAO/RCED-00-49R, December 15, 1999.

Credit Reform: Key Credit Agencies Had Difficulty Making Reasonable Loan Program Cost Estimates, GAO/AIMD-99-31, January 29, 1999.

Mr. TOWNS. Thank you very much.

Let me just go to one other thing. Mr. Walker, when you testified before us last year I remember I commented on how we had leveled off in the number of clean audits given in comparison to the prior year. This year we seem to be reversing that course without taking into account the number of agencies that are restating prior audit results. Are there any broad-based themes among the five agencies that received qualified or disclaimers on their audits? Can you tell us what specific actions may be taken in the short term to increase our numbers of clean audits among—forget about DOD. Forget about that.

Mr. WALKER. It is only about $100 billion, not counting the supplemental.

Mr. TOWNS. If you can.

Mr. WALKER. Sure. I will be happy, Mr. Towns.

First, to set the record straight, while there are 18 agencies that received clean opinions in 2003, 11 of those were restated as a result of the 2004 financial reports, but of those 11, 4 didn't get a clean opinion last year, so in reality it is 11 rather than 7.

Mr. TOWNS. Right. Exactly.

Mr. WALKER. Although for the record, 18 minus 11 is 7. And I will even certify that. But in any event, I think the common denominators are some of the things that we touched on earlier: not having effective systems and processes, not having appropriate controls, not being able to do work earlier in the year, not having the total team committed to getting things done within the appropriate milestones, and then some of the challenges that have been associated with reconciling budgetary results with the financial statement results. I believe those are the ones that are the primary challenges we need to continue to work on.

Mr. TOWNS. Right. Thank you very much.

Let me just ask you very quickly, Mr. Martin, it seems to me there are issues concerning the quality of audits received by agencies. Can you cite for us any particular concerns regarding the agency audit process you have noted during your tenure? Are there specific shortcomings or deficiencies within the agencies in order to meet the information requirements for auditors to complete their work?

Mr. MARTIN. I think there are numerous impediments to the auditors completing their work. I guess on the Government-wide audit there are what we call "scope limitations" because the information on the financial statements was not provided to the auditors in a timely manner so that they didn't have the opportunity to review a final set of statements, for example.

So there are issues with the auditors not being engaged in a timely manner. Say, for example, we at the Department of Education didn't get our books closed and our August statements done until October, then there is no way the auditors would have enough time to meet an November 15 deadline.

So the agency has a responsibility to produce statements in a timely manner, which goes back to the issue of having good financial systems so you can generate statements monthly. If you can do that with the proper controls, then you can ask your auditors to come in and start their audit work in February or March. Or, as is the case in many corporations, the auditors never leave. They are there year-round. We essentially invited our auditors to come in year-round if they wanted to, if that would help us meet the November 15 date.

Mr. TOWNS. All right.

Thank you very much, Mr. Chairman. I see my time has expired.

Mr. PLATTS. Thank you, Mr. Towns.

I am going to come back to the restatement issue, which will lead me into internal controls and the quarterly reconciliation issue.

Mr. Walker, in your written testimony you reference the range of restatements going from a few million dollars to $91 billion, and I wasn't sure what your reference was there. You talk about restatements to CFO Act agencies for fiscal year 2000 ranged from correcting two line items on one agency's balance sheet to numerous line items on several. The amounts range from several million dollars to over $91 billion. The $91 billion, can you expand on that?

Mr. WALKER. Mr. Chairman, that $91 billion was the Department of Health and Human Services, and that was an adjustment that was necessary with regard to that statement of budgetary resources that I mentioned before.

Mr. PLATTS. So that is one of those where hopefully we won't see—they are just getting transition to how to handle that reconciliation, that will be fewer and fewer need for restatements in the future as they get better experienced at that?

Mr. WALKER. That is our hope and expectation.

Mr. PLATTS. OK. Thank you.

We have talked a lot kind of internal control issue, and we were at the committee delighted with OMB's Circular A–123 trying to strengthen internal controls. As you are aware, I sponsored the DHS financial accountability legislation where we are requiring an audit of their internal controls because of where they are starting at, 22 agencies with many material deficiencies, and trying to get it right up front rather than coming back down the road and correcting it, so requiring that audit. We did not include in that legislation that every CFO agency has to have an audit of internal controls.

My question for the three of you would be: on the A–123 circular, does it go far enough, in your opinions, or should we go further and be looking at audits of internal controls for all agencies, knowing that there is a substantial additional cost for that requirement?

Mr. MARTIN. I guess I wouldn't recommend audits for all agencies. I think in some instances it might be appropriate, but a cost/benefit of doing that I think is not there. So I would say as a general proposition no, I wouldn't recommend it for all agencies.

Mr. PLATTS. Do you believe that the circular requirements go far enough in establishing when you should go farther?

Mr. MARTIN. Yes, sir, Mr. Chairman, I do.

Mr. PLATTS. Mr. Walker or Mr. Hammond.

Mr. WALKER. This is an issue that I expect for the principals of the Joint Financial Management Improvement Program to deal with. One of the issues that is on our agenda is to look at the Sarbanes-Oxley Act, which applies to the private sector, and to be able to discuss whether and to what extent any of those provisions should be applied to the Federal Government.

I would note for the record that while we are not required to do it, the GAO for years has voluntarily expressed an opinion on the system of internal accounting controls for the entities that we audit, not only the consolidated financial statements of the U.S. Government, but the IRS, the Bureau of Public Debt, the FDIC, and soon to be released the Securities and Exchange Commission for the first time.

So I do think it is something the principals need to talk about. I think we have to think about where does it make sense and where does it not.

Clearly, every Federal agency it doesn't make sense, and so I think we need to think about value and risk, cost/benefit, and hopefully we will make some progress on it.

Mr. PLATTS. Mr. Walker, would you think that an agency like DOD, which has significant internal controls, it should be more likely a requirement, or is it an overwhelming task where they stand, where it wouldn't be effective at this point in time?

Mr. WALKER. Ultimately I believe that would be an agency where it would likely meet the criteria, where it would be something you would want to do; however, I think we have to keep in mind right now and for the foreseeable future it is likely that the DOD is going to end up issuing an annual statement, which it is allowed to do by law, which basically says they are unauditable.

Clearly, they are going to have to focus on their systems, processes, and controls in order to be able to get in a position where they are auditable. But you wouldn't achieve much by telling them they have to obtain an opinion on their internal controls now because they can't even get an opinion on their financial statement.

Mr. PLATTS. Right.

Mr. Martin.

Mr. MARTIN. I think you will find if you look at the OMB circular, what it really reflects is a very thoughtful approach to implementing Sarbanes-Oxley at a Federal level to get started. It allows for an incremental review and implementation based on the nature of the agency, and I think, Mr. Chairman, it gets to exactly the point you are after. It focuses attention where attention is needed and doesn't cast an overall blanket affecting everyone and spreading that cost.

Mr. PLATTS. And takes that cost/benefit approach.

Mr. MARTIN. Exactly.

Mr. PLATTS. OK.

Mr. HAMMOND. Mr. Chairman, it is highly likely that if one was to try to attempt to conduct an audit of the system of internal accounting controls for the Department of Defense that it would likely be an adverse opinion if you got an opinion at all.

Mr. PLATTS. All right. And that issue, Mr. Walker, your staff is going to be with us next week for a hearing on this issue in greater detail, and it is something we are going to stay with because internal controls, I have come to believe—now I am starting my third year as Chair—is so critical to everything we have talked about, and so the greater our focus on that. That is why, with the Federal Financial Management Improvement Act, we are kind of trying to revitalize that, focus on that, and hand-in-hand with the OMB circular, that we hopefully will make some progress.

Mr. HAMMOND. I agree with you, Mr. Chairman. Internal controls are absolutely critical.

Mr. PLATTS. On extension of restatement, I was trying to find in my notes—I marked up all your testimonies and have too many notes to find what I was looking for, but, Mr. Walker, I think it was in your testimony talking about reconciliation, or it might have been Mr. Hammond, and the number of agencies that are not reconciling quarterly as they are supposed to. Was that in your testimony?

Mr. HAMMOND. I presented some figures, Mr. Chairman, on the nature of reconciliation having to do with the improvement in fund balance reconciliation over time, as well as what we have been learning from the reconciliation dealing with intra-governmental activity. What we have learned there is that there are a significant number of agencies that are out of balance on intra-governmental activity, that number is getting smaller, and what has allowed it to get smaller is our ability to focus in on the specific items, understand the nature of the differences, give the agencies information that they can work with and work backward from.

What we have learned is that the situation is probably worse than we thought when we started this, but it has gotten better in the last year and a half as we have been able to address it, which is a difficult place to be in but it is an interesting realization for us to understand how this information fits together and be able to work back to understand how to get rid of the difference.

Mr. PLATTS. You helped me get ahead of what I wanted to get to, and it was actually in Mr. Walker's specific testimony, but it relates to the intra-governmental transfers, and that was one of the issues I was going to move to, the size of the problem there, but that we are making progress. As we have talked before, there is a belief that you have identified it now, what is driving it, and that a year from now we should see less problems within that area of intra-governmental transfers.

Mr. HAMMOND. Yes. In fact, if I could split that problem into three pieces for an understanding, I think it is very helpful for me.

One is there are certain proprietary accounts—for example, investments that one agency may have on the books of the Treasury Department. They are very discrete. It is an area once we isolated it we are able to find the differences, and for all practical purposes we have resolved all those remaining differences in those areas.

We have a second set of activity which is the commercial type of activity that takes place between agencies. It is a little less discrete. This is buying and selling goods or services between an agency or paying rent or buying IT services.

The difference there may stem from timing, it may stem from accounting methodology, but fundamentally the only way to fix that area is to get the agencies together to work up a common solution and a standardized approach to dealing with it. It is not the type of area that can be resolved unilaterally.

And then the third area, which is the one that we really have to come to grips with, has to do with the transfers of spending authority between agencies. In essence, this is the whole way that the budgetary account system ties in behind the proprietary systems. That is a much more difficult task at this point, understanding how these flows be able to be matched up and eliminated between, in essence, the centralized source of those transfers as well as the agency that ultimately ends up using those.

Mr. PLATTS. And the prognosis for all three? I mean, the first obviously we are in good shape. The second two is where we are still working.

Mr. HAMMOND. The second one there is a considerable willingness on the part of the agencies to deal with this because it does reflect—it ties back. That is the nice thing about the subject we are dealing with is that everything is inter-related, and what agencies are discovering is that some of those restatements tend to the treatment of budgetary activity which tend to the controls over the way they do business between agencies, so there is a vested interest in understanding where that comes from and resolving it at the agency level.

The third problem is actually a problem in need of a solution, and that is where we are going to spend some considerable time over the next few months. It is not one yet that we have been able to isolate what we think would be the answer for solving it. Once we do that, I suspect it is going to be pretty straightforward. But because of the nature of the way appropriations are created and moved, it is a little more technically challenging just to get our arms around it.

Mr. PLATTS. As you move forward, we welcome that dialog as you try to identify that solution for that third aspect and how you are going to move forward with a solution once it is identified.

Mr. HAMMOND. I would be happy to.

Mr. PLATTS. My followup is to you, Mr. Hammond. Really it relates to Mr. Walker's testimony about the requirement of OMB and Treasury that the CFOs of 35 departments and agencies reconcile on a quarterly basis. What caught my attention was the statement that a substantial number of these agencies did not fully perform the required reconciliations for fiscal years 2003 and 2004. With there being a Treasury requirement, I guess I have two questions. One, why didn't they? And what repercussions were there for not doing what they are required to do?

Mr. HAMMOND. Those are excellent questions. The primary reason they didn't reconcile, as I understand it, stems from the fact that those transactions that were unable to be reconciled fall into that second category of activity: agency commercial activity between each other. That commercial activity is frequently done at a detailed sub-level and there is not sufficient information available easily between agencies to be able to match up that activity to be able to reconcile it. That is a solvable problem.

Mr. PLATTS. How long have they been required to reconcile quarterly?

Mr. HAMMOND. For about a year.

Mr. PLATTS. So that is new. So it is fair to say this time around it is a newer requirement so they didn't have the detail they needed; but if a year from now they still can't reconcile because they don't have the detail required to reconcile, then there is a little more responsibility that they are not fulfilling?

Mr. HAMMOND. Right. Exactly. And that would be a more fundamental problem, because what we do is we provide not only the tools and the information, but we also provide feedback. We prepare, in essence, a report card type of format of agency performance on our reporting requirements at the end of the year, which we then send back to the CFO of each of the agencies.

So if you were to see a situation where it would constantly stay the same, that would be indicative of a need for further attention at the agency level, and I think both OMB and Treasury would be committed to try and followup on that.

Mr. PLATTS. Thank you.

Mr. Towns, did you have any other questions?

Mr. TOWNS. Yes.

Mr. PLATTS. Sure.

Mr. TOWNS. This would be to you, Mr. Martin. I am trying to understand so we can be helpful along the way, and I really, really mean that. Maybe you can sort of help me through this process a little.

Many agencies place extensive reliance, as I understand it, on contractor support to prepare the financial statement. I would think that would affect the agency's ability to build and sustain a long-term financial management capability. Don't they have to take bids and then, if the contractors don't do what—I mean, walk me through this process. I am trying to make certain I fully understand every aspect.

Mr. MARTIN. I think what you will find at our department and probably throughout Government is that contractors are, especially in the IT area and the accounting area, that there is significant level of contractor participation, and what we are trying to do at the Department of Education essentially is to wean ourselves from this kind of contractor support.

I looked at some of my senior CFO staff a couple of years ago and I said, "Bring in the resumes. I want to see the resumes of the contractors and I want to see the resumes of our staff." Our people are just as good on paper, and in many instances better, than the contract staff. So I said to my folks, "Why do we need contractors to do this work? Let me know how many contract hours we have, and starting now we are going to reduce the number of contract hours so we are not dependent on those people. You folks should be able to produce financial statements without significant contractor intervention."

Mr. TOWNS. So my concern is real?

Mr. MARTIN. You are right on point.

Mr. TOWNS. Thank you. Thank you very much.

Thank you, Mr. Chairman.

Mr. PLATTS. Thank you, Mr. Towns.

As you were correcting the record for our accuracy on math, I referenced the FFMIA Act next week. We are actually doing the Federal Managers Financial Integrity Act next week, FMFIA. My staff director said we have talked openly about one of our efforts of the committee this year is reorganizing the dozen or 15 different financial management acts of the last 20 years into a more cohesive and easily understood and implemented plan for all of our financial managers throughout the Federal Government. One benefit would be to get rid of all the acronyms so I don't get myself confused here.

On that point, that reorganization effort, we are certainly going to look for insights and guidance from all three of you and your agencies and your experience as we look to try to bring all this together in a more efficient way.

I want to turn. Mr. Walker, we have touched on, in a minimal sense but regularly throughout today's hearing, on the Department of Defense and that 600-pound gorilla out there that we need to deal with if we really want to get a clean opinion on the consolidated Federal Government statements. One of the issues there as chief management officer and your staff and your office has been working with the committee on how to approach that issue. I was wondering if you could give us your emphasis or arguments on the importance in moving in that direction. We talked a little bit before we started the hearing. And then if there is an update where GAO stands on maybe proposed legislation language, that would be great.

Mr. WALKER. First, based upon our latest update of GAO's high-risk report, which we issued in the last week of January of this year, DOD now has 14 of 25 high-risk areas; 8 are DOD only, and they also share the six Government-wide areas. That is two more than they had last year. And several of these have been on the list since the beginning.

I have become convinced, along with my colleagues at GAO, that a number of things are going to have to happen in order for DOD to effectively deal with these high-risk areas, of which financial management is but one and it is related to a number of other ones, such as the modernization of their information systems, etc.

One of the things that I believe is that if you go to the Department of Defense and you ask them who is in charge, who is responsible, who is accountable, who is qualified, who is resourced, and who is in the right position to be in charge of business transformation, I don't know that you would get an answer. Or if you did get an answer, you wouldn't get a consistent answer. That is a problem.

We need to recognize the reality that it will take years to address DOD's high-risk areas, and it will take the sustained attention of a highly qualified individual with a proven track record of success in dealing with these types of issues over a sustained period of time.

Our view is that one way to go about that is to create a new position. You could call it "Chief Management Officer," or you could call it "Chief Operating Officer." The words shouldn't matter, but it needs to be somebody at the Deputy Secretary level for management. A position that is not a substitute for but a complement to the current Deputy Secretary position. We need somebody with a proven track record of success in both the public sector and the private sector who woule focus on various fundamental business transformation efforts.

We need to have somebody, I believe, who has a term appointment, e.g., 7 years, because history has shown that, irrespective of whether you are in the private sector, the public sector, or the not-for-profit sector, on average it takes 7 plus years to effectuate a needed transformation, and in the Government it takes longer because it is not used to changing as much, much less the Department of Defense with so many layers and levels and systems.

We also ought to have a performance contract for that person. I am pleased to say that the Defense Business Board, which advises Secretary Rumsfeld and Deputy Secretary Wolfowitz, of which I am an ex officio member—and I will go to one of those meetings tonight and tomorrow—has recommended that the Department of Defense establish such a position.

While the Department of Defense could theoretically do this administratively by taking one of their current allocations, you can't achieve certain things administratively. You can't necessarily achieve the type of stature, the term appointment that I believe is important, nor can you institutionalize the issue.

There is no question in my mind that Secretary Rumsfeld on down is committed to trying to deal with this problem. There is absolutely no question in my mind on that. But, quite frankly, they have a lot of other things they are having to deal with and there are enough things going on day to day that each of the Under Secretaries and Assistant Secretaries and Service Secretaries have to deal with, and everybody is focused on their own silo or line item. We need somebody who is focused full time to make this happen.

As far as the audit, while the DOD has a goal, they don't have a comprehensive, integrated, and credible plan with appropriate milestones and accountability mechanisms to achieve this goal. In orer to achieve a goal you need to have a plan, and they don't have one yet. They need one. And when they approach it, they are going to have to approach it in a matrixed fashion. They are going to have to work over time to try to get more entities that can get clean opinions and more line items that are cleaned up so that over time they will move to where they will get a qualified opinion, and hopefully before the end of my term a clean opinion.

Mr. PLATTS. Before I continue I want to recognize we have been joined by our subcommittee vice chairlady, the gentlelady from North Carolina, Virginia Foxx. We are delighted to have you with us.

Ms. FOXX. Thank you, Mr. Chairman. I am sorry there was a conflict and I am late.

Mr. PLATTS. As a new member here, you will find that we are called upon to be in four spots at once on a regular basis, so we are delighted to have you be with us and look forward to working with you and with our ranking member, Mr. Towns, as we go forward.

Mr. Walker, I want to followup on what you have already said. I share your belief. We have had great efforts. You look at Secretary Rumsfeld September 10, 2001, when he lays out his priorities, one of which that day is financial management at DOD, and the events of the next day understandably run the course here and dominated their challenges. I think that is one of the challenges for Deputy Secretary Wolfowitz. Their priority, as it needs to be, is fighting war and winning war. While they have a great intent and had some good people—Dov Zakheim and others—the fact of that turnover, the CFO, the Deputy CFO, the Deputy Under Secretary for Management, all those things have led—I think you said earlier, a well-intended goal, but without a plan or ability to move forward to reach the goal.

I look forward to working with you again, when CMO or whatever office or title we want to have. One of the things you mentioned, though, in creating it was doing it statutorily instead of administratively, which I agree with because of that permanence if you do it administratively. You can say we are going to do it for a 7-year term, but change of administrations one way or the other is going to be a change in 3-plus years from now, whether that continues if we do it statutorily.

You also mentioned performance contract. Could you expand on what you envision there?

Mr. WALKER. Yes. A performance contract wouldn't require a statutory provision, but the concept being that this person would be responsible and accountable for making sure that comprehensive and integrated plan was developed, that there were key milestones, and that appropriate accountability mechanisms are in place. I think it would be appropriate to consider having some type of performance contract whereby the individual would be held accountable for achieving those key milestones, obviously with appropriate accountability for other parties that are contributing, as well. That should affect how much they get paid, and it also should affect their job security.

Mr. PLATTS. I appreciate that because it kind of goes to my question about reconciliation issues. I asked what are the consequences. One of the challenges, I think, when we try to analogize Sarbanes-Oxley and other issues of the private sector to public sector is in my 2 years I have found that we often aren't doing what we are supposed to be doing, what statues require in the area of financial management. Where there is a carrot/stick aspect to that would be important.

On the issue, update where you stand on proposed language. Still in the early——

Mr. WALKER. We are very close. We are happy to provide technical assistance to the committee in that regard.

Mr. PLATTS. We greatly appreciate it and look forward to moving forward on that issue with you, because it is something that for DOD in particular, and as I have said when we have had NASA here and DOD, helping them to clean up their financial house is going to allow them to focus more efficiently and effectively on their primary missions, whether it be going to space with NASA or, you know, the efforts of defending our Nation at DOD.

Virginia, did you have anything, any questions?

Ms. FOXX. Not at this time, Mr. Chairman.

Mr. PLATTS. Not at this time? OK.

I want to come back to one other issue, Mr. Walker, you touched on, and I know you probably spent a fair amount of time maybe at the Budget Committee today. When we talk about that $43 trillion of liabilities that are out there, we could probably spend days on all of them. Social Security though is one that is on the front burner, and a lot of discussions in your testimony. You also gave to us a copy of your statement, which I appreciated receiving, your address a week or two ago with State and local governments and some of the challenges out there. You referenced that you want to go into more detail in your question and answer period, and I obviously wasn't there for that.

When I read your testimony and the need for changes, some of the ideas that are out there such as the wage index for initial calculation of benefits, you know, the cap on the payroll tax at roughly $90,000, the idea of personal accounts, could you touch on those as you read what ones we should focus on most, or combination of, or you think is going to allow us specifically for Social Security to get on the right track?

Mr. WALKER. As you know, Mr. Chairman, GAO has done quite a bit of work in this area already. I expect that we will be doing some more. We have come up with criteria that we believe any Social Security reform proposal should be evaluated based on in order to make sure that it is a level playing field and a fair and balanced analysis.

As you know, I used to be a trustee of Social Security and Medicare from 1990 through 1995, so I am pretty deep on these issues.

One of the things that you referred to me before that I noted in my speech at the National Press Club last week was I really believe that, while Social Security does not face immediate crisis, it does face a large and growing financing problem that is getting bigger every day, and it would be prudent to address sooner rather than later. I think one reason is because Social Security is only $3.7 trillion of our $43 trillion challenge.

The other thing that I mentioned was I believe that Congress has an opportunity, working with the President, who obviously would have to sign the bill, to exceed the expectations of every generation of Americans in doing Social Security reform. You don't have that opportunity in Medicare. You do have that opportunity in Social Secretary.

The reason I say that is if you take individuals at a certain age or older—the President has suggested 55, but that may or may not be the right age—and you say those individuals will not be affected in any way, shape, or form, they will get the current deal, and those are the ones who are most concerned because they don't have time to make adjustments.

If you then take people younger than whatever age you select—for example, Baby Boomers, Generation X, Generation Y—you could make progressively greater changes, whether it be on the replacement rates, the retirement ages, the indexing formulas, whatever, but progressively greater changes the younger you are but phased in over a number of years, you can end up giving everybody more than they think they are going to get—not necessarily more than has been promised, but more than they think they are going to get.

For example, my father, who is retired, is going to get every dime. I am assuming there is going to be some hair cut to my benefits. My children are assuming there is going to be a bigger hair cut. The fact of the matter is that if we act soon there is an opportunity to make more modest changes than otherwise will have to be made, and hopefully it will give us some credibility and some confidence to start dealing with some of the bigger challenges that are going to be a lot tougher to deal with, are going to take many years, and where you are not going to exceed the expectations of potentially any generation. The prima facie example of that is Medicare.

Mr. PLATTS. And your point of building credibility is one that I think is so important, because these issues politically have been that third rail—Social Security, Medicare there now as well. If we are able to take on the issue—and Mr. Hammond referenced earlier the third category of intra-governmental. A problem in need of a solution goes to Social Security. We should all agree that it is a problem. The question is: what is the solution and how do we go about implementing it? If we can get to that discussion, it is a lot more likely to be a policy focus instead of partisan focused, as it is currently. But if we do right on Social Security, then we will have that trust of the people so when we take on Medicare and that huge unfunded liability, that we can do it in a way that will do as best we can by everybody in a fair and honest fashion.

I use my own family, the debate between 2042, which is in the consolidated financial statements, versus 2052 in CBO. I said my daughter is 5. She doesn't get retired until at least 2067. Either date, we have a problem. And I have got a Mom who is 71 who is already there. So I am looking at it from a sense of protecting those there and doing right by those who are many, many decades away from getting there.

Your frankness on this issue, not just in the past month but for many years, is—I am sure you have felt like you are crying out and no one was listening. Well, finally we have a President and I hope House and Senate that are closely listening to the message you have been conveying and documenting so effectively and are going to act.

I think President Bush has said—and I had the pleasure of being with him yesterday, about 15 of us House Members—in the end people respect if you are willing to take on problems and actually present solutions and are willing to act to solve problems, as opposed to just passing them on, which is, as you have well told us, what we have been doing for years.

Ms. Foxx.

Ms. FOXX. Yes. Mr. Walker, I appreciate very much what the chairman was just saying. Not having had the privilege to have heard you before, I wonder if you are saying you wouldn't characterize it as a crisis. That seems to be what the popular press picks up in a lot of cases is that it is no crisis, therefore we don't need to deal with it. The chairman is indicating that you have tried in times past to indicate to people that there is a real problem.

Do you have any other suggestions? Or you may want to tell me this later if you have already said it in the meeting. How do you get people's attention. If you don't want to call it a crisis, then how do you get people's attention that if nothing is done it soon will become a crisis?

Again, I don't need you to go into great detail, but it is obvious you have given it some thought.

Mr. WALKER. The first thing is before you can solve a problem there has to be broad-based consensus that there is a problem that needs to be solved, and there also has to be at least majority agreement that—I mean on both sides of the aisle, a majority of total members and of the population hopefully—that believe that it is prudent to act sooner rather than later.

I would be happy to provide you and your office my testimony before the House Budget Committee—I will give you one today. It lays out a number of reasons why it is prudent that we act sooner rather than later.

The biggest reason is you can look at it micro or macro. On a micro level, the sooner you act the less dramatic the changes have to be, the more time you have to phase it in, because time is currently working against us. The problem is getting bigger every day because of known demographic trends.

From a macro standpoint, this is a small downpayment on the work that has to be done. It is $3.7 trillion out of $43 trillion. We need to start solving some of these long-range imbalances. With Social Security you have the potential to exceed the expectation of all generations of Americans, that sounds like to me it could be a win.

I think part of the problem is there has been too much focus on individual elements of a possible proposal like, for example, individual accounts. I mean, individual accounts may or may not be part of a comprehensive solution to Social Security, but even if they are, they are only going to be a piece of a package and other things have to happen in order to assure the solvency and sustainability of the system.

I have been very concerned because there is no doubt in my mind I believe that a clear and compelling case can be made that it is prudent to act now. At the same point in time, we are not off on a very good foot because it is too partisan, it is too ideological, and it is too focused on individual elements of a potential reform package rather than reaching the first objective. The first objective is to obtain agreement that we have a problem. It is a large and growing problem. We need to solve it, and it is prudent to solve it sooner rather than later. Once we are there, then we can talk about how best to go about that, what are the possible elements and related tradeoffs, what are the pros and cons.

I honestly believe, based on my experience as a trustee, and being on two Social Security Reform Commissions in the past, having been involved in national town hall meetings around the country on these issues in the past, that the American people are a lot smarter than many give them credit. I give them a lot of credit. I am sure you all do, too. They are very smart. You give them the facts. You speak the truth. They will empower you to act.

Mr. PLATTS. And that education process, what the problem is today is a critically important first step, because I describe it as a problem that we need to address. If we don't, it will be a crisis for when we reach that 2018 or 2042, whatever year in the future it will become a crisis if we don't address the problem we have today.

Mr. WALKER. That is true, and part of the problem is that many times Government historically has not addressed issues until a crisis is upon us, which is fundamentally imprudent given these known demographic trends and our long-range imbalances.

Let me give you an example real quickly and I will move out of this. In 1983, when the Greenspan Commission was created, we were within weeks of not sending out the checks on time. Now, believe me, that would be a crisis. There would be a big signal.

Mr. PLATTS. You wouldn't want to be in our District offices when that happens.

Ms. FOXX. Right.

Mr. WALKER. I would say there would be consequences. But the fact of the matter is today's equivalent of 1983 is 2042. But it would be fundamentally imprudent to wait until 2042, not just because of Social Security; because of the much broader fiscal imbalance challenge that we face.

Mr. PLATTS. Yes. I want to just conclude. In your testimony, Mr. Walker, to put a plug in something we are working on, a number of places in your written testimony you talk about the way we are reporting not adequately showing the results that agencies are getting for the taxpayer dollars and the importance of program review and ongoing process at the Department of Education and Treasury and with our legislation, our PAR Act legislation that we moved last fall out of the full committee. We didn't have time to get it on the House floor schedule before the end, but I have talked to Chairman Davis and we will likely move it in March in the full committee. It is something that we are trying to help, again, from a statutory standpoint, put some permanence into what the administration is doing, I think, a wonderful job going through the part process of trying to be more results oriented and not just, "You have X dollars and spent X dollars appropriately," but, "Did you achieve any results for the American people when you spent X dollars?" Our legislation is going to try to help push that in a statutory sense.

I want to thank the three of you again for your several hours here today with us and your preparation and your day-in and day-out work. We look forward very much to continuing our interactions with each of you and your offices as we move forward over these coming 2 years.

Mr. WALKER. If I can, Mr. Chairman——

Mr. PLATTS. Sure.

Mr. WALKER [continuing]. I would like to thank you again for holding this hearing and making it an annual occurrence. Second, I would like to thank all the very capable GAO staff who worked on this year's financial statement audit, because without their efforts it just wouldn't happen.

Thank you.

Mr. PLATTS. As I left the capital on December 15th, my daily commute back to my home in York, I thought I heard a big sigh of relief out of GAO that it was all done and submitted. We know that is quite a herculean effort that goes into that audit process.

We have a couple of things, I guess. We are going to keep the record open for 2 weeks that you are going to followup with, Mr. Towns, any information you want to submit.

I want to recognize staff from both sides, as well, who help make these things run smoothly.

This hearing stands adjourned.

[Whereupon, at 3:57 p.m., the subcommittee was adjourned.]

[The prepared statement of Hon. Jon C. Porter follows:]

STATEMENT FOR THE RECORD
CONGRESSMAN JON PORTER (R-NV)
"FINANCIAL REPORT" HEARING
FEBRUARY 9, 2005

Mr. Chairman, I appreciate your holding this hearing today. I also would like to thank our witnesses for coming here to Capitol Hill in order to discuss this issue today.

As the Chairman of the Subcommittee for Civil Service and Agency Organization, I take great interest in making sure that our Federal agencies are using taxpayers' dollars effectively. I believe that Federal fiscal responsibility and agency organization are inextricably linked, and I find it troubling that the General Accounting Office (GAO) recently found that the accuracy of data in the consolidated financial statements was materially deficient for some agencies.

In my home state of Nevada, most of my constituents in Southern Nevada come into contact with Federal agencies, whether they know it or not, every day of the year. So, I am a firm believer in making sure that our Federal agencies are working effectively in order to better serve the American public. Although there are many agencies that are abiding by the financial and managerial rules set forth by Congress, I would like make sure that all of our agencies are working under these guidelines within the very near future.

Again, Mr. Chairman, I appreciate being here today, and I am looking forward to hearing the witnesses speak.

* * *

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

DEPUTY DIRECTOR
FOR MANAGEMENT

MAR 17 2005

The Honorable Todd Russell Platts
Chairman
Subcommittee on Government Management, Finance
and Accountability
Committee on Government Reform
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Platts:

I am writing to clarify an issue that arose during the February 9, 2005, hearing before the Committee on Government Reform on the topic of the Government-wide financial statement. This matter relates to the effect of restatements of previously-issued financial statements on the number of unqualified audit opinions received for major Federal agencies in Fiscal Year (FY) 2003. I would appreciate this letter being made part of the official record of the hearing.

Restatements of financial statements occur when issues arise subsequent to the issuance of the auditors' report that have a material effect on the financial statements. Once the material error is identified, the new information is audited. Based on the reliability of this new information, the auditor then decides to either maintain the same opinion or to change it.

In FY 2003, 20 of the 24 major Federal agencies initially received unqualified audit opinions on their financial statements. Nine of the 20 agencies with unqualified audit opinions, however, restated their FY 2003 financial statements in their FY 2004 Performance and Accountability Reports (PARs). For two of these agencies, their respective auditor downgraded the level of their previously-issued unqualified opinions. The net result of this change is a revised total of 18 unqualified opinions for FY 2003. The attached chart provides an agency-by-agency analysis of the FY 2003 auditors' opinions.

The Office of Management and Budget (OMB) has several initiatives underway to improve internal control over financial reporting and reduce the risk of a financial statement restatement in the future. For example, a revision to OMB Circular A-123, *Management's Responsibility for Internal Control*, strengthens the process agencies must undertake to assess and report on internal control effectiveness. In addition, OMB is aggressively monitoring control weaknesses under the President's Management Agenda and holding agencies accountable for implementing corrective actions.

Improving internal control and correcting long-standing control weaknesses at Federal agencies is not a short-term endeavor. However, OMB and the agencies remain committed to taking the necessary steps toward overall financial reporting improvements. As these initiatives take hold over the long-term, we expect agency restatements to decline.

Thank you for the opportunity to comment on this important issue.

Sincerely,

Clay Johnson III
Deputy Director for Management

Enclosure

Identical Letter Sent to The Honorable Edolphus Towns

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OFFICE OF MANAGEMENT AND BUDGET
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Attachment

FY 2003 Financial Statement Results

Audit Opinion	Restated 2003	2003 Initial Opinion
Unqualified	18	20
Qualified	1	0
Disclaimer	5	4

Agency	Type of Opinion	
CFO Act Agencies:	**Restated Opinions 2003**	**Initial Opinions 2003**
Department of Agriculture	Unqualified	Unqualified
Department of Commerce	N/A	Unqualified
Department of Defense	Disclaimer	Disclaimer
Department of Education	N/A	Unqualified
Department of Energy	N/A	Unqualified
Department of Health and Human Services	Unqualified	Unqualified
Department of Homeland Security	N/A	Disclaimer
Department of Housing and Urban Development	N/A	Unqualified
Department of Interior	N/A	Unqualified
Department of Labor	N/A	Unqualified
Department of Justice	Disclaimer	Unqualified
Department of State	Unqualified	Unqualified
Department of Transportation	Unqualified	Unqualified
Department of Treasury	N/A	Unqualified
Department of Veterans Affairs	N/A	Unqualified
Agency for International Development	N/A	Unqualified
Environmental Protection Agency	N/A	Unqualified
General Services Administration	Unqualified	Unqualified
National Aeronautics and Space Administration	N/A	Disclaimer
National Science Foundation	Unqualified	Unqualified
Nuclear Regulatory Commission	Qualified	Unqualified
Office of Personnel Management	Unqualified	Unqualified
Small Business Administration	Disclaimer	Disclaimer
Social Security Administration	N/A	Unqualified