# FEDERAL FINANCIAL STATEMENTS FOR FISCAL YEAR 2006: FISCAL OUTLOOK, MANAGEMENT WEAKNESSES AND CONSEQUENCES

## HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

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# FEDERAL FINANCIAL STATEMENTS FOR FISCAL YEAR 2006: FISCAL OUTLOOK, MANAGEMENT WEAKNESSES AND CONSEQUENCES

**TUESDAY, MARCH 20, 2007**

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
ORGANIZATION, AND PROCUREMENT,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
*Washington, DC.*

The subcommittee met, pursuant to notice, at 2:55 p.m. in room 2154, Rayburn House Office Building, Hon. Edolphus Towns (chairman of the subcommittee) presiding.

Present: Representatives Towns, Murphy, Welch, Platts, and Bilbray.

Staff present: Michael McCarthy, staff director; Rick Blake, professional staff member; Velvet Johnson, counsel; Cecelia Morton, clerk; Kristina Husar and Alex Cooper, minority professional staff members; and Larry Brady, minority senior investigator and policy advisor.

Mr. TOWNS. The subcommittee will come to order.

Welcome to today's hearing on the Federal Government's fiscal year 2006 consolidated financial statement. This hearing addresses a very important issue for the Congress and the Oversight Committee. As stewards of taxpayers' dollars, we owe American citizens no less than full transparency and accountability over the Federal Government's operations and fiscal condition. We need to be certain that Federal assets are protected from loss or misuse. It is imperative that we fully understand the cost of the Government's operations and the implications of our financial commitments.

I am pleased that the Government is continuing to make progress on improving financial management. For the second consecutive year, every major Federal agency issued their audited financial statements within 45 days of the end of the fiscal year. Of the 24 CFO agencies, 19 received a clean audit opinion. In addition, OMB reported improper payments were reduced by $9 billion over the past 2 years.

However, as in previous years, the 2006 audit demonstrates that, although many agencies have improved their financial management practices, there is still much work to be done.

This marks the 10th consecutive year that GAO was unable to render an opinion on the Government's consolidated financial statements. This situation is due to longstanding financial management issues at the Department of Defense, the Government's inability to

reconcile accounting between agencies, and the Government's ineffective process for preparing its financial statements.

Good financial management is more than just a paperwork exercise. Weak financial management can directly impact Government operations and security.

Last year financial problems at the Defense Security Service caused that agency to abruptly stop processing security clearances for Government contractor employees. Because of this, thousands of employees were at risk of losing their jobs because their clearances were expiring and contractors had to increase salaries to retain employees with clearances, costs that were eventually passed along to the taxpayers.

Similarly, problems with finances at the Federal Protective Services are threatening the security of our Federal buildings. Government departments failed to properly reimburse FPS for guarding the buildings, which caused FPS to delay payments to contract guards and pay millions of dollars in interest. Now, FPS is cutting back the number of officers and security coverages at Federal buildings, and it can be traced back to breakdowns in the financial accounting and funds transfer between departments.

Today's hearing will look at the progress that has been made in improving financial management and the challenges that remain. We will examine the problems that some agencies have experienced to see how to solve them and how other agencies can avoid the same problems. Specifically, we will explore problems with installing new financial systems, and with interdepartmental accounting, and we will look at the bigger picture of how the Government measures its long-term assets and obligations.

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

I now yield to Mr. Platts on the minority side.

Mr. PLATTS. Thank you, Mr. Chairman. I would just like to say, one, thank you for holding the hearing and continuing the important work of this committee and oversight responsibilities with our Federal Government's financial management practices and the well-being of our finances, and in advance thank our witnesses, both this and the following panel, for their day-in and day-out work on this very important issue that, as you and I have joked, I think, in the past that we were going to have our witnesses admit to steroid use, because if we did we would have the room filled with cameras, as it should be, because the financial well-being of our Nation and the impact on the daily lives of our citizens is, to me, one of the most important issues here in Washington. Certainly those who are going to testify before us today understand that. Again, I appreciate their great work.

I do apologize. Because of trying to be in several places at once, I will be here for the opening statements and then try to return for the Q and A and the second panel.

Thank you, Mr. Chairman.

Mr. TOWNS. Thank you very much.

Congressman Murphy.

Mr. MURPHY. Thank you, Mr. Chairman.

Often the repeated phrase that Government should work more like a business doesn't exactly prove an apt analogy, but when it comes to issues of financial management, when it comes to making sure that we have good audited financial statements, it certainly is an apt analogy, and I am very thankful to the chairman again for being able to be a member of this subcommittee, a new member of this subcommittee.

I thank the witnesses for being here to shed some light on a very important issue to the new constituents in my District who care deeply about how their taxes are spent by this Government, and taxpayers across the country.

Thank you, Mr. Chairman.

Mr. TOWNS. Thank you very much.

At this time I yield to the ranking member of the subcommittee for his opening statement, Mr. Bilbray of California.

Mr. BILBRAY. Mr. Chairman, I apologize for my tardiness.

I appreciate the witnesses here today. Mr. Chairman, I just appreciate the ability to participate in this hearing. As somebody who spent 18 years in local government, from being a mayor to a chairman of a county of 3 million, I am obviously very interested in that huge leap between the theory of how we want to spend our money and the reality of what really does happen with those funds.

With no other ado, Mr. Chairman, I yield back and thank you again for the participation.

Mr. TOWNS. Thank you.

I yield to Mr. Welch.

Mr. WELCH. I want to thank you for holding this hearing. I look forward to serving with you on this subcommittee. My colleague, Mr. Murphy, said better than I can say everything I would have said, so I am going to ask to have his remarks re-recorded in my name. [Laughter.]

Mr. TOWNS. You are going to do very well on this subcommittee.

Thank you very much.

Actually, the first panel, of course, is already at the table. It is our longstanding policy, as you know, to swear the witnesses in.

[Witnesses sworn.]

Mr. TOWNS. Let the record reflect they have spoken in the affirmative.

Our first panel features two leaders in advancing Federal financial management and promoting Government accountability. David Walker is the Comptroller General of the United States and leads the Government Accountability Office, the investigative and auditing agency for the U.S. Congress. Mr. Walker is a certified public accountant and has extensive executive level experience in both Government and private industry financial management.

Linda Combs is the Controller in the Office of Management and Budget in the Executive Office of the President. As Controller, Dr. Combs oversees Government-wide financial management policies and requirements. She also has extensive experience in Federal financial management and has served as a leader in several Federal agencies.

Your entire statement is in the record, and I will ask that each witness summarize your testimony in the time provided, and, of course, that is 5 minutes.

Please proceed, Mr. Walker.

## STATEMENTS OF DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES, GOVERNMENT ACCOUNTABILITY OFFICE; AND LINDA COMBS, CONTROLLER, OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT

### STATEMENT OF DAVID M. WALKER

Mr. WALKER. Chairman Towns, members of the subcommittee, it is a pleasure to be here today to report on the U.S. Government's consolidated financial statements for the years 2006 and 2005.

Since enactment of key financial reforms in the 1990's, the Federal Government has made substantial progress in improving financial management activities and practices; however, the Federal Government still has a long way to go in order to address several principal challenges to fully realizing strong Federal financial management.

As you mentioned, Mr. Chairman, for the 10th consecutive year, certain material weaknesses in financial reporting and other limitations in the scope of our work resulted in conditions that prevented the GAO from being able to provide the Congress and the American people with an opinion as to whether the consolidated financial statements of their Government was fairly stated in conformity with generally accepted accounting principles.

Furthermore, we also reported that the Federal Government did not maintain effective internal control over financial reporting and compliance with certain significant laws and regulations.

For the third consecutive year the GAO included an emphasis paragraph in our audit report noting that our current fiscal path is unsustainable and that tough choices by the President and the Congress are necessary in order to restore our Nation's long-term fiscal sustainability.

Currently, our Nation's financial condition is worse than advertised. From a broad financial management perspective, the Federal Government's deteriorating long-range financial condition and fiscal imbalance are matters of increasing concern. The fiscal year 2006 financial report disclosed that, despite a reported increase in revenues for fiscal year 2006 of about $255 billion, the Federal Government's cost exceeded its revenues by $450 billion, the net operating cost.

Furthermore, the total of reported liabilities, contingencies, and unfunded commitments for things like Social Security and Medicare rose from about $20 trillion in 2000 to about $50 trillion in 2006. That is a 147 percent increase in 6 short years.

To put things in perspective, $50 trillion amounts to $440,000 per American household, and median household income in America is less than $50,000.

Table two on page 6 of my testimony I would commend to you, because that takes these huge numbers and puts it in terms that I think you and others can fully appreciate.

At some point we are going to have to start making some tough choices in order to put us in a more prudent and sustainable path. That will include, among other things, increasing transparency and

enhancing the relevancy of key financial, performance, and budget reporting; reinstituting and strengthening budget controls; strengthening oversight of programs and activities; and re-engineering, reprioritizing the entire base of the Federal Government.

The Federal Government restated certain of its fiscal year 2005 consolidated financial statements as part of this year financial reports to correct certain errors. Since fiscal year 2004, we, at GAO, have reported our concerns about restatements to Federal agencies' previously issued financial statements. Frequent restatements to correct errors can serve to undermine public trust and confidence in both the entity and the responsible parties. As has been the case for 9 previous fiscal years, the Federal Government did not maintain an effective system on total controls.

But on the positive side of the ledger, for fiscal year 2006, 24 of 24 CFO Act agencies reported within 45 days, and 19 of 24 CFO Act agencies were able to obtain a clean opinion on their consolidated financial statements, up considerably from where we were a few short years ago.

The three primary impediments to an opinion on the financial statements are: the Department of Defense, intergovernmental activity, and preparing the consolidated financial statements.

In summary, the Federal Government's financial management is much improved since the CFO Act and FMMIA were enacted in the 1990's, but we still have a ways to go, and the tail on the dog is the Department of Defense.

Thank you, Mr. Chairman. I would be happy to answer any questions you might have.

[The prepared statement of Mr. Walker follows:]

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and Government Reform, House of Representatives

For Release on Delivery
Expected at 2:00 p.m. EDT
Tuesday, March 20, 2007

# FISCAL YEAR 2006 U.S. GOVERNMENT FINANCIAL STATEMENTS

## Sustained Improvement in Federal Financial Management Is Crucial to Addressing Our Nation's Accountability and Fiscal Stewardship Challenges

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


GAO-07-607T

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# Highlights

Highlights of GAO-07-607T, a testimony before the Subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and 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. The Congress and the President need to have timely, reliable, and useful financial and performance information. Sound decisions on the current results and future direction of vital federal government programs and policies are made more difficult without such 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 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 and activities; (3) impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and (4) hinder the federal government from having reliable financial information to operate in an economical, efficient, and effective manner.

www.gao.gov/cgi-bin/getrpt?GAO-07-607T.

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 or engelg@gao.gov.

March 20, 2007

# FISCAL YEAR 2006 U.S. GOVERNMENT FINANCIAL STATEMENTS

## Sustained Improvement in Federal Financial Management Is Crucial to Addressing Our Nation's Accountability and Fiscal Stewardship Challenges

### What GAO Found

For the 10th consecutive year, certain material weaknesses in financial reporting and other limitations on the scope of GAO's work resulted in conditions that continued to prevent GAO from being able to provide Congress and the American people 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. While over the past 10 years significant progress has been made in improving financial management since the U.S. government began preparing consolidated financial statements, three major impediments continue to prevent GAO from rendering an opinion on the consolidated financial statements: (1) serious financial management problems at the Department of Defense, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Further, in GAO's opinion, as of September 30, 2006, the federal government did not maintain effective internal controls over financial reporting and compliance with significant laws and regulations due to numerous material weaknesses.

From a broad federal financial management perspective, the federal government's financial condition and fiscal outlook are worse than many may understand. The U.S. government's total reported liabilities, net social insurance commitments, and other fiscal exposures continue to grow and now total over $50 trillion, representing approximately four times the nation's total output (GDP) in fiscal year 2006, up from about $20 trillion, or two times GDP in fiscal year 2000. The federal government faces large and growing structural deficits in the future due primarily to known demographic trends and rising health care costs. These structural deficits which are virtually certain given the design of our current programs and policies will mean escalating and ultimately unsustainable federal deficits and debt levels. Based on various measures and using reasonable assumptions the federal government's current fiscal policy is unsustainable. Continuing on this imprudent and unsustainable path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our domestic tranquility and national security. Tough choices by the President and the Congress are necessary in order to address the nation's large and growing long-term fiscal imbalance.

The federal government should consider the need for further revisions to the current federal financial reporting model to recognize the unique needs of the federal government. While the current reporting model recognizes some of these needs, a broad reconsideration of issues such as the kind of information that may be relevant and useful for a sovereign nation, could stimulate needed discussion and lead to reporting enhancements that might help the Congress deliberate strategies to address the nation's growing long-term fiscal imbalance. Furthermore, additional transparency in connection with federal budget reporting and legislative proposals is needed.

Mr. Chairman and Members of the Subcommittee:

I am most pleased to be here today to discuss our report on the U.S. government's consolidated financial statements for fiscal years 2006 and 2005. 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 the 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. Such hearings play a vital role in ensuring that the federal government is held accountable to the American people. Our work was conducted in accordance with U.S. generally accepted government auditing standards.

Both the consolidated financial statements and our report on them are included in the fiscal year 2006 *Financial Report of the United States Government (Financial Report)*. The most recent report was issued by the Department of the Treasury (Treasury) on December 15, 2006, and is available through GAO's Internet site, at http://www.gao.gov/financial/fy2006financialreport.html, and Treasury's Internet site, at http://www.fms.treas.gov/fr/06frusg/06frusg.pdf. I also would like to highlight a guide we issued in September 2005 titled *Understanding the Primary Components of the Annual Financial Report of the United States Government*,[1] which was prepared to help those who seek to obtain a better understanding of the *Financial Report*. This guide can also be found on GAO's Internet site at http://www.gao.gov/new.items/d05958sp.pdf.

Since the enactment of key financial management reforms, the federal government has made substantial progress in improving financial management activities and practices. Federal financial systems requirements have been developed and internal control has been strengthened. Nonetheless, as I recently testified before the Senate Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs, the federal government still has a long way to go to address several principal challenges to fully

[1]GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-05-958SP (Washington, D.C.: September 2005).

realizing strong federal financial management.[2] For the 10th consecutive year, certain material weaknesses[3] in financial reporting and other limitations on the scope of our work resulted in conditions that continued to prevent us from being able to provide the Congress and the American people 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). Further, we also reported that the federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2006. Until the problems that I will discuss today and that are discussed in our audit report are adequately addressed, they will continue to have adverse implications for the federal government and the taxpayers.

GAO's audit report also included an emphasis paragraph for the 3rd consecutive year noting that the nation's current fiscal path is unsustainable and that tough choices by the President and the Congress are necessary to address the nation's large and growing long-term fiscal imbalance. In fact, the federal government's financial condition and fiscal outlook are worse than many may understand. The value of the federal government's net social insurance commitments, liabilities, and other fiscal exposures is now reported at over $50 trillion, representing close to four times Gross Domestic Product (GDP) in fiscal year 2006 and up from about $20 trillion or two times GDP in 2000. One way to think about it is: if we wanted to put aside today enough to cover these promises, it would take about $440,000 per American household, up from $190,000 in 2000. As these numbers indicate, the federal government faces large and growing structural deficits primarily related to Medicare and other social insurance commitments. These structural deficits—which are virtually certain given the design of our current programs and policies—will mean escalating and ultimately unsustainable federal deficits and debt levels. Simply put, despite an almost 12 percent increase in federal revenues this year, our nation's financial condition and long-term fiscal imbalance continue to deteriorate and are on an imprudent and unsustainable course.

[2]GAO, *Critical Accountability and Fiscal Stewardship Challenges Facing Our Nation*, GAO-07-542T (Washington, D.C.: March 2007).

[3]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.

In this testimony, I will discuss (1) the challenges posed by the federal government's fiscal condition and my views on a possible way forward, including ideas for consideration to improve the transparency of long-term costs; (2) our continued concerns about restatements to prior year financial statements; (3) the major issues relating to the consolidated financial statements for fiscal years 2006 and 2005, including systems problems that continue to hinder federal agency accountability; and (4) the need for an improved federal financial reporting model. I will also describe progress that has been made toward addressing major impediments to an opinion on the consolidated financial statements.

## The Nation's Fiscal Imbalance

From a broad financial management perspective, the federal government's deteriorating long-range financial condition and long-term fiscal imbalance are matters of increasing concern. We face large and growing structural deficits due primarily to known demographic trends and rising health care costs. There is a need to engage in a fundamental review, repriorization, and reengineering of the base of the government. Understanding and addressing the federal government's financial condition and long-term fiscal imbalance are critical to maintain fiscal flexibility so that we can respond to current and emerging social, economic, and security challenges.

### The Reported Long-Term Fiscal Outlook

The fiscal year 2006 *Financial Report* disclosed that, despite a reported increase in revenues in fiscal year 2006 of about $255 billion, the federal government's costs exceeded its revenues by $450 billion (i.e., net operating cost). Further, as of September 30, 2006, the U.S. government reported in the 2006 *Financial Report* that it owed (i.e., liabilities) more than it owned (i.e., assets) by almost $9 trillion. In addition, the Statement of Social Insurance in the *Financial Report* disclosed an additional $39 trillion of the government's social insurance responsibilities, including Medicare and Social Security. The total of the reported liabilities (e.g., debt), contingencies (e.g., insurance), and social insurance and other commitments and promises (e.g., Social Security, Medicare)—rose from $20 trillion to about $50 trillion in the last 6 years.

Over the next few decades, the nation's fiscal outlook will be shaped largely by known demographic trends and rising health care costs. As the baby-boom generation retires, federal spending on current retirement and health care programs—Social Security, Medicare, and Medicaid—will grow dramatically. These programs represent $39 trillion of the $50 trillion long-term fiscal exposure. A range of other federal fiscal commitments,

some explicit and some representing implicit public expectations, also bind the nation's fiscal future. Absent policy changes, a growing imbalance between expected federal spending and tax revenues will mean escalating and ultimately unsustainable federal deficits and debt levels.

There are various ways to consider and assess the long-term fiscal outlook. In this regard, information included in the *Financial Report*, and other information and analyses, can be used to more fully understand the nation's long-term fiscal outlook, including:

- the Statement of Social Insurance,
- major reported long-term fiscal exposures, and
- long-term fiscal simulations.

## Statement of Social Insurance

The Statement of Social Insurance in the *Financial Report* displays the present value[4] of projected revenues and expenditures for scheduled benefits of certain benefit programs that are referred to as social insurance (e.g., Social Security, Medicare). For Social Security and Medicare alone, projected expenditures for scheduled benefits for the next 75 years exceed earmarked revenues (e.g., dedicated payroll taxes, premiums, and existing government bonds in the trust funds) for the same period by approximately $39 trillion in present value terms. Stated differently, one would need approximately $39 trillion invested today to deliver on the currently promised benefits not covered by earmarked revenues for the next 75 years. Table 1 shows a simplified version of the Statement of Social Insurance by its primary components.

[4]Present value is the discounted value of a payment or stream of payments to be received or paid in the future, taking into consideration a specific interest or discount rate.

**Table 1: Simplified Statement of Social Insurance as of January 1, 2006**

Dollars in trillions

| | Social Security | Medicare Hospital Insurance (Part A) | Medicare Supplementary Medical Insurance – Part B | Medicare Supplementary Medical Insurance – Part D | Total |
|---|---|---|---|---|---|
| Present value of future revenue (earmarked contributions, taxes, and premiums) | $32 | $11 | $5 | $2 | $50 |
| Present value of expenditures for scheduled future benefits[a] | (39) | (22) | (18) | (10) | (89) |
| Present value of future expenditures in excess of future revenue[b] | ($7) | ($11) | ($13) | ($8) | ($39) |

Source: The Department of the Treasury.

[a]These amounts include administrative expenses for the programs.

[b]Under current law, Social Security and Federal Hospital Insurance (Medicare Part A) payments are limited to amounts available to the respective trust funds.

Note: Data are from the fiscal year 2006 *Financial Report.*

## Major Reported Long-Term Fiscal Exposures

GAO developed the concept of "fiscal exposures" to provide a framework for considering the wide range of responsibilities, programs, and activities that explicitly or implicitly expose the federal government to future spending.

The concept of fiscal exposures is meant to provide a broader perspective on long-term costs. Major reported long-term fiscal exposures in fiscal year 2006 with a present value totaling over $50 trillion consisted of about $10 trillion of liabilities reported on the Balance Sheet, $1 trillion of other commitments and contingencies, and the $39 trillion of social insurance responsibilities, the last two of which are reported elsewhere in the *Financial Report.* This $50 trillion compares to about $20 trillion in fiscal year 2000.

These large numbers are difficult to comprehend. Table 2 seeks to translate them into several figures and ratios that are more understandable.

**Table 2: Understanding the Size of Major Reported Fiscal Exposures**

| | 2000 | 2006 | Percentage increase |
|---|---|---|---|
| **Major fiscal exposures** | $20.4 trillion | $50.5 trillion | 147% |
| **Total household net worth** | $42.0 trillion | $53.3 trillion | 27% |
| Ratio of fiscal exposures to net worth | 49 percent | 95 percent | 94% |
| **Burden** | | | |
| Per person | $70,000 | $170,000 | 132% |
| Per full-time worker | $165,000 | $400,000 | 143% |
| Per household | $190,000 | $440,000 | 134% |
| **Income** | | | |
| Median household income | $41,990 | $46,326 | 10% |
| Disposable personal income per capita | $25,127 | $31,519 | 25% |
| **Ratio of household burden to median income** | 4.5 | 9.5 | 112% |

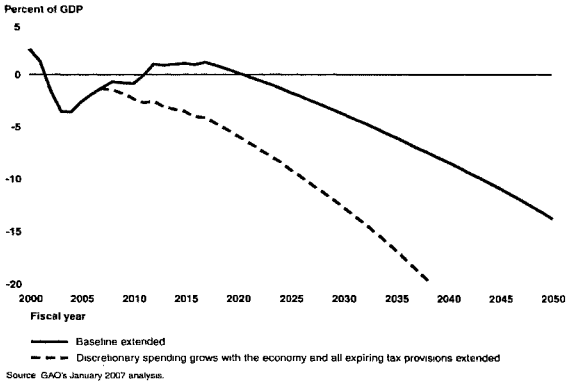
Sources: GAO analysis of data from the Department of the Treasury, Federal Reserve Board, U.S. Census Bureau, and Bureau of Economic Analysis.

Note: Percentage increases reflect actual data and may differ from calculation of rounded numbers presented in table.

## Long-Term Fiscal Simulations

Another way to assess the U.S. government's long-term fiscal outlook and the sustainability of federal programs is to run simulations of future revenues and costs for all federal programs, based on a continuation of current or proposed policy. The simulations GAO has published since 1992 are designed to do that. As shown in figure 1, GAO's long-term simulations—which are neither forecasts nor predictions—continue to show ever-increasing long-term deficits resulting in a federal debt level that ultimately spirals out of control. The timing of deficits and the resulting debt buildup varies depending on the assumptions used; one alternative (baseline extended) takes the legislatively-mandated baseline from the Congressional Budget Office (CBO) for the first 10 years and then keeps discretionary spending and revenues constant as a share of GDP while letting Social Security, Medicare, and Medicaid grow as projected by the Trustees and CBO under midrange assumptions. The other, perhaps more realistic, scenario based on the administration's announced policy preferences changes only two things in the first 10 years: discretionary spending grows with the economy and all expiring tax provisions are extended. Like the "baseline extended" scenario, after 10 years both revenues and discretionary spending remain constant as a share of the economy. Under either optimistic set of assumptions, the federal government's current fiscal policy is unsustainable.

**Figure 1: Unified Surpluses and Deficits as a Share of Gross Domestic Product (GDP) under Alternative Fiscal Policy Simulations**




Source: GAO's January 2007 analysis.

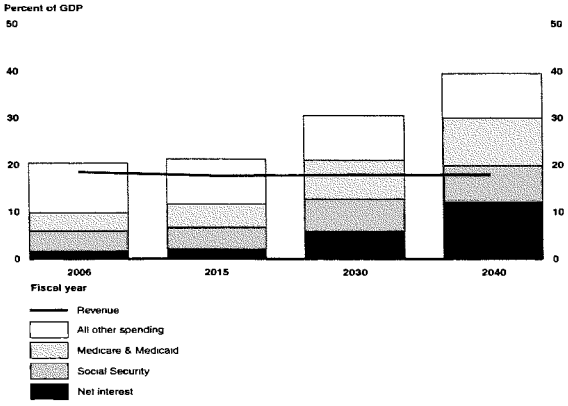
Note: The simulation assumes currently scheduled Social Security benefits are paid in full throughout the simulation period.

Over the long term, the nation's growing fiscal imbalance stems primarily from the aging of the population and rising health care costs. Absent significant changes on the spending or revenue sides of the budget or both, these long-term deficits will encumber a growing share of federal resources and test the capacity of current and future generations to afford both today's and tomorrow's commitments. Continuing on this unsustainable path will gradually erode, if not suddenly damage our economy, our standard of living, and ultimately our domestic tranquility and national security.

If, for example, as shown in figure 2, it is assumed that recent tax reductions are made permanent and discretionary spending keeps pace with the growth of our economy, our long-term simulations suggest that by 2040 federal revenues may be adequate to pay little more than interest on debt held by the public and some Social Security benefits. Neither slowing the growth in discretionary spending nor allowing the tax provisions, including the tax cuts enacted in 2001 and 2003, to expire—nor both together—would eliminate the imbalance. As figures 1 and 2 illustrate,

regardless of the assumptions used, the problem is too big to be solved by economic growth alone.

**Figure 2: Potential Fiscal Outcomes under Alternative Simulation: Discretionary Spending Grows with GDP after 2007 and All Expiring Tax Provisions Are Extended**




Source: GAO's January 2007 analysis

Note: Alternative Minimum Tax (AMT) exemption amount is retained at the 2006 level through 2017 and expiring tax provisions are extended. After 2017, revenue as a share of GDP is held constant—implicitly assuming that action is taken to offset increased revenue from real bracket creep, the AMT, and tax-deferred retirement accounts.

At some point, action will need to be taken to change the nation's fiscal course. The sooner appropriate actions are taken, the sooner the miracle of compounding will begin to work for the federal budget rather than against it. Conversely, the longer that action to deal with the nation's long-term fiscal outlook is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing. Acting sooner rather than later will give us more time to phase in gradual changes, while also providing more time for those likely to be most affected to make compensatory changes.

The "fiscal gap" is a quantitative measure of long-term fiscal imbalance. Under GAO's more realistic simulation, assuming debt held by the public

remains at the current share of the economy (i.e., GDP), closing the fiscal gap would require spending cuts or tax increases equal to 8 percent of the entire economy each year over the next 75 years, or a total of about $61 trillion in present value terms. To put this in perspective, closing the gap would require an immediate and permanent increase in federal tax revenues of more than 40 percent or an equivalent reduction in federal program spending (i.e., in all spending except for interest on the debt held by the public, which cannot be directly controlled).

## A Possible Way Forward

Although the long-term fiscal outlook is driven primarily by rising health care costs and known demographics, we cannot ignore other government programs and activities. There is a need to engage in a fundamental review, reprioritization, and reengineering of the base of government. Aligning the federal government to meet the challenges and capitalize on the opportunities of the 21st century will require a fundamental review of what the federal government does, how it does it, and how it is financed. Many of the federal government's current policies, programs, functions, and activities are based on conditions that existed decades ago, are not results-based, and are not well aligned with 21st century realities. We need to address the growing costs of the major entitlement programs and also review and reexamine all other major programs, policies, and activities on both the spending and the revenue side of the budget. Programs that run through the tax code—sometimes referred to as tax expenditures[5]—must be reexamined along with those that run through the spending side. As we move forward, the federal government needs to start making tough choices in setting priorities and linking resources and activities to results. I recently provided all members of the new Congress with a package of materials to help them understand facts regarding the long-term fiscal

[5]In addition to the reported net cost, the federal government foregoes tax revenues as a result of preferential provisions, such as tax exclusions, credits, and deductions. These revenue losses are referred to as tax expenditures.

imbalance of the federal government, why we should act sooner rather than later, and what types of changes need to be considered.[6]

Meeting our nation's large, growing, and structural fiscal imbalance will require a multipronged approach:

- increasing transparency and enhancing the relevancy of key financial, performance, and budget reporting and estimates to highlight our long-term fiscal challenges;
- reinstituting and strengthening budget controls for both spending and tax policies to deal with both near-term and longer-term deficits;
- strengthening oversight of programs and activities, including creating approaches to better facilitate the discussion of integrated solutions to crosscutting issues; and
- reengineering and reprioritizing the federal government's existing programs, policies, and activities to address 21st century challenges and capitalize on related opportunities.

In two of my January 2007 testimonies,[7] I proposed a number of ideas for consideration to improve the transparency of long-term costs, including supplemental reporting in the President's budget submission and additional cost information on proposals before adoption. In November 2006, I provided the congressional leadership with recommendations, based on the work of GAO, for consideration for the agenda of the 110th Congress.[8] These recommendations focused on three areas: (1) targets for near-term oversight, (2) policies and programs that are in need of fundamental reform and reengineering, and (3) governance issues. One of

[6]GAO, *Fiscal Stewardship: A Critical Challenge Facing Our Nation*, GAO-07-362SP (Washington, D.C.: January 2007); *The Nation's Long-Term Fiscal Outlook: September 2006 Update*, GAO-06-1077R (Washington, D.C.: Sept. 15, 2006); *Understanding the Similarities and Differences between Accrual and Cash Deficits*, GAO-07-117SP (Washington, D.C.: December 2006) and its supplement, *Accrual and Cash Deficits: Update for Fiscal Year 2006*, GAO-07-341SP (Washington, D.C.: Jan. 22, 2007); *Understanding the Primary Components of the Annual Financial Report of the United States*, GAO-05-958SP (Washington, D.C.: September 2005); *and Statement of the Comptroller General of the United States* transmitting GAO's report on the U.S. government's consolidated financial statements for fiscal years 2006 and 2005.

[7]GAO, *Long-term Budget Outlook: Saving Our Future Requires Tough Choices Today*, GAO-07-342T (Washington, D.C.: Jan. 11, 2007); *Long-term Budget Outlook: Deficits Matter—Saving Our Future Requires Tough Choices Today*, GAO-07-389T (Washington, D.C.: Jan. 23, 2007).

[8]GAO, *Suggested Areas for Oversight for the 110th Congress*, GAO-07-235R (Washington, D.C.: Nov. 17, 2006).

the areas I pointed out that warranted congressional attention was the development of a portfolio of outcome-based key national indicators (e.g., economic, security, social, environmental) to help measure progress toward national outcomes, assess conditions and trends, and help communicate complex issues. The Congress could take a leadership role in highlighting the need for a U.S. national indicator system to inform strategic planning, enhance performance and accountability reporting, inform congressional oversight and decision making, and stimulate greater citizen engagement. In my view, this should include consideration of a public/private partnership to help make this key concept a reality sooner rather than later.

In order to effectively address our long-term fiscal imbalance, fundamental reform of existing entitlement programs is essential. However, entitlement reform alone will not get the job done. We also need to reprioritize and constrain other federal government spending and generate more revenues—hopefully through a reformed tax system. *GAO's 21st Century Challenges: Reexamining the Base of the Federal Government*[9] contains a suggested list of specific federal activities for reexamination, illustrative reexamination questions, and perspectives on various strategies, processes, and approaches for congressional consideration stemming from our audit and evaluation work that can be used in reexamining the federal base. Answers to these questions may draw on the work of GAO and others; however, only elected officials can and should decide which issues to address as well as how and when to address them. Addressing these problems will require tough choices, and our fiscal clock is ticking. As a result, the time to start is now, to help save our future.

## Restatements to Financial Statements

The federal government restated certain of its fiscal year 2005 consolidated financial statements to correct errors.[10] Restatements relating to property, plant, and equipment resulted from misstatements by the

[9]GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP, (Washington, D.C.: February 2005).

[10]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, when such errors caused the financial statements to be materially misstated. Errors in financial statements can 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.

Department of Defense, which had received a disclaimer on its originally issued as well as its restated fiscal year 2005 financial statements.[11] Certain other restatements that were made to the consolidated financial statements related to errors that occurred during the preparation of the fiscal year 2005 Reconciliation of Net Operating Cost and Unified Budget Deficit.

Since fiscal year 2004, we have reported our concerns about restatements to federal agencies' previously issued financial statements. During fiscal year 2005, we reviewed the causes and nature of the restatements made by nine CFO act agencies in fiscal year 2004 to their fiscal year 2003 financial statements. Between 2005 and 2006 we issued reports covering five of these nine CFO act agencies that included recommendations for improvements in internal controls and procedures to prevent or detect future similar errors.[12] In October 2006, we issued a capping report to the Office of Management and Budget (OMB), which communicated our observations on the transparency and timeliness of the nine federal agencies and their auditor's restatement disclosures.[13] The primary contributing factor for the restatement disclosure issues that we identified was insufficient guidance available at the time to both the agencies' management and their respective auditors for disclosure of the restatements and the timeliness of such disclosures. In August 2005, OMB revised Circular No. A-136, *Financial Reporting Requirements*, which provides additional guidance to federal agencies' management regarding disclosure of restatements to previously issued financial statements. Revisions made to OMB Circular No. A-136 address many of our concerns

[11]In addition to the Department of Defense, at least three other Chief Financial Officers (CFO) act agencies restated certain of their fiscal year 2005 financial statements to correct misstatements.

[12]GAO, *Financial Audit: Restatements to the Department of State's Fiscal Year 2003 Financial Statements*, GAO-05-814R (Washington, D.C.: Sept. 20, 2005); *Financial Audit: Restatements to the Nuclear Regulatory Commission's Fiscal Year 2003 Financial Statements*, GAO-06-30R (Washington, D.C.: Oct. 27, 2005); *Financial Audit: Restatements to the General Services Administration's Fiscal Year 2003 Financial Statements*, GAO-06-70R (Washington, D.C.: Dec. 6, 2005); *Financial Audit: Restatements to the National Science Foundation's Fiscal Year 2003 Financial Statements*, GAO-06-229R (Washington, D.C.: Dec. 22, 2005); and *Financial Audit: Restatements to the Department of Agriculture's Fiscal Year 2003 Financial Statements*, GAO-06-254R (Washington, D.C.: Jan. 26, 2006).

[13]GAO, *Financial Audit: Restated Financial Statements: Agencies' Management and Auditor Disclosures of Causes and Effects and Timely Communication to Users*, GAO-07-91 (Washington, D.C.: Oct. 5, 2006).

regarding the agencies' disclosure of restatements. In addition, in August 2006, OMB issued Bulletin No. 06-03, Audit Requirements for Federal Financial Statements, which provides some information regarding reporting on restatements. However, we believe that OMB needs to timely provide additional, though complementary, restatement guidance. As such, our October 2006 report contained recommendations to OMB to further improve the restatement guidance available to agencies' management and the agencies' respective auditors. In addition, the January 2007 revision of generally accepted government auditing standards (GAGAS) includes a section on reporting on restatement of previously issued financial statements.[14]

Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. Material internal control weaknesses discussed in our fiscal year 2006 audit report serve to increase the risk that additional errors may occur and not be identified on a timely basis by agency management or their auditors, resulting in further restatements.

## Highlights of Major Issues Related to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2006 and 2005

As has been the case for the previous nine fiscal years, the federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain material information reported in the U.S. government's consolidated financial statements. The underlying material weaknesses in internal control, 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, 2006, and 2005.[15]

Appendix I describes the material weaknesses that contributed to our disclaimer of opinion in more detail and highlights the primary effects of

[14]GAGAS, promulgated by the Comptroller General of the United States, are to be followed by federal auditors and audit organizations and by other auditors auditing federal organizations, programs, or activities when required by law, contract, or policy. These standards pertain to auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports. GAGAS incorporate American Institute of Certified Public Accountants' field work and reporting standards and the related Statements on Auditing Standards for financial audits unless the Comptroller General of the United States excludes them by formal announcement.

[15]We previously reported that certain material weaknesses prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2005.

these material weaknesses on the consolidated financial statements and on the management of federal government operations. The material weaknesses that contributed to our disclaimer of opinion 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;
- support significant portions of the total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain agencies;
- adequately account for and reconcile intragovernmental activity and balances between federal agencies;
- ensure that the federal government's consolidated financial statements were (1) consistent with the underlying audited agency financial statements, (2) balanced, and (3) in conformity with GAAP; and
- identify and either resolve or explain material differences that exist between certain components of the budget deficit reported in Treasury's records, used to prepare the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities, and related amounts reported in federal agencies' financial statements and underlying financial information and records.

Due to the material weaknesses and the additional limitations on the scope of our work, as discussed in our audit report, there may also be additional issues that could affect the consolidated financial statements that have not been identified.

In addition to the material weaknesses that contributed to our disclaimer of opinion, which were discussed above, we found the following four other material weaknesses in internal control as of September 30, 2006. These weaknesses are discussed in more detail in appendix II, including the primary effects of the material weaknesses on the consolidated financial statements and on the management of federal government operations. These other material weaknesses were the federal government's inability to

- implement effective credit reform estimation and related financial reporting processes,
- determine the full 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.

Individual federal agency financial statement audit reports identify additional reportable conditions[16] in internal control, some of which were reported by agency auditors as being material weaknesses at the individual agency level. These additional reportable conditions do not represent material weaknesses at the governmentwide level. Regarding agencies' internal controls, in December 2004, OMB revised its Circular No. A-123, Management's Responsibility for Internal Control, to provide guidance to federal managers on improving the accountability and effectiveness of federal programs and operations by establishing, assessing, correcting, and reporting on management controls. Requiring federal managers, at the executive level, to focus on internal control demonstrates a renewed emphasis on identifying and addressing internal control weaknesses.

OMB recognized that due to the complexity of some agencies, implementation of these new requirements may span more than 1 year. Accordingly, certain agencies have adopted multiyear implementation plans. OMB stated that it will continue to work with the Chief Financial Officers Council to identify potential areas for additional guidance and share agencies' best practices. It will be important that OMB monitor and oversee federal agencies' implementation of these new requirements.

## System Problems at Agencies Continue to Hinder Accountability

For fiscal year 2006, 18 of 24 CFO Act agencies were able to attain unqualified opinions on their financial statements by the November 15, 2006, reporting deadline established by OMB (see app. III). The independent auditor of the Department of State subsequently withdrew its disclaimer of opinion on the department's fiscal year 2006 financial statements and reissued an unqualified opinion on such financial statements dated December 12, 2006. As a result, 19 CFO Act agencies

[16]Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control that could adversely affect the federal government's ability to meet the internal control objectives described in our audit report.

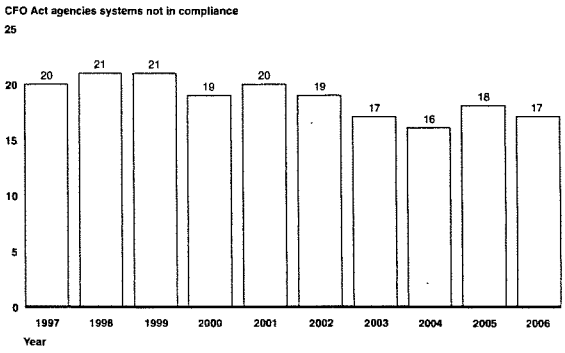
received unqualified opinions on their fiscal year 2006 financial statements. However, irrespective of these unqualified opinions, many agencies do not have timely, reliable, and useful financial information and effective controls with which to make informed decisions and ensure accountability on an ongoing basis. 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 2006 assessments performed by agency inspectors general or their contract auditors under the Federal Financial Management Improvement Act of 1996 (FFMIA) show that serious problems continue to affect financial management systems at most of the 24 CFO Act agencies. These problems include nonintegrated financial systems, lack of accurate and timely recording of data, inadequate reconciliation procedures, noncompliance with accounting standards and the U.S. Government Standard General Ledger (SGL), and weak security over information systems. 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, decision making, and performance reporting.

Under FFMIA, as a part of the CFO Act agencies' financial statement audits, 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. These factors are critical for improving accountability over government operations and routinely producing sound cost and operating performance information. Noncompliance with federal financial management systems requirements was the deficiency most frequently reported by auditors. These deficiencies involved not only core financial systems, but also administrative and programmatic systems.

The ability of federal financial management systems to substantially address FFMIA requirements has not advanced at the same pace as obtaining unqualified opinions on agency financial statements. As shown in figure 3, in fiscal year 2006, auditors for 17 of the 24 CFO Act agencies reported that the agencies' financial management systems did not substantially comply with one or more of FFMIA's three requirements compared to auditors for 20 of the 24 CFO Act agencies in fiscal year 1997.

**Figure 3: Auditors' FFMIA Assessments for Fiscal Years 1997 through 2006**




Source: Independent auditors' reports for fiscal years 1997 through 2006 prepared by agency inspectors general and contract auditors

Note: Data come from independent auditors' reports for fiscal years 1997 through 2006 prepared by agency inspectors general and contract auditors.

For 6 of the 7 CFO Act agencies whose auditors did not report substantial noncompliance with FFMIA requirements for fiscal year 2006, auditors provided negative assurance, meaning that nothing came to their attention indicating that the agencies' financial management systems did not substantially fulfill FFMIA requirements. The auditors for these 6 agencies[17] did not definitively state whether the agencies' systems substantially complied with FFMIA requirements, as is required under the statute. In contrast, auditors for the Agency for International Development (AID) provided positive assurance by stating that the agency's financial management systems substantially complied with the requirements of FFMIA. AID's auditors had not reported AID's financial management systems as substantially compliant in prior years. Further, auditors for GSA cited actions taken to address financial reporting controls and provided negative assurance on FFMIA in fiscal year 2006; whereas, in

[17]The CFO Act agencies whose auditors provided negative assurance were the Department of Commerce, Environmental Protection Agency, General Services Administration (GSA), National Science Foundation, Office of Personnel Management, and the Social Security Administration.

fiscal year 2005 they had reported the agency's systems as not compliant. Conversely, auditors for the Department of Labor (Labor) reported that the agencies' financial management systems did not substantially comply with FFMIA requirements in fiscal year 2006 due to newly identified weaknesses in Labor's information security controls. The auditors had not reported any FFMIA compliance issues at the agency in fiscal years 2004 and 2005.

In an effort to address FFMIA-related 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, help provide accountability to taxpayers, and assist in congressional oversight. Whether in government or the private sector, implementing and upgrading systems is a resource-consuming and difficult job that brings a degree of 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. The failure to do so can have serious repercussions. For example, auditors at the Department of Energy (Energy) and the National Aeronautical and Space Administration (NASA) have reported many issues related to the implementation of new financial management systems at those agencies. NASA has received disclaimers of opinion on their financial statements since implementing their new system in fiscal year 2003. While management at both agencies are taking actions to address the problems resulting from the systems implementation, more work is needed to meet FFMIA requirements and obtain an unqualified opinion on their financial statements.

The financial management line of business is OMB's initiative to help address the need to reduce the cost and improve the outcome of federal financial systems implementations. This initiative promotes leveraging of shared service solutions to enhance the government's performance and services. OMB has projects under way to develop standard business processes, a common governmentwide accounting structure, and specific measures to assess the performance of shared service providers to help provide a foundation for the financial management line of business initiative. Because the federal government is one of the largest, most complex organizations in the world, operating, maintaining, and modernizing its financial management systems represents a monumental challenge—from both cost and technical perspectives. As pressure mounts

to increase accountability, and efforts to diminish federal spending intensify, sustained and committed leadership will be a key factor in the successful implementation of governmentwide initiatives.

## Addressing Major Impediments to an Opinion on the Consolidated Financial Statements

Three major impediments to our ability to render an opinion on the U.S. government's consolidated financial statements continued to be: (1) serious financial management problems at DOD, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Extensive efforts by DOD officials and cooperative efforts between agency chief financial officers, inspectors general, Treasury officials, and OMB officials will be needed to resolve these serious obstacles to achieving an opinion on the U.S. government's consolidated financial statements.

### Financial Management at DOD

Essential to further improving financial management governmentwide and ultimately to achieving an opinion on the U.S. government's consolidated financial statements is the resolution of serious weaknesses in DOD's business operations. DOD is one of the largest and most complex organizations in the world. For decades, we have reported on the lack of efficiency and effectiveness in DOD's business operations, including financial management, and the effect these deficiencies have had on the department's, and the government's, ability to oversee, manage, and report on its operations. DOD's financial management weaknesses are pervasive, complex, long-standing, and deeply rooted in virtually all its business operations. Execution of DOD's business operations spans a wide range of defense organizations, including the military services and their respective major commands and functional activities, numerous large defense agencies and field activities, and various combatant and joint operational commands that are responsible for military operations for specific geographic regions or theaters of operations. The nature and severity of DOD's business operations and system deficiencies not only affect financial reporting, but also impede the ability of DOD managers to receive and utilize the full range of information needed to effectively manage day-to-day operations. Such weaknesses adversely affect DOD's (and the government's) ability to control costs; ensure basic accountability; anticipate future costs and claims on the budget; measure performance; maintain funds control; prevent fraud, waste, and abuse; and address

pressing management issues, including supporting warfighters and their families. To date, none of the military services or major DOD components has passed the test of an independent financial audit[18] because of pervasive weaknesses in business management processes, controls, and systems. Moreover, of the 27 areas on GAO's high-risk list, DOD has 8 of its own high-risk areas and shares responsibility for 7 governmentwide high-risk areas.[19]

Effective oversight, reporting, and decision making depends upon information that is timely, reliable, and useful. DOD has transformation efforts underway to improve its business management processes, control, and systems. These efforts will take many years to complete and represent a huge challenge to the department since improvements must be made while continuing to support ongoing operations and activities. While the department is making progress in developing and implementing approaches to better understand and address weaknesses in its business operations, more remains to be done.

On March 1, 2006, I testified[20] that DOD had issued a third key component of its business transformation strategy: the Financial Improvement and Audit Readiness (FIAR) Plan.[21] According to DOD, the FIAR Plan, which was issued in December 2005 and updated in June and September of 2006, is intended to provide DOD components with a construct for resolving problems affecting the accuracy, reliability, and timeliness of financial

[18]Although not major DOD components, the Military Retirement Fund received an unqualified audit opinion on its fiscal year 2006 financial statements, and the DOD Medicare Eligible Retiree Health Care Fund received a qualified audit opinion on its fiscal year 2006 financial statements.

[19]GAO, *High-Risk Series: An Update*, GAO-07-310 (Washington, D.C.: January 2007). The eight specific DOD high-risk areas are: (1) approach to business transformation, (2) business systems modernization, (3) contract management, (4) financial management, (5) personnel security clearance program, (6) supply chain management, (7) support infrastructure management, and (8) weapon systems acquisition. The seven governmentwide high-risk areas are (1) disability programs, (2) interagency contracting, (3) information systems and critical infrastructure, (4) information sharing for homeland security, (5) human capital, (6) real property, and (7) protection of critical technologies.

[20]GAO, *Fiscal Year 2005 U.S. Government Financial Statements: Sustained Improvement in Federal Financial Management Is Crucial to Addressing Our Nation's Financial Condition and Long-term Fiscal Imbalance*, GAO-06-406T (Washington, D.C.: Mar. 1, 2006).

[21]The Business Enterprise Architecture and the Enterprise Transition Plan are the other two key components of DOD's business transformation strategy.

information, and obtaining clean financial statement audit opinions. In addition, the FIAR Plan outlines the business rules and oversight structure DOD has established to guide financial improvement activities and audit preparation efforts. According to DOD, its June and September 2006 FIAR Plan updates were largely intended to refine previous versions of the plan by (1) identifying milestones that must be met for assertions regarding the reliability of reported financial statement information to occur on time, (2) improving consistency between components regarding their corrective actions and milestones, and (3) expanding on earlier descriptions of how the FIAR Plan will be integrated with the Enterprise Transition Plan. We have reported and made numerous recommendations to DOD regarding DOD's efforts to develop and implement its Business Enterprise Architecture and Transition Plan and obtain favorable audit opinions. In addition, we have reviewed the FIAR Plan and related updates, and discussed them with DOD and OMB. However, we cannot comment on specific focus areas or milestones identified in the FIAR Plan because we have not seen any of the underlying component or other subordinate plans upon which the FIAR Plan is based.

DOD has taken important steps toward developing key components of its business transformation strategy. However, we continue to stress that while the reliability of reported financial statement information is important, the effectiveness of DOD's FIAR Plan in addressing the department's financial management deficiencies will ultimately be measured by the department's ability to provide timely, reliable, and useful information for day-to-day management and decision making. Furthermore, the department continues to lack a comprehensive, enterprisewide approach to planning and decision making and the sustained leadership needed to ensure successful transformation and address systemic business challenges. More specifically, DOD has not yet developed a plan that covers all key business functions, and contains results-oriented goals, measures, and expectations that link organizational and individual performance goals, while also being clearly linked to DOD's overall investment plans. Furthermore, as we previously testified, because of the complexity and long-term nature of business transformation, we continue to believe that DOD needs a Chief Management Official (CMO) with significant authority, experience, and tenure to provide sustained leadership and integrate DOD's overall business transformation efforts. The National Defense Authorization Act for Fiscal Year 2006[22] directs the

[22]National Defense Authorization Act for Fiscal Year 2006, Pub. L. No. 109-163, § 907, 119 Stat. 3136, 3403 (Jan. 6, 2006).

department to study the feasibility of a CMO position in DOD. In this regard, the Institute for Defense Analysis issued its report in December 2006 and, among other things, called upon the Congress to establish a Deputy CMO (executive level III official) at the department. Further, in May 2006, the Defense Business Board recommended, among other things, the creation of a Principal Under Secretary of Defense, as a level II official with a 5-year term appointment, to serve as CMO. I strongly support an executive level II official and believe that someone at this level is needed to be successful given the magnitude of the challenge and the need to effect change across the department. It is important to note that a CMO would not assume the responsibilities of the undersecretaries of defense, the service secretaries, or other DOD officials for the day-to-day management of the department. Rather, the CMO would be responsible and accountable for planning, integrating, and executing the overall business transformation effort. The reason I am so passionate about the need for a CMO at DOD is that progress at DOD has historically been painfully slow. A host of well-intended past improvement initiatives have largely failed. I am concerned that without a CMO who is responsible and accountable for demonstrable results and sustained success, history will continue to repeat itself.

We will continue to monitor DOD's efforts to transform its business operations and address its financial management deficiencies as part of our continuing DOD business enterprise architecture work and our oversight of DOD's financial statement audit.

## 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 CFO Act agencies did not adequately perform the required reconciliations for fiscal years 2006 and 2005. For these fiscal years, based on trading partner information provided in the

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

Governmentwide Financial Reporting System (GFRS) discussed below, 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 as of the end of the fiscal year. After analysis of the "Material Difference Reports" for fiscal year 2006, we noted that a significant number of CFOs were unable to adequately explain the differences with their trading partners or did not provide adequate documentation to support responses on the CFO Representations. For both fiscal years 2006 and 2005, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. In addition, for fiscal year 2006, about 31 percent of the significant agencies identified by Treasury and OMB did not perform the required audit procedures on their intragovernmental trading partner data included in the footnotes to their closing packages.[24] As a result of the above, the federal government's ability to determine the effect of these differences on the amounts reported in the consolidated financial statements is significantly impaired.

To help address this longstanding problem, on November 13, 2006, OMB issued Memorandum No. M-07-03, Business Rules for Intragovernmental Transactions, which has also been incorporated in the Treasury Financial Manual.[25] The OMB memorandum added criteria for resolving intragovernmental disputes and major differences between trading partners for certain intragovernmental transactions by creating the Chief Financial Officers Council's Intragovernmental Dispute Resolution Committee.[26] Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong commitment by federal agencies to fully implement the recently issued business rules, and continued strong leadership by OMB.

## Preparing the Consolidated Financial Statements

While further progress was demonstrated in fiscal year 2006, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are

[24]GFRS uses a closing package methodology that has been developed to capture each federal agency's information and link the agencies' audited financial statements to the governmentwide consolidated financial statements.

[25]Treasury Financial Manual, Bulletin No. 2007-3, *Intragovernmental Business Rules.*

[26]The U.S. Chief Financial Officer's Council is an organization of the CFOs and Deputy CFOs of the largest federal agencies and senior officials of OMB and Treasury who work collaboratively to improve financial management in the U.S. government.

consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP. For fiscal year 2006, Treasury showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies' audited financial statements and that the Balance Sheet and Statement of Net Cost were consistent with federal agencies' audited financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process for compiling the consolidated financial statements did not ensure that the information in the remaining three principal financial statements and notes were fully consistent with the underlying information in federal agencies' audited financial statements and other financial data. During fiscal year 2006, Treasury, in coordination with OMB, developed and began implementing corrective action plans and milestones for short-term and long-range solutions for certain internal control weaknesses we have previously reported regarding the process for preparing the consolidated financial statements. Resolving some of these internal control weaknesses will be a difficult challenge and will require a strong commitment from Treasury and OMB as they execute and implement their corrective action plans.

## The Need for an Improved Federal Financial Reporting Model

The *Financial Report of the United States Government* provides useful information on the government's financial position at the end of the fiscal year and changes that have occurred over the course of the year. However, in evaluating the nation's fiscal condition, it is critical to look beyond the short-term results and consider the overall long-term financial condition and long-term fiscal imbalance of the government—that is, the sustainability of the federal government's programs, commitments, and responsibilities in relation to the resources expected to be available. More important than the government's $450 billion net operating cost for the year ended September 30, 2006, fiscal simulations by GAO and others show that over the long-term, we face large and growing structural deficits due primarily to Medicare and other social insurance commitments.

As I have testified before, the current financial reporting model does not clearly, comprehensively 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 a potentially unrealistic and misleading picture of the federal government's overall performance, financial condition, and future fiscal outlook.

After a decade of reporting at the governmentwide level perhaps now is an appropriate time to step back and consider the need for further revisions to the current federal financial reporting model, which would affect both consolidated and agency financial reporting. While the current reporting model recognizes some of the unique needs of the federal government, a broad reconsideration of the federal financial reporting model could address the following types of questions:

- What kind of information is most relevant and useful for a sovereign nation?
- Do traditional financial statements convey information in a transparent manner?
- What is the role of the balance sheet in the federal government reporting model?
- How should items that are unique to the federal government, such as social insurance commitments and the power to tax, be reported?

Engaging in a reevaluation of this nature could stimulate discussion that would bring about a new way of thinking about the federal government's financial and performance reporting needs. To understand various perceptions and needs of the stakeholders for federal financial reporting, a wide variety of stakeholders from the public and private sector should be consulted. Ultimately, the goal of such a reevaluation would be reporting enhancements that can help the Congress deliberate strategies to address the federal government's challenges, including those of our growing long-term fiscal imbalance.

More specifically, we continue to support several specific improvements to federal financial reporting. For example, the federal government's financial reporting should be expanded to disclose the reasons for significant changes during the year in scheduled social insurance benefits and funding. It should also include a Statement of Fiscal Sustainability—providing a long-term look at the sustainability of current federal fiscal policy in the context of all major federal spending programs and tax policies. The reporting on fiscal sustainability should include additional information that will assist in understanding the sustainability of current social insurance and other federal programs, including key measures of fiscal sustainability and intergenerational equity,[27] projected annual cash

[27]Intergenerational equity assesses the extent to which different age groups may be required to assume financial burdens to sustain federal responsibilities.

flows, and changes in fiscal sustainability during the reporting period. We believe that such reporting needs to reflect the significant commitments associated with the Social Security and Medicare programs while recognizing a liability for the net assets (principally investments in special U.S. Treasury securities) of the "trust funds." Other areas to consider might include the reporting of key outcome-based performance information. We support the current efforts of the Federal Accounting Standards Advisory Board (FASAB) to begin a project on fiscal sustainability reporting. In addition, an easily understandable summary annual report should be prepared and published that includes in a clear, concise, and transparent manner, key financial and performance information embodied in the *Financial Report*.

## Closing Comments

In closing, given the federal government's current financial condition and growing long-term fiscal imbalance, the need for the Congress and the President to have timely, reliable, and useful financial and performance information is greater than ever. Sound decisions on the current results and future direction of vital federal government programs and policies are more difficult without such information. Until the problems discussed in this testimony are effectively addressed, they will continue to have adverse implications for the federal government and the taxpayers.

Addressing the nation's long-term fiscal imbalance constitutes a major transformational challenge that may take a generation or more to resolve. Given the size of the projected deficit, the U.S. government will not be able to grow its way out of this problem—tough choices will be required.

Across government, financial management improvement initiatives are underway, and if effectively implemented, have the potential to greatly improve the quality of financial management information as well as the efficiency and effectiveness of agency operations. By the end of my term as Comptroller General, I would like to see the civilian CFO Act agencies routinely producing not only annual financial statements that can pass the scrutiny of a financial audit, but also quarterly financial statements and other meaningful financial and performance data to help guide decision makers on a day-to-day basis. For DOD, my expectations are not as high given the current status of DOD's financial management practices, yet it is realistic for at least major portions of DOD's financial information to become auditable by the end of my term. Moreover, progress on developing meaningful financial and performance reporting on the federal government will be a key area that I will continue to champion. I am determined to do whatever I can to help ensure that we are not the first

generation to leave our children and grandchildren a legacy of failed fiscal stewardship and the hardships that would bring.

Finally, I want to emphasize the value of sustained congressional interest in these issues, as demonstrated by this subcommittee's leadership. It will be key that, going forward, the appropriations, budget, authorizing, and oversight committees hold agency top leadership accountable for resolving the remaining problems and that they support improvement efforts.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other members of the subcommittee may have at this time.

## GAO Contacts and Acknowledgments

For further information regarding this testimony, please contact Jeffrey C. Steinhoff, Managing Director; Gary T. Engel, Director; and Paula Rascona, Acting Director; Financial Management and Assurance, at (202) 512-2600. Key contributions to this testimony were also made by staff on the Consolidated Financial Statement audit team.

# Appendix I: Material Weaknesses Contributing to Our Disclaimer of Opinion

The continuing material weaknesses discussed below contributed to our disclaimer of opinion on the federal government's consolidated financial statements. 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.

## 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 weaknesses in reporting assets and liabilities, material weaknesses 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 2006 and 2005, 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 Budget of the United States Government concerning obligations and outlays.

## 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 adequately perform the required reconciliations for fiscal years 2006 and 2005. For these fiscal

years, based on trading partner information provided in the Governmentwide *Financial Report* System (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 as of the end of the fiscal year. After analysis of the Material Difference Reports for fiscal year 2006, we noted that a significant number of CFOs were unable to adequately explain the differences with their trading partners or did not provide adequate documentation to support responses on the CFO Representations. For both fiscal years 2006 and 2005, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. In addition, for fiscal year 2006, about 31 percent of the significant agencies identified by Treasury and OMB did not perform the required audit procedures on their intragovernmental trading partner data included in the footnotes to their closing packages.[1] As a result of the above, the federal government's ability to determine the impact of these differences on the amounts reported in the consolidated financial statements is significantly impaired.

## Preparation of Consolidated Financial Statements

While further progress was demonstrated in fiscal year 2006, 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). In addition, as discussed in our scope limitation section of our audit report, Treasury could not provide the final fiscal year 2006 consolidated financial statements and supporting documentation in time for us to complete all of our planned auditing procedures. During our fiscal year 2006 audit, we found the following:[2]

[1]GFRS uses a closing package methodology that has been developed to capture each federal agency's information and link the agencies' audited financial statements to the governmentwide consolidated financial statements.

[2]Most of the issues we identified in fiscal year 2006 existed in fiscal year 2005, and many have existed for a number of years. In April 2006, we reported in greater detail on the issues we identified, in GAO, *Financial Audit: Significant Internal Control Weaknesses Remain in Preparing the Consolidated Financial Statements of the U.S. Government*, GAO-06-415 (Washington, D.C.: Apr. 21, 2006). This report includes numerous recommendations to Treasury and OMB.

- Treasury showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies' audited financial statements and that the Balance Sheet and the Statement of Net Cost were consistent with federal agencies' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process for compiling the consolidated financial statements did not ensure that the information in the remaining three principal financial statements and notes were fully consistent with the underlying information in federal agencies' audited financial statements and other financial data.
- To make the fiscal years 2006 and 2005 consolidated financial statements balance, Treasury recorded net decreases of $11 billion and $4.1 billion, respectively, to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled "Other—Unmatched transactions and balances."[2] An additional net $10.4 billion and $3.2 billion of unmatched transactions were recorded in the Statement of Net Cost for fiscal years 2006 and 2005, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.
- The federal government did not have an adequate process to fully identify and report items needed to reconcile the operating results, which for fiscal year 2006 showed a net operating cost of $449.5 billion, to the budget results, which for the same period showed a unified budget deficit of $247.7 billion.
- Treasury's elimination of certain intragovernmental activity and balances continues to be impaired by the federal agencies' problems in handling their intragovernmental transactions. As discussed above, amounts reported for federal agency trading partners for certain intragovernmental accounts were significantly out of balance. This resulted in the need for unsupported intragovernmental elimination entries by Treasury in order to force the Statements of Operations and Changes in Net Position into balance. In addition, differences in other intragovernmental accounts, primarily related to transactions with the General Fund, have not been reconciled, still remain unresolved, and total hundreds of billions of dollars. Therefore, the federal government continues to be unable to determine the impact of unreconciled intragovernmental activity and balances on the consolidated financial statements.
- We have consistently reported that certain financial information required by GAAP was not disclosed in the consolidated financial statements. In 2006, the Federal Accounting Standards Advisory Board issued a new

[2]Although Treasury was unable to determine how much of the unmatched transactions and balances, if any, relate to operations, it reported this amount as a component of net operating cost in the consolidated financial statements.

standard that eliminated or lessened the disclosure requirements for the consolidated financial statements related to certain information that Treasury had not been reporting.[4] There continued, though, to be other disclosures required by GAAP that are not disclosed in the consolidated financial statements. Treasury has plans to address certain of the omitted disclosures in future years' consolidated financial statements. Because of certain of the material weaknesses noted in our audit report, we were unable to determine if the omitted information was material to the consolidated financial statements.

- Treasury continued to make progress in addressing certain other internal control weaknesses in Treasury's process for preparing the consolidated financial statements. However, internal control weaknesses continued to exist involving a lack of (1) appropriate documentation of certain policies and procedures for preparing the consolidated financial statements, (2) adequate supporting documentation for certain adjustments made to the consolidated financial statements, and (3) effective management reviews.
- The consolidated financial statements include financial information for the executive, legislative, and judicial branches, to the extent that federal agencies within those branches have provided Treasury such information. However, as we have reported in past years, there continue to be undetermined amounts of assets, liabilities, costs, and revenues that are not included, and the federal government did not provide evidence or disclose in the consolidated financial statements that the excluded financial information was immaterial.
- As in previous years, Treasury did not have adequate systems and personnel to address the magnitude of the fiscal year 2006 financial reporting challenges it faced, such as (1) GFRS undergoing further development[5] and not yet being fully operational, and (2) weaknesses in Treasury's process for preparing the consolidated financial statements as discussed above. 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 help ensure reliable financial reporting by the reporting date.

[4]SFFAS No. 32, *Consolidated Financial Report of the United States Government Requirements*, Implementing Statement of Federal Financial Accounting Concepts 4, "Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government" (Washington, D.C.: Sept. 28, 2006).

[5]See GAO, *Financial Management Systems: Lack of Disciplined Processes Puts Effective Implementation of Treasury's Governmentwide Financial Report System at Risk*, GAO-06-413 (Washington, D.C.: Apr. 21, 2006).

- During fiscal year 2006, Treasury, in coordination with OMB, developed and began implementing corrective action plans and milestones for short-term and long-range solutions for certain internal control weaknesses we have previously reported regarding the process for preparing the consolidated financial statements. Resolving some of these internal control weaknesses will be a difficult challenge and will require a strong commitment from Treasury and OMB as they execute and implement their corrective action plans.

## Outlays and Receipts—Components of the Budget Deficit

Both the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities report the budget deficit for fiscal years 2006 and 2005 of $247.7 billion and $318.6 billion, respectively.[6] The budget deficit is calculated by subtracting actual budget outlays (outlays) from actual budget receipts (receipts).

For several years, we have been reporting material unreconciled differences between the total net outlays reported in selected federal agencies' Statement of Budgetary Resources (SBR) and Treasury's central accounting records used to compute the budget deficit[7] reported in the consolidated financial statements. OMB and Treasury have been working with federal agencies to reduce these material unreconciled differences. Such efforts have resulted in significantly reducing the net outlay differences in fiscal year 2006. However, billions of dollars of differences still exist in this and other components of the deficit because the federal government does not have effective processes and procedures for identifying, resolving, and explaining material differences in the components of the deficit between Treasury's central accounting records and information reported in agency financial statements and underlying agency financial information and records. Until these differences are timely reconciled by the federal government, their effect on the U.S. government's consolidated financial statements will be unknown.

[6]The budget deficit, receipts, and outlays amounts are reported in Treasury's *Monthly Treasury Statement* and the *Budget of the United States Government*.

[7]See GAO's audit report on its audit of the federal government's fiscal year 2005 financial statements that was incorporated in the *2005 Financial Report of the U.S. Government* published by Treasury. Also, see GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Improvement*, GAO-04-45 (Washington, D.C.: Oct. 30, 2003).

In fiscal year 2006, we again noted that several agencies' auditors reported internal control weaknesses (1) affecting the agencies' SBRs, and (2) relating to monitoring, accounting, and reporting of budgetary transactions. These weaknesses could affect the reporting and calculation of the net outlay amounts in the agencies' SBRs. In addition, such weaknesses also affect the agencies' ability to report reliable budgetary information to Treasury and OMB and may affect the unified budget outlays reported by Treasury in its Combined Statement of Receipts, Outlays, and Balances,[8] and certain amounts reported in the President's Budget.

[8]Treasury's *Combined Statement of Receipts, Outlays, and Balances* presents budget results and cash-related assets and liabilities of the federal government with supporting details. Treasury represents this report as the recognized official publication of receipts and outlays of the federal government based on agency reporting.

# Appendix II: Other Material Weaknesses

The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2006. In addition to the material weaknesses discussed in appendix I that contributed to our disclaimer of opinion, we found the following four other material weaknesses in internal control.

## Loans Receivable and Loan Guarantee Liabilities

Federal agencies accounting for the majority of the reported balances for direct loans and loan guarantee liabilities continue to have internal control weaknesses related to their credit reform estimation and related financial reporting processes. While progress in addressing these long-standing weaknesses was reported by federal credit agencies, these issues and the complexities associated with estimating the costs of lending activities significantly increase the risk that material misstatements in agency and governmentwide financial statements could occur and go undetected. Further, these weaknesses 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.

## Improper Payments

Under the leadership of OMB, agencies have continued to make progress in addressing improper payments. Improvements, though, are still needed to fully address the requirements of the Improper Payments Information Act of 2002 (IPIA).[1] Major challenges remain in meeting the goals of the act and ultimately better ensuring the integrity of payments.[2] The IPIA requires federal agencies to review all programs and activities, identify those that may be susceptible to significant improper payments,[3] estimate and report the annual amount of improper payments for those programs, and

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

[2]See GAO, *Improper Payments: Incomplete Reporting under the Improper Payments Information Act Masks the Extent of the Problem*, GAO-07-254T (Washington, D.C.: Dec. 5, 2006).

[3]IPIA defines improper payments as any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. It includes any payment to an ineligible recipient, any payment for an ineligible service, any duplicate payment, payments for services not received, and any payment that does not account for credit for applicable discounts. OMB's guidance defines significant improper payments as those in any particular program that exceed both 2.5 percent of program payments and $10 million annually.

implement actions to cost-effectively reduce improper payments. In addition, OMB has established a program-specific initiative under the President's Management Agenda for 15 federal agencies to hold federal agency managers accountable for meeting the goals of IPIA and to ensure that the necessary attention and resources are dedicated to meeting the IPIA requirements.

For fiscal year 2006, federal agencies' estimates of improper payments, based on available information, totaled about $42 billion, a net increase of about $4 billion, or an 11 percent increase, from the prior year improper payment estimate of $38 billion.[4] This increase was primarily attributable to 10 newly reported programs with improper payment estimates totaling about $2.3 billion and certain federal agencies reporting an increase in estimates for programs that had previously reported.

We found that some agencies have not annually reviewed all programs and activities, have not estimated improper payments for all risk-susceptible programs, or have not estimated improper payments for all components of risk-susceptible programs. For example, we noted that in fiscal year 2006, improper payment estimates were not made for 9 risk-susceptible federal programs, including Medicaid, with total program outlays of about $183 billion for fiscal year 2006. Further, we noted some agencies reported noncompliance issues and major management challenges related to IPIA implementation, including the methodologies used to estimate improper payments, adequacy of agency documentation, management oversight, and contract management.

## 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

[4]In their fiscal year 2006 Performance and Accountability Reports (PAR), selected federal agencies updated their fiscal year 2005 improper payment estimates to reflect changes since issuance of their fiscal year 2005 PARs. These updates increased the governmentwide improper payment estimate for fiscal year 2005 from $38 billion to $39 billion.

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 the implementation of the Federal Information Security Management Act of 2002[5] and on information security. In addition, the administration has taken important actions to improve information security, such as requiring agencies in OMB Memorandum M-06-16[6] to perform specific actions to protect certain personally identifiable information and issuing extensive guidance on information security.

## 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,[7] an issue that has been reported in our financial statement audit reports for the past 9 years. Due to errors and delays in recording taxpayer information, payments, and other activities, 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.

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

[6]OMB Memorandum No. M-06-16, *Protection of Sensitive Agency Information* (June 23, 2006).

[7]GAO, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements*, GAO-07-136 (Washington, D.C.: Nov. 9, 2006).

# Appendix III: Fiscal Year 2006 Audit Results

**Table 3: CFO Act Agencies: Fiscal Year 2006 Audit Results and Principal Auditors**

| CFO Act agencies | Opinion rendered by agency auditor | Agencies' auditors reported material weaknesses or noncompliance | Principal auditor |
|---|---|---|---|
| Agency for International Development | Unqualified | √ | OIG |
| Agriculture | Unqualified | √ | OIG |
| Commerce | Unqualified | √ | KPMG LLP |
| Defense | Disclaimer | √ | OIG |
| Education | Unqualified | √ | Ernst & Young, LLP |
| Energy | [a] | √ | KPMG LLP |
| Environmental Protection Agency | Unqualified | √ | OIG |
| General Services Administration | Unqualified | √ | Pricewaterhouse Coopers LLP |
| Health and Human Services | Unqualified | √ | Pricewaterhouse Coopers LLP |
| Homeland Security | [b] | √ | KPMG LLP |
| Housing and Urban Development | Unqualified | √ | OIG |
| Interior | Unqualified | √ | KPMG LLP |
| Justice | Unqualified | √ | KPMG LLP |
| Labor | Unqualified | √ | KPMG LLP |
| National Aeronautics and Space Administration | Disclaimer | √ | Ernst & Young, LLP |
| National Science Foundation | Unqualified | | Clifton Gunderson LLP |
| Nuclear Regulatory Commission | Unqualified | √ | R. Navarro & Associates, Inc. |
| Office of Personnel Management | Unqualified | √ | KPMG LLP |
| Small Business Administration | Unqualified | √ | KPMG LLP |
| Social Security Administration | Unqualified | | Pricewaterhouse Coopers LLP |
| State | [c] | √ | Leonard G. Birnbaum and Company, LLP |
| Transportation | Qualified | √ | OIG |
| Treasury | Unqualified | √ | KPMG LLP |
| Veterans Affairs | Unqualified | √ | Deloitte & Touche LLP |

Source: GAO.

[a]For fiscal year 2006, only the Consolidated Balance Sheet of the Department of Energy was subjected to audit, and the auditor qualified its opinion on this statement.

[b]For fiscal year 2006, only the Consolidated Balance Sheet and the related Statement of Custodial Activity of the Department of Homeland Security were subjected to audit; the auditor was unable to express an opinion on these two financial statements.

[c]The auditor of the Department of State's (State) fiscal year 2006 financial statements disclaimed an opinion because they were not provided complete financial statements or responses to certain requests for evidential material in time to meet the November 15, 2006, reporting deadline. Subsequently, the auditors satisfied themselves about the amounts presented on the financial statements. As a result, the auditor issued an unqualified opinion on State's fiscal year 2006 financial statements dated December 12, 2006.

Mr. TOWNS. Thank you very much, Mr. Walker.
Dr. Combs.

**STATEMENT OF LINDA COMBS**

Ms. COMBS. Thank you, Congressman Towns, Congressman Bilbray and other distinguished members of the subcommittee. I thank you for providing us an opportunity to be with you today to discuss with you OMB's vision for strengthening Federal financial management in the coming years.

Improving financial management is one of this administration's top management priorities. With the launch of the President's management agenda in 2001, the President issued a call to action for Federal managers to achieve a series of critical financial management goals that, if attained, would help American citizens gauge whether the people's money is being properly accounted for and wisely spent, increase transparency into the fiscal health of the Federal Government, and provide reliable financial information to be used by Federal leaders so they can mange their day-to-day operations of their Government and ours more efficiently.

I am pleased to report that the Federal financial community is positioned to meet those challenges. We have, indeed, achieved significant forward progress on all the key indicators of the President's management agenda, and specifically, as you and Mr. Walker have just pointed out, 19 major agencies that represent 75 percent of all Federal outlays achieved a clean audit opinion last year. The number of auditor reported material weaknesses has reduced approximately 15 percent from just the past year. And, for the second consecutive year, as has already been pointed out, every major Federal agency issued their audited financial statement within 45 days of the previous year. Just to put that in a tiny bit of perspective for us, it was taking as long as 5 months to complete financial reports in 2001. Improper payments has declined to $36.3 billion from $45.1 billion in 2004, so in those 2 short years we have taken improper payment improvements down by $9 billion. We have disposed of more than $4.2 billion in excess real property since 2004.

It is now incumbent upon the Federal financial community to build on this foundation of progress so that we are prepared to address the fiscal challenges that lie ahead. Federal managers must continue to mobilize resources, rededicate efforts, and strengthen our accounting practices. We have to implement stronger internal controls, issue financial reports more timely, eliminate instances of error and waste, and use financial data on a day-to-day basis to manage cost. Also, we must approach these management improvement activities with an eye toward balancing the cost of our efforts against the benefits that they ultimately derive for the taxpayer.

As we set out to achieve new and better levels of financial performance and do so in a cost-effective manner, it is critical that the Federal community orient itself around a common set of priorities and a clear and consistent road map for improvement. Therefore, pursuant to the CFO Act of 1990, my office, the Office of Federal Financial Management within OMB, issues an annual plan to Congress that highlights our key financial management goals, how we measure them, our expected performance over the next 5 years, and the steps we will take to ensure their success.

To achieve these important objectives described in our report, the Federal financial community has undertaken a series of reforms intended to strengthen key areas of financial management. These activities include improving and/or strengthening areas such as internal controls, financial systems, payment accuracy, real property management, grants management, financial reporting of the Government, as a whole.

Our recently issued annual report describes in great detail our planned actions in these areas and how we are going to measure our progress over time. The Federal financial community undertakes a myriad of day-to-day activities, as well, so that we can comply with the CFO Act of 1990.

We believe in transparency and we believe that the CFO Council, along with the President's Council on Integrity and Efficiency, which is comprised of our IGs throughout Government, is currently joining forces to improve both the cost effectiveness of how we go about producing our audited financial statements and how we present this information so that it is understandable and so that excessive costs are not taken to drain on agency resources.

Every tax dollar is far too precious for us not to make well-informed decisions. This administration looks forward to continuing our partnership with Congress, with GAO to address these specific problems that we have. We have a long way to go. We need to be stronger. We need to be smarter. And we need to, indeed, have more sustainable accountability.

We will build on our successes.

Thank you for your continuing support and effort. I look forward to answering your questions.

[The prepared statement of Ms. Combs follows:]

Testimony of the Honorable Linda M. Combs
Controller
Office of Management and Budget

before the

Subcommittee on Government Management, Organization, and Procurement
House Committee on Oversight and Government Reform

March 20, 2007

There may be no more important responsibility of government than to act as an effective steward of the taxpayers' money. It is therefore no surprise that the President has made improving financial performance one of his top management priorities. With the launch of the President's Management Agenda (PMA) in 2001, the President issued a "call to action" for Federal managers to achieve a series of critical financial management goals that, if attained, would help American citizens gauge whether "the people's money" is being properly accounted for and wisely spent, increase transparency into the fiscal health of the Federal Government, and provide reliable financial information to be used by Federal leaders to manage the day-to-day operations of the government more efficiently.

With the rising costs of entitlement programs expected to create an unprecedented and enormous fiscal imbalance for the Federal Government in the coming decades, achieving our financial management goals is more critical today than any other time in our nation's history. The financial management community is not only responsible for reporting on the extent and nature of our fiscal challenges, it also plays a critical role in developing and implementing strategies to control Federal spending and otherwise ensure that the fiscal health of the Federal Government remains sound.

I am pleased to report that the Federal financial community is well positioned to meet these challenges, having achieved significant forward progress on all the key indicators of the PMA initiatives related to financial management. Specifically, in fiscal year (FY) 2006:

- Nineteen major agencies, representing more than 75% of all Federal outlays, achieved a clean audit opinion.
- The number of auditor-reported material weaknesses was reduced by approximately 15% (from 48 reported in FY 2005 to 41 reported this past year).
- For the second consecutive year, every major Federal agency issued their audited financial statements within 45 days of the close of the fiscal year. Prior to 2001, some of

these major Federal agencies took as long as five months to complete their financial reports.

- Improper payments declined to $36.3 billion for those programs that originally reported a total of $45.1 billion in FY 2004. This represents an approximate $9 billion improvement in 2 years.
- The Federal Government has disposed of more than $4.2 billion in excess real property since FY 2004.

It is now incumbent upon the Federal community to build on this foundation of progress so that we are prepared to address the fiscal challenges that lie ahead. Federal managers must continue to mobilize resources and re-dedicate efforts to strengthen accounting practices, implement stronger internal controls, issue financial reports more timely, eliminate instances of error and waste, and use financial data to manage costs. Also, we must approach these management improvement activities with an eye towards balancing the costs of our efforts against the benefits they ultimately derive for the taxpayer. Stated simply, we must not spend $2 on our management improvement efforts if the return to the taxpayer is only $1.

As we set out to achieve new and better levels of financial performance, and do so in a cost-effective manner, it is critical that the Federal financial community orient itself around a common set of priorities, an agreed upon plan for action, and a clear and consistent roadmap for improvement. Therefore, pursuant to the Chief Financial Officers Act of 1990 (CFO Act), the Office of Federal Financial Management (OFFM) within the Office of Management and Budget (OMB) has published the "2007 Federal Financial Management Report – A Framework for Improving Financial Performance." The Framework, released in January of 2007, is intended to provide the public with a simple reporting tool for identifying: (1) The PMA – How We Define and Measure Financial Management Success; (2) Reform Activities – Priority Financial Management Initiatives that Support PMA Objectives; and (3) Core Activities – The Foundation of Effective Financial Management.

The PMA

When the CFO Act was signed into law more than 15 years ago, the Federal Government was responding to numerous financial management challenges. The Comptroller General at the time had testified that billions of dollars were "at risk" in the Federal Government's programs due to inadequate financial management systems and controls. Agencies generally could not give assurance that their financial statements were accurate and reliable, as only one agency was able to achieve a clean audit opinion in the Act's first year of implementation.

The CFO Act was a direct response to these deficiencies and was aimed toward reforming financial management practices within the Federal Government. The Act called for stronger financial leadership, more disciplined financial controls, improved financial management systems, and accurate and timely financial information for decision-making. If implemented effectively, the reform environment created by law, administrative action, and executive order provides a solid foundation for continual improvements in the Federal Government's stewardship of the public's tax dollars. The primary instrument used by the Administration to

implement the principles of the CFO Act and other Federal financial management laws is the Improving Financial Performance Initiative of the PMA. Under this initiative, the President identified a limited number of clear, meaningful, and attainable financial goals that every Federal agency must meet. Each individual goal is an indicator of financial management excellence, and reflects standards established either by law or Administrative action.

As a primary goal, every agency CFO is responsible for meeting standards that reflect a sound foundation of Federal financial management: achieving a "clean" audit, resolving material weaknesses in a timely manner, implementing and/or maintaining a financial system that meets Federal standards, meeting reporting deadlines, and complying with laws and regulations. These standards ensure that Federal agencies are properly accounting for taxpayer dollars and can produce financial information that is both timely and reliable. Federal agencies must achieve these standards to move from "red" to "yellow" status on the PMA stop light scorecard system. To achieve a "green" status score, CFOs must build on the "yellow" standards by ensuring that financial information is available for managers on demand and is actively being used to drive results in key areas of operations.

In addition to the Improving Financial Performance Initiative, the President has also established additional PMA initiatives to eliminate improper payments and right-size the Federal Government's real estate. The accompanying table demonstrates the key goals for the financial management-related PMA initiatives, with the corresponding FY 2006 results and 5-year performance targets.

**PMA GOALS, RESULTS & TARGETS**

| PMA GOALS | FY 2006 RESULTS | FY 2011 PERFORMANCE TARGETS |
|---|---|---|
| **Increase # of Clean Audit Opinions** | **19 of 24 CFO Act Agencies w/ Clean Opinion** | **22 of 24 CFO Act Agencies w/ Clean Opinion** |
| **Reduce # of Material Weaknesses (MW)** | **15% Reduction in Auditor MWs from Prior Year** | **50% Elimination of all Current Government-wide MWs** |
| **Timely Financial Reporting** | **All Agencies Report w/in 45 Days** | **All Agencies Report w/in 45 Days** |
| **Dispose of Excess Real Property** | **$4.2 Billion in Excess Property Disposed of Since 2004** | **$11 Billion in Excess Property Disposed** |
| **Eliminate Improper Payments (IP)** | **$9 Billion IP Reduction from 2004 Base** | **$20 Billion IP Reduction from 2004 Base** |

As a result of the PMA, every CFO across the Federal Government now shares common goals for improving financial performance, and a financial management community exists that works closely with one another to respond to long-standing and arising financial challenges. As OMB, Federal CFOs, and the larger financial management community look toward the next 5 years of financial management improvements, the PMA will continue to guide our efforts.

As indicated in the table above, most agencies now receive a clean opinion on their audited financial statement each year. However, some agencies, such as the Department Homeland Security (DHS) and Department of Energy (DOE), did not achieve that goal in FY 2006. During today's hearing, you will hear directly from these agencies on their specific plans to address financial management challenges. OMB will continue to play a key role in these efforts by using the PMA to hold DHS and DOE accountable for meeting the milestones on their financial improvement plans and demonstrating measurable progress towards achieving a clean opinion and resolving material weaknesses.

The PMA framework has proved successful to date, with numerous agencies, such as the Department of Housing and Urban Development (HUD), the General Services Administration (GSA), the Department of Justice (DOJ), and the Small Business Administration (SBA), moving from either a qualified or disclaimed opinion to a clean opinion in the past few years through action plans that were tracked closely through the PMA.

At DOE, we have seen measurable progress since it first received a disclaimer of opinion in 2005 and expect that in the coming year they will join the ranks of HUD, GSA, DOJ, and SBA and regain its overall clean financial statement opinion in FY 2007. Specifically, DOE improved its audit results in FY 2006 and received a qualified opinion on its balance sheet; however, they still had a disclaimer of opinion on the overall financial statements.

At DHS, the achievement of a clean audit is on a longer time horizon. However, DHS has taken several critical steps that serve as an important foundation for improving their financial management. Most notable, DHS has developed what it terms the Internal Controls over Financial Reporting (ICOFR) Playbook. This playbook, when implemented fully, will dramatically strengthen policies and procedures throughout the Department and yield significant improvements in key financial outcomes related to the audit.

Reform and Core Activities

To support the PMA, the Federal financial community has undertaken a series of reforms intended to strengthen key areas of financial management and thus help ensure the PMA's success. These activities include improving and/or strengthening: internal controls, financial systems, payment accuracy, real property management, grants management, and financial reporting for the government as a whole (including enhanced reporting on social insurance programs and the sustainability of the government's finances over time). To ensure the Federal community has a common understanding of what we are trying to accomplish, OMB's Framework for Improving Financial Performance establishes an overarching strategic goal, a 5-year performance target, short-term objectives, and priority actions for the coming year.

The Federal financial community also undertakes a myriad of day-to-day activities or core functions that are necessary to effectively manage the resources of the Federal Government. These activities include improving, strengthening, and monitoring financial systems and reports, internal controls, auditing standards, and asset and grants management. In collaboration with the financial management community, OFFM works to ensure that the government-wide policies and requirements that drive our core activities are user friendly, transparent, consistently

complied with by Federal agencies, and facilitate improved financial management without undue burden on agency and taxpayer resources.

Of equal importance to the transparency and clarity of the Framework, the reform and core activities within the Framework will help position the financial management community to meet the fiscal challenges that face our nation today. Due to the expected growth of Social Security, Medicare, and other entitlement programs, the Federal Government faces an imbalance of more than $40[1] trillion, in present value terms, over the next 75 years. Our efforts to strengthen government-wide reporting (including on social insurance programs) will ensure that policymakers and the public have comprehensive data on the sustainability of the government's finances that facilitates and guides entitlement reform efforts and other decisions on Federal spending. To this end, Treasury Secretary Paulson and OMB Director Portman sent a copy of the United States 2006 Financial Report of the U.S. Government to every member of Congress on December 15, 2006. The report was also posted on the Treasury Financial Management Service's website and a link to it is on the front page of OMB's website. In addition, we are working with the financial management community to strengthen internal controls, reduce payment errors, and manage our assets more efficiently, to help control costs in an environment where Federal resources for non-entitlement programs will become increasingly scarce.

Moving Forward Through Smarter, Stronger, and Sustainable Accountability

While the financial management community has made significant progress since the enactment of the CFO Act in 1990 and is executing a sound and transparent strategic plan, much remains to be done before the government can say that it has achieved the level of financial management for which we are striving. As we move forward on our plan, we will increase the reliability and transparency of the government's financial information while placing special emphasis on the principle that our improvement activities must have a positive return on investment for the taxpayer.

To this end, the CFO Council (CFOC) and the President's Council on Integrity and Efficiency (PCIE) are currently joining forces to improve the cost-effectiveness of how we go about producing audited financial statements. The presentation of our financial data should be understandable and useful without becoming an excessive cost and drain on agency resources. The CFOC and PCIE will work together with the larger financial community and the Congress to determine if we are sharing the right information with the Government's stakeholders, if the data are timely and in the right format for decision making, and if the appropriate amount of audit scrutiny and precision exists, without compromising audit quality. By improving the cost-effectiveness of our current activities, we will empower our financial leaders to expand their focus beyond clean audits and material weakness resolution into other critical areas of fiscal responsibility, such as the reporting of the full costs of Federal programs and activities so that Federal managers have better information to make key business decisions.

[1] The amount is about $44 trillion on a close group basis, which excludes the benefit payments and contributions of individuals under age 15 (or not yet born). On an open group basis (current and future participants) this amount is about $39 trillion.

Every tax dollar is too precious not to make well-informed decisions. This Administration looks forward to continuing our partnership with Congress to pursue fiscal health by holding agencies accountable, improving financial management through the PMA, addressing our long-term fiscal challenges, and striving for stronger, smarter, and sustainable accountability. We will build on our current successes, maintain and enhance our day-to-day (core) activities, and incorporate reform initiatives to move every agency to financial management excellence and to "green" status on the PMA stop light scorecard. We will be strategic with the financial management policies we set and how we manage our programs in order to account for and wisely spend "the people's money."

Mr. TOWNS. Thank you very much.

Let me thank both of you for your testimony.

Let me begin, Mr. Walker, with you. You know, DOD always appears to be the problem. Is there any reasonable possibility of DOD getting a clean audit in the next few years?

Mr. WALKER. I would sure like, Chairman Towns, for the Department of Defense to be able to achieve a clean audit opinion before I leave office, which is October 25, 2013, but I wouldn't bet a lot of money on it. I believe that their current approach to trying to improve their financial management systems and controls and their plan to try to achieve, you know, an audit opinion is vastly superior to their prior one, but I think most likely we are going to be at a point where there are several major entities within the Department of Defense will be in a position to have a clean audit opinion before the end of my term, and possibly several line items across the agency. We are going to try to make sure that more than that gets done, but I am not that optimistic as of this point.

Mr. TOWNS. What about the new DOD plan for better financial management? Will that help?

Mr. WALKER. The so-called FIAR plan, F-I-A-R——

Mr. TOWNS. Yes.

Mr. WALKER [continuing]. I believe it is clearly superior to their past plan. As you may recall, their past plan called for them to have a clean audit opinion for the entire Department of Defense by fiscal year 2007. It was totally unrealistic. Their new plan takes the entities that they hope to be able to achieve an opinion on and the line items that cross the different silos within the Department of Defense and talks about making progress on an installment basis toward ultimately achieving an opinion on the overall Department. Clearly superior but, frankly, they are really just getting started within the last year or so.

Mr. TOWNS. Do you want to comment on that?

Ms. COMBS. I would totally agree with what Mr. Walker has had to say about that. I would just add that I think also the effort that is underway, in terms of their A–123, their administrative order 123, internal controls effort, will probably help to accelerate some of the difficulties that they have had in the past. They are working very, very hard to try to correct deficiencies.

Mr. TOWNS. All right.

Mr. Walker, you paint a very sobering portrait of the long-term fiscal outlook for the Federal Government. I want to ask you about private sector liabilities and whether they are accounted for.

As you know, when the Federal Government had to spend hundreds of millions of dollars to bail out failing savings and loans in the 1980's, it created a real financial shock. Today the Federal Government acts as a guarantor for a lot of private debt by law for things like student loans, pension benefits, publicly chartered companies like Fannie Mae. Are these potential liabilities accounted for in the Government's balance sheet? And how do we know if the Federal Government is properly managing the risk for these private sector liabilities? How do we know?

Mr. WALKER. Well, first, as you note, Chairman Towns, on one hand you have traditional liabilities, which would be for things like debt held by the public, which would be for unfunded pension and

health care to military and civilians that are Government employees. You have certain commitments and contingencies. For example, to the extent that the Government, you know, might guarantee certain debt, to the extent that the Government might step up if certain entities fail, then those are various contingencies. And then we have certain unfunded commitments, the difference between what we have promised with Social Security and Medicare and the dedicated payroll tax revenues and premiums that we have available to meet those promises.

The answer is: if it is a firm commitment of the U.S. Government, if we have identified the likely event, if it is probable that it will occur, and if we can estimate within a reasonable degree of certainty the amounts of money involved, then under that circumstance it would be booked as a liability. Unless and until all three of those conditions exist, it would not be.

Let me give you an example. The Pension Benefit Guarantee Corporation is a U.S. Government corporation. Technically, the United States is not liable for its obligations. Technically the PBGC can borrow, I believe, up to $100 million. Its assets, however, are far less than its liabilities. It is in the hole about $20 billion. There is not a liability on the Government's financial statements for the PBGC, but we do disclose that contingency. We do note that it is under-funded by about $20 billion and what the nature and extent of the Government's obligations might be with regard to that.

Mr. TOWNS. Right. Thank you very much.

I yield to the ranking member, Congressman Bilbray.

Mr. BILBRAY. Thank you.

Mr. Walker, I want to just tell you I am very impressed with your commitment to fiscal sanity. I know there is not a lot of fans for you around this Hill, but I want you to know that you have one here. I appreciate your straight talk on the issues.

Department of Homeland Security has been put together by those of us in Congress trying to organize something, a whole lot of loose pieces that were thrown together under the crisis of 9/11, and is now struggling to try to be an organized strategy. Is there any light at the end of the tunnel that this agency is actually going to be able to function as hoped for, from the fiscal point of view?

Mr. WALKER. Yes. Absolutely. I think, frankly, DHS will probably get there before DOD will get there. The fundamental difference is the Department of Homeland Security represented 22 different departments and agencies that had different cultures, different systems, different structures, and, frankly, until September 11, 2001, most of them weren't even focused on homeland security. Their missions were fundamentally changed.

In contrast, take the Department of Defense, which was created in 1947. This is the 60th anniversary of the creation of the Department of Defense. They were all in the defense business. There weren't as many entities involved. Yet, here 60 years later they are still in last place in financial management.

So yes, we can be successful. We will be successful.

Mr. BILBRAY. I appreciate that. And, for the record, I opposed the Department of Defense. I think we ought to be up front and call it the Department of War, exactly what it is. I think that the politi-

cal correctness changing terminologies, we spend more time talking about terminology rather than getting the job done.

Department of War, Department of Defense, has there ever been a time in our history where they have been not the problem child with this kind of stuff? I am a history major. I go back and remember having issues such as Stewart raiding Union wagons and sending a telegram back saying you guys ought to all be thrown in prison because the mules aren't worth pulling the wagons because you guys are cutting deals on the purchase of equipment for the Army.

Has there been any time that we can really show that the Army, the Navy, or—we won't mention the Marine Corps. We don't want to get in trouble here—but that the Department of War, Department of Defense has been a good player in this, or has it all historically been the problem that most of us perceive it to be?

Mr. WALKER. I am also a student of history and I also have responsibilities for auditor generals around the world, and so it is not just the United States but it is also looking at other countries. Defense Departments, War Departments, whatever you want to call it—by the way, we used to call it War in the past—have always been challenged from a financial and fiscal standpoint, and frankly in part because, in general, they are not held as accountable as other departments and agencies are.

I will tell you that one of the things that I have done in recent years is I have looked to some of the other countries to find out what their experiences have been and they typically are about the last one to get their financial act together, the Department of Defense or War or whatever you want to call it in other countries, but most of them have.

For example, the United Kingdom has been able to achieve a clean opinion on its financial statements for several years in a row. That was not the case until recent years. So they typically are a lag indicator and they have been a problem for a long time.

Mr. BILBRAY. Yes. Just an editorial note: they also at almost exactly at that time abandoned their carrier and their task force and their ability to project their military force overseas extensively, but that does have an overall impact.

You know, Ms. Combs, OMB is talking about that they found over $45 billion in 2004 in improper payments. What do you think we can do to reduce those improper payments?

Ms. COMBS. Well, we are currently involved in a number of ways of reducing those improper payments already. One of the things that we used the President's management agenda score card for and we used the process of the score card is to hold agencies accountable for reductions in these key strategic areas that we know are going to make the biggest difference in how successful their entire financial operations are.

One of the things that we are very, very pleased with is the improper payments initiative. I think the improper payments initiative starts out by looking at risk-susceptible programs, and in this way we are able to take the highest-risk programs in each of the departments and agencies and target those. So we used some strategic ways of looking at who has the highest levels of improper payments and what are some things we can do within each one of those programs within each department.

We meet with those folks frequently. We have a lot of engagement with our departments and agencies from the financial management side of OMB. One of the things that we have found that helps in eliminating improper payments is extra verifications. I know Mr. Walker and I have talked about this. We were able to talk about it earlier today, how pleased we are with some of the various programs. HUD, for example, this year just got off the high-risk list for two of their programs that had been on the high-risk list since 1994. A lot of what goes on in getting agencies off that high-risk list and reducing improper payments is being sure that payments are going to the right individuals and that payments to individuals where they don't belong are removed. We find extra verification to be one of the key elements that we use in reducing improper payments.

Mr. BILBRAY. Thank you, Mr. Chairman. I know my time has expired. I would like a followup question whenever it is possible.

Mr. TOWNS. Thank you very much.

I now yield to the gentleman from Connecticut, Mr. Murphy.

Mr. MURPHY. Thank you, Mr. Chairman.

I wanted to go back to the DOD for a moment. It is hard not to, given the amount of time this subcommittee and full committee has spent overseeing a lot of the funds spent through DOD and I think have raised awareness in the public over the money being spent through the DOD and State Department.

Mr. Walker, help me maybe zero in on the issue a little bit. Are the issues within DOD system-wide, or are we talking about specific departments, agencies, pieces of DOD that raise greater issues than others?

Mr. WALKER. Some entities are better than others in DOD, but it is a department-wide problem. Just to put a little meat on the bones, the Department has about 2,000 legacy non-integrated information systems that have financial and other management information in them that were created independently by the different services, by the different DOD offices that exist. They don't talk to each other. In many cases you have to enter a 16-digit code for each transaction. It has to be entered into multiple systems. That is just an example of the problem.

One of the things that we are recommending is that, since DOD has 15 of 26 high-risk areas on GAO's high-risk list of which financial management is but one, we are recommending that the Department create a new chief management official, a level two official with a proven track record of success with a term appointment to focus full-time on these longstanding and systemic management problems.

Mr. MURPHY. The FAIR plan, does that address some of these questions of lack of interoperability?

Mr. WALKER. That plan, along with their business systems information plan, which is—you know, they have a business transformation unit that is focusing more on the information technology and the enterprise architecture. That, in conjunction with that plan, is trying to take a look at these systems.

Mr. MURPHY. Mr. Chairman, just one last question.

Mr. Walker, I just want to point to one interesting piece within your written testimony where you made a comment and said that

"The managers within DOD lack access to the full range of information—" this is directly from your statement—"to the full range of information needed to effectively manage day-to-day operations." Just talk a little bit about what is behind that concern.

Mr. WALKER. Well, what is important to keep in mind is the objective here is not just to get a clean opinion on your financial statements, because all that says is that the numbers are fairly presented in all material respects.

Mr. MURPHY. Right.

Mr. WALKER. You could have all kinds of economy, efficiency, effectiveness problems and still get a clean opinion on your financial statements. Ultimately what has to happen is that you need systems and controls that will provide timely, accurate, and useful financial and management information to be able to make informed decisions day to day. They don't even have systems and controls that will allow them to be able to get an audit opinion once a year, much less systems and controls that will allow them to have information.

For example, inventory. They don't know how much inventory they have, nor necessarily what condition it is in or where it is, which can cause them to continue to buy things where they already have plenty of it.

They also can have a circumstance which we have reported on where they are selling excess inventory for cents on the dollar when they are buying it for a dollar.

Mr. MURPHY. And obviously an inventory system, you know, if you are in the business world, is one of the first things you are going to invest in. On that example, what are the barriers in DOD to having a basic system of inventory cataloging?

Mr. WALKER. A lot of it has to do with outdated systems, information systems, all independent systems—everybody has got their own system—and ineffective controls. So that is illustrative of the problem that they have in many areas.

Mr. MURPHY. Good.

Thank you, Mr. Chairman.

Mr. TOWNS. Thank you very much.

Let me just come back to you, Mr. Walker, and actually, you too, Dr. Combs. Each of you in your testimony mentioned possible changes to the way the Government measures and audits its assets and liabilities. We often hear questions about whether we measure the right things and whether the auditing method we use now matches the risk involved. Are we spending too much money auditing low-risk items and not paying enough attention to higher-risk items?

Mr. WALKER. Well, let me, if I can, Mr. Chairman, address two elements. One deals with financial reporting and the other deals with auditing. I think my statement talks about both.

On financial reporting, I think we have to recognize that we are not a private sector business. We are a sovereign Nation. Therefore, we need to make sure that our financial reporting recognizes that reality and that we are providing financial information that is useful and relevant for the type of entity that we are.

In some cases I think we need to think about whether or not a traditional balance sheet makes sense for the Federal Government.

On the other hand, we need more fiscal sustainability in intergenerational equity reporting, which is not something you would see in the private sector, because if we don't end up mending our ways we are going to mortgage the future of our kids and grandkids something terrible. We need to recognize that and we need to show that.

We also need more performance reporting. We don't have a stock price. The U.S. Government doesn't have a stock price. We don't have certain market proxies that can say how well we are doing. So we need key national indicators and indicators that can help us see how we are doing for a variety of reasons.

Now on the audit, audits by definition are supposed to be focused on materiality. Materiality is both quantitative and qualitative. You are supposed to focus your energy and efforts based upon risk and based upon relevant materiality. So some of that is already considered in how you are going about the audit.

I do, however, think it is relevant, including for the Department of Defense, to decide how many entities should they seek to obtain an audit opinion on, because the more entities you seek to obtain an audit opinion on, the more money it is going to cost you, and therefore I think they need to step back and say how many different entities should end up receiving an audit opinion so that we can go about this in a way that will achieve better transparency and accountability, but in a cost-effective manner.

Ms. COMBS. You know, I think one of the reasons we selected the 45 day reporting time table was so that some day when we have a consolidated audit for the Federal Government we could do that within, let's say, 60 days, and that would be consistent with what the private sector offers.

I think in order to think toward the future along those lines, I know Mr. Walker and I agree that we have to be very, very careful on how we use these reporting models, and we have to recognize that the Federal Government has some unique needs, and when we start consolidating agency and financial reporting by agency into a consolidated report, we need to be looking now at the current reporting model and to see if it really does provide for reliable, transparent, user friendly kind of financial statement.

Mr. Walker and I were talking right before the hearing how we would very much like for the general public to know more and to use more of the financial information that we provide.

Our office has fairly recently started what we call a smarter accountability work group. We are working with chief financial officers, along with members of the President's Council on Integrity and Efficiency, the IGs, and this work group is currently being charged with producing a white paper on strategic directions that we might look at to look at how we are actually doing our reporting. We look forward to sharing that with a greater financial community and seeing if there are some things that we can do that are, indeed, smarter and lead to stronger and sustainable accountability for the Federal Government.

Mr. TOWNS. Thank you very much.

Just before I yield to the ranking member, the Sarbanes-Oxley Act required better internal controls and financial reporting for

public companies. Have the requirements of Sarbanes-Oxley had any spill-over effect in the area of Government accounting?

Mr. WALKER. First, as you know, Mr. Chairman, Sarbanes-Oxley applies to public companies. It doesn't apply to closely held companies, it doesn't apply to not-for-profit entities, and it certainly doesn't apply to the Federal Government, which is a lot more than a not-for-profit. We are losing money big time. So it doesn't apply.

One of the things that the JFMIP—the Joint Financial Management Improvement Program Principles—have looked at—and I am chairman of that group. It is the Secretary of the Treasury, Director of OMB, Director of OPM, and myself as Comptroller General of the United States—we have looked at whether and to what extent some of the concepts of Sarbanes-Oxley might make sense to apply to the Federal Government.

In some cases the answer is yes, in some cases the answer is clearly no. In some cases, quite frankly, the Federal Government was already ahead of the private sector. For example, GAO has expressed opinions on the internal control systems and financial management on the entities that we audit well before Sarbanes-Oxley was passed. The independence requirements for auditors, we had already modernized our independence requirements before Sarbanes-Oxley was passed.

But there are still issues that we need to look at at the principal level to determine whether or not they make sense for the Federal Government.

Mr. TOWNS. OK. Thank you.

I yield to the ranking member, Congressman Bilbray.

Mr. BILBRAY. Thank you.

I am sure neither one of you are old enough to have been around back when the savings and loan assets were liquidated by the Trust, the Land Trust, but I will tell you one thing that really became obvious to somebody watching the people make money off of the liquidation of the savings and loan assets was that the American taxpayer didn't get their fair share out of that. I saw people that were friends of mine making millions and millions of dollars because the Federal Government basically liquidated assets at 10 cents on the dollar, and anybody that had enough money to be able to put together those packages walked away with huge assets.

Why do I bring this up? I think that one of the biggest concerns I have is I may not see those who are actually being hurt, but I see money going or assets going to people who really shouldn't be getting those assets from the Federal Government. We don't talk too much about that. The guys, millionaires made big millions off of savings and loan debacle.

Right now do we have any idea how much assets are going to illegal immigrants within this country right now?

Mr. WALKER. I don't have a number that I can give you, Mr. Bilbray. I will give you three examples of areas of concern that we have at GAO along the lines of what you are talking about.

No. 1, I already mentioned where the Defense Department sells things for cents on the dollar when it is buying it for a dollar on a relative basis. Another example is we have huge excess facilities in the Federal Government. It is on our high-risk list. We are going to need to rationalize that and we are going to need to sell off a

lot of that. We need to make sure we learn from the lessons of the past and get a good deal for the taxpayers. The third example is the Federal Government owns, for the benefit of American citizens, a lot of mineral rights and a lot of lands. And in many cases we are not getting fair value for those mineral rights.

Mr. BILBRAY. Again, I echo that, too.

Mr. Chairman, something to remember. I come from a Navy town, but for lands that the U.S. Government has bought, we not only have a right, we have a responsibility to put that back on the fair market and get a fair return for it and not just make an in-kind gift to whatever political subdivision is lined up to take it.

You know, in San Diego we had some unique situations where the city had actually donated land for training facilities on the condition it be used for it, so that you should transfer back. But that is so rare that it is astonishing that you have huge tracts of land that are worth billions and billions of dollars. Monterey would be a good example. Don't tell Sam Farr I said this, but huge assets being thrown away over there.

My concern, Ms. Combs, you were talking about identifications. You know, I am looking at some of my colleagues talking about giving amnesty to 12 million illegals, and I don't mean to hit on this, but it is estimated that will be about 60 million people that will be a $50 billion hit on our Treasury every year.

Your mention about documentation and issues like that, was that referring only to contractors, or is that general for recipients across the board?

Ms. COMBS. No, sir. I was also referring to recipients. Most Federal benefit programs, as I understand it, are required by statute to verify the immigration status of non-citizens through SAVE, the Save Program, under the U.S. Citizenship and Immigration Services. I understand this to be a Web-based system that allows agencies to electronically verify immigration status against USCIS data bases to help ensure that only eligible non-citizens receive Federal, State, or local benefits.

Now, I will say we also know that there are some benefit programs administered by State agencies, for example, that do permit individuals to self-declare their citizenship status.

Mr. BILBRAY. Ms. Combs, let me interrupt. We have contracts. We are giving grants to a group like Acorn that is actively recruiting people illegally in the country to get home loans based on the fact that they are under-served, under their grant. So a lot of these things I don't think that we are being really open about the fact that not only this is going on—and I appreciate the fact that you are saying let's recognize it—we are, be it for political or some other reason, we are actively giving grants to groups that are openly, publicly telling the news media, yes, we are providing loans to these people. They are here. We don't care if they are illegal. We are going to provide these services to them.

Go ahead, Mr. Walker.

Mr. WALKER. If I can, let me mention a couple of things.

One, on the immigration challenge, two dimensions. From a practical standpoint, I don't think you are really going to get control of the immigration problem until we start enforcing our labor laws.

The fact is that the average daily wage in Mexico for an unskilled worker is $4.50.

Mr. BILBRAY. Mr. Walker, I totally agree. That is why we have Silvestre Reyes' bill out there to make it simple so we can crack down on employers.

Mr. WALKER. Right. I mean, you know, if you don't do that you are not going to choke it off. But let me mention a couple other things.

No. 1, Social Security and Medicare, I get questions a lot saying, gee, can't we solve Social Security and Medicare's problems by just opening up immigration, allowing more immigration? The answer is no, you can't come close to doing that.

There is the key: when you are talking about immigration, you are talking about economic growth, and if you are talking about the fiscal impact on the Federal Government, just for that purpose, the key is what are the average skills and knowledge of the individuals involved. If the average skills and knowledge are above average for our country, it will be a net plus over time. If they are below average, it will be a net minus over time. That is what we need to understand, because in our economy we have to compete based on skills, knowledge, innovation, productivity, quality. We can't compete on wages.

Mr. BILBRAY. So in other words, if it was such a great deal for the economy and for the budget, you would be coming here and recommending that we, to create more poor people to help the economy, we would cut all our funding to these anti-poverty programs so we can generate our own domestic supply, rather than have to import.

Mr. WALKER. I will have to think about that, Mr. Bilbray.

Mr. BILBRAY. The point being is that entry level laborers do not pay the expense of the minimum standard that we allow everyone to live by in this country.

Mr. WALKER. And if you also look at the nature of Social Security and Medicare, by definition they provide more and take less from people who are less well off.

Mr. BILBRAY. Mr. Chairman, I only bring this up because California is at a crisis now to where even Governor Schwarzenegger, an immigrant, who wants to provide health care to illegal immigrant kids has said we have to cutoff welfare to the children of the people, U.S. citizens, at 5 years, cutoff welfare, because we can't afford to continue to pay people to stay here illegally just because their children were born here. I mean, this is Schwarzenegger saying the budget is forcing us to have to do things that we never thought we would ever live to do.

Mr. WALKER. Can I piggyback real quick, Mr. Chairman, on that? I apologize.

You know, we have a lot of policies that are based on the past, and one of the policies that I think we need to reconsider is we have a policy that says that if you are born in the United States you are automatically a citizen. Now, when was that created? A long time ago when it was a long journey where one risked life and limb in order to come to the United States, and when we were seeking actively to try to populate this great continent. Yet, we still

haven't looked to try to modernize that, and I think that is something that has to be on the table.

There is a difference between a pathway to citizenship and a pathway to legal status.

Mr. BILBRAY. I appreciate it, Mr. Walker. Just to let you know, it was late 1940's that we allowed people who were not permanent resident aliens to get that automatic citizenship. Guest workers didn't qualify in those days.

Mr. TOWNS. I am going to have to stop the citizenship debate and move to my colleague from Vermont.

Mr. WELCH. Thank you, Mr. Chairman.

Mr. Walker, I want to ask about some accounting issues across Federal departments and also between different agencies within the same department. GAO, as you know, identified this as a material weakness, and on our second panel we are going to hear how that problem has been for DHS.

From your perspective, what is the main problem that doesn't allow agencies to do what seems to be a straightforward thing; namely, match up their accounts? Is that a use of different accounting definitions, technology, poor communication? What's the deal?

Mr. WALKER. It is a combination of factors. Any time you deal with, you know, an inter-entity transaction, it means that both sides have to have their act together with regard to systems and controls.

Mr. WELCH. So do you and OMB have any recommendations for standardizing the transactions so that agencies can clear each other's accounts better?

Mr. WALKER. Well, you know, one of the things that I think we need to be thinking about is something that Brazil has already implemented, and that is Brazil had very similar problems to what we had, and they ended up going to a standardized financial management system with standard definitions and specifications with regard to information systems on financial management. I mean, my gut feeling is that if Brazil can do it, we can do it, although that is clearly a multi-year effort.

Mr. WELCH. Thank you.

Mr. TOWNS. Thank you very much. No further questions. The first panel is actually being discharged at this time. Thank you very much for your testimony. We really appreciate your coming and sharing with us. We look forward to continuing to work with you.

Mr. WALKER. Thank you.

Ms. COMBS. Thank you, Mr. Chairman.

Mr. WALKER. If I can say for the record, Mr. Chairman, believe it or not, Mr. Bilbray, I have not had one complaint about stating the facts and speaking the truth on financial and fiscal issues and many, many compliments on both sides of the aisle. Thank you.

Mr. TOWNS. No doubt about it. You tell it like it is, and I like that. We eventually will get the message. Sometimes, though, some people catch on a lot faster than others. Sometimes it takes some of us 2½ hours to watch 60 Minutes. But that doesn't mean we can't watch it; it just takes us longer.

Mr. BILBRAY. Actually, Mr. Walker, after the testimony today, we may give you an honorary membership in the Immigration Caucus. OK?

Mr. TOWNS. I would like to welcome our second panel. As with the first panel, it is our committee policy that witnesses are sworn in, so please rise and raise your right hands.

[Witnesses sworn.]

Mr. TOWNS. Let the record reflect that they all answered in the affirmative.

Let me briefly introduce each witness.

James Campbell is Acting Chief Financial Officer for the Department of Energy. He is a Certified Public Accountant and has over 30 years of financial management experience in both the private sector and the Federal Government, with the last 28 years in the Department of Energy in various financial management capacities.

William Maharay is Deputy Inspector General for the Office of Audit Services at the Department of Energy. He has more than 25 years with the Department, and he oversees the financial statement audit at the Department of Energy.

David L. Norquist is Chief Financial Officer at the Department of Homeland Security. Mr. Norquist was leader in the financial management at the Department of Defense and served as a professional staff member here on Capitol Hill with the House Appropriations Committee.

Mr. James Taylor is Deputy Inspector General at the Department of Homeland Security. He, too, has extensive experience as a Federal financial manager, and in his current position oversees financial auditing at DHS.

Your entire statement, gentlemen, will be in the record. I would like to ask you to try to summarize within the period of 5 minutes to allow time for our questions from the panel.

Why don't we start with you, Mr. Campbell, and come right down the line.

## STATEMENTS OF JAMES T. CAMPBELL, ACTING CHIEF FINANCIAL OFFICER, U.S. DEPARTMENT OF ENERGY; WILLIAM MAHARAY, DEPUTY INSPECTOR GENERAL OF AUDIT SERVICES, U.S. DEPARTMENT OF ENERGY; DAVID NORQUIST, CHIEF FINANCIAL OFFICER, U.S. DEPARTMENT OF HOMELAND SECURITY; AND JAMES L. TAYLOR, DEPUTY INSPECTOR GENERAL, U.S. DEPARTMENT OF HOMELAND SECURITY

### STATEMENT OF JAMES T. CAMPBELL

Mr. CAMPBELL. Thank you, Mr. Chairman and members of the subcommittee. I appreciate the opportunity to address you today to describe the progress we are making at the Department of Energy in overcoming the financial management challenges that have caused us to lose our unqualified audit opinion on the fiscal year 2005 and 2006 financial statements.

We are working hard to restore our financial management credibility, and we expect this progress to be reflected in the audit of the fiscal year 2007 consolidated financial statements.

I understand the subcommittee is interested in the events and conditions surrounding our fiscal year 2006 audit opinion, but I

would not be forthright if I did not disclose the conditions that occurred in fiscal year 2005 that led to that 2006 audit opinion.

For the record, the Department received unqualified audit opinions on its financial statements for 6 consecutive years, from fiscal years 1999 through 2004. However, in fiscal year 2005 the Department implemented two initiatives to achieve long-term benefits that profoundly altered the accounting operating environment.

First, at the beginning of the fiscal year the Department consolidated and centralized its financial services operations to gain efficiencies that were identified through a competitive sourcing study that was run by the in-house team.

Second, 6 months later we changed most of the Department's accounting processes and deployed a non-customized, federally certified commercial off-the-shelf financial system. In hindsight, the Department might have been better served by implementing these business transformations sequentially.

Concurrent implementation presented short-term management challenges which prevented the Department from producing timely, auditable financial statements and, consequently, our auditors reported a material weakness in internal control related to financial control and reporting and issued a disclaimer of opinion on the fiscal year 2005 financial statements.

This disclaimer led to the development and implementation of a 2-year plan for regaining our unqualified audit opinion. A 2-year recovery was required since the disclaimer on the ending fiscal year 2005 balances automatically became a disclaimer on the fiscal year 2006 opening balances. Once the Department receives an unqualified opinion on its balance sheet, it will then have an audit-acceptable opening balance on which to base the opinion on the rest of the financial statements. The earliest this can be achieved is on the fiscal year 2007 statements.

The Department's senior leadership took the audit outcome very seriously. The Secretary and the Deputy Secretary made it perfectly clear that the financial problems we experienced were not solely owned by the Office of the Chief Financial Officer but rather by every element of the Department, and called on the entire senior leadership team to engage in solving this serious management challenge.

In October 2005 the chief financial officer established a multi-disciplinary team of financial professionals from both headquarters and our field institutions to identify the root cause of these management challenges and to recommend a path for it. In December of that year, the team presented its results to the Deputy Secretary, and he accepted the recommendations without modification. In short, 30 issues were identified in 3 broad categories: people, processes, and technology. It was originally assumed that the root cause was the new accounting system, but the analysis revealed most problems were related to people and processes.

The overriding recommendations centered on the need for clarifying financial management roles and responsibilities, redefining business processes to reflect the Department's new accounting environment, and gaining a greater understanding of the new system's functionality and reporting capabilities.

From February to June 2006, the Office of Inspector General initiated a series of reviews to determine whether the Department's plan and completed corrective actions adequately addressed critical control weaknesses in the financial management and reporting process. While the reviews were substantially less in scope than the financial statement audit, they provided a clear indication for the Department's senior leadership of the progress on our remediation.

Fiscal year 2006 was the first full year present with our new core financial system, and the many issues and challenges contained in our remediation plan commanded considerable attention and staff resources throughout the year. While the financial statement audit ORs were only engaged to issue an opinion on our 2006 balance sheet because of the aforementioned opening balance issues, the audit did cover the entire scope of our financial operations.

The audit opinion on the balance sheet was upgraded from a disclaimer opinion to a qualified opinion, which is a major step closer to us achieving the goal of an unqualified opinion in 2007. The qualification was due to concerns relating to the Department's accounting and reporting for obligations and undelivered orders.

As we progressed into 2006, the senior leadership continued to provide strong direction and support for addressing these issues preventing us from reaching our goals. A task force was established, a plan was developed and executed to correct the problems with obligations and undelivered orders. The planned actions included: correcting abnormal balances, clarifying procedures, and performing a comprehensive reconciliation of about 1,200 contracts comprising over 95 percent of our September 30, 2006, undelivered orders balance.

This phase of the remediation is now complete. The auditors are currently retesting the ending fiscal year 2006 balances, and we are optimistic, based on the work we have performed, that this audit will confirm the propriety of our undelivered orders balance, clear the qualification on the ending fiscal year 2006 balances, setting the stage for regaining an unqualified audit opinion on all financial statements this fiscal year.

In summary, implementing a core financial system, establishing and operating under a new chart of accounts, and reorganizing financial services operations are never easy undertakings. Doing them in the same fiscal year created a major management challenge for the Department. Decisions to implement these initiatives were made with the best of intentions, and, while we did not fully anticipate all the challenges that we encountered, the Department's response to these challenges has been aggressive, effective, and has positioned us for improved financial management.

Successful completion of these actions would not have been possible without a strong partnership with the Office of Inspector General and without the outstanding dedication and professionalism of the entire CFO community.

We look forward to regaining our unqualified audit opinion this fiscal year and restoring financial management credibility with our customers and our stakeholders.

This concludes my opening statement, and I would be pleased to respond to any questions you or the subcommittee may have, sir.

[The prepared statement of Mr. Campbell follows:]

**TESTIMONY OF JAMES T. CAMPBELL**
**ACTING CHIEF FINANCIAL OFFICER**
**U.S. DEPARTMENT OF ENERGY**
**WASHINGTON, D.C.**

**BEFORE THE**
**SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,**
**ORGANIZATION AND PROCUREMENT**
**COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM**
**U.S. HOUSE OF REPRESENTATIVES**

**MARCH 20, 2007**

Mr. Chairman, Mr. Ranking Member, and Members of the Subcommittee – I appreciate the opportunity to address you today to describe the progress the Department of Energy is making in overcoming the financial management challenges that caused us to lose our unqualified audit opinion on the Fiscal Year (FY) 2005 and 2006 financial statements. The Department of Energy has a long history of strong financial management. We are working hard to restore our financial management credibility, and we expect this progress to be reflected in the audit of the FY 2007 consolidated financial statements.

I understand that the Committee is interested in the events and conditions surrounding our FY 2006 audit opinion, but I would not be forthright if I did not disclose the conditions that occurred in FY 2005 that led to our FY 2006 audit opinion. The Department received unqualified audit opinions on its consolidated financial statements for six consecutive years from FY 1999 to FY 2004. However, in FY 2005, the Department implemented two initiatives to achieve long-term benefits that profoundly altered the accounting operating environment in the Department. First, at the beginning of FY 2005, the Department consolidated and centralized its financial services operations to gain efficiencies that were identified through a competitive sourcing study that was won by the in-house team. Second, six months later, we changed most of the Department's accounting processes and deployed a non-customized, Federally-certified, commercial off-the-shelf core financial system. In hindsight, the Department might have been better served by implementing these business transformations sequentially. Concurrent implementation presented short-term management challenges, which prevented the Department from producing timely, auditable FY 2005 financial statements and, consequently, our auditors reported a material weakness in internal control related to financial control and reporting, and

issued a disclaimer of opinion (i.e., was unable to provide an opinion) on the FY 2005 financial statements.

The disclaimer of opinion on the FY 2005 financial statements led to the development and implementation of a two-year plan for regaining our unqualified audit opinion. A two-year recovery was required since the disclaimer on the ending FY 2005 balances automatically became a disclaimer on the FY 2006 opening balances. Once the Department receives an unqualified opinion on its balance sheet, it will then have an audit-acceptable opening balance on which to base the opinion on the rest of the financial statements. The earliest this can be achieved is on the Department's FY 2007 financial statements.

**FY 2005 Remediation Efforts**

The Department's senior leadership took the audit outcome very seriously. The Secretary and Deputy Secretary made it clear that the financial problems we experienced were not solely owned by the Office of the Chief Financial Officer, but rather by every element of the Department, and called on the entire leadership team to engage in solving this serious management challenge. In October of 2005, the Chief Financial Officer established a multi-disciplinary team of financial professionals from both Headquarters and the field to identify the root causes of the Department's financial management challenges and to recommend a path forward. The team began its analysis before the Department received the official FY 2005 audit results and, once received, incorporated the results into their analysis. In December of 2005, the team presented its results to the Deputy Secretary, and he accepted the recommendations without modification. In short, 30 issues were identified in three broad categories: 1) people; 2) processes; and 3) technology issues. It was originally assumed that the root cause was the new accounting system, but the analysis revealed most problems were related to people and processes. The overriding recommendations centered on the need for: clarifying financial management roles and responsibilities; re-defining business processes to reflect the Department's new accounting environment; and gaining a greater understanding of the new system's functionality and reporting capabilities. The team also presented the remediation plan to all senior financial leaders and program resource managers in December 2005. A senior manager

was assigned ownership for each area, and work began immediately on the 22 high and medium priority issues.

**Office of Inspector General Review of Remediation Activities**

From February to June 2006, the Office of Inspector General (OIG) initiated a series of reviews to determine whether the Department's planned and completed corrective actions adequately addressed critical control weaknesses in the financial management and reporting process. As part of that effort, the OIG issued four progress reports on the Department's efforts. Each report commented on observed progress and included recommended actions such as accelerated reconciliations and a re-prioritization of remediation activities. While the reviews were substantially less in scope than the financial statement audit, they provided a clear indication for the Department's senior leadership of the progress on our remediation efforts.

**The FY 2006 Audit Result**

FY 2006 was the first full year of operations with the Department's new core financial system, and the many issues and challenges contained in the remediation plan commanded considerable attention and staff resources throughout the year. While the financial statement auditors were only engaged to issue an opinion on our FY 2006 consolidated balance sheet because of opening balance issues relating to FY 2005, the audit covered the entire scope of the Department's financial operations. The FY 2006 audit opinion on the balance sheet was upgraded from a disclaimer of opinion to a qualified opinion, which is a major step closer to an unqualified opinion. The qualification in FY 2006 was due to concerns relating to the Department's accounting and reporting for obligations and undelivered orders, and this issue was identified as a material weakness. The Inspector General, in a memorandum accompanying the auditors' report, did note that the Department, "made substantial progress in correcting a number of financial controls and reporting weaknesses that led to the disclaimer of an audit opinion on the FY 2005 financial statements."

**FY 2006 Remediation Activities**

The Department's senior leadership continued to provide strong direction and support for addressing the issues preventing the Department from regaining its unqualified audit opinion.

Biweekly briefings were presented to the entire Departmental senior leadership team on the status of our remediation efforts. A task force was established, and a plan was developed and executed to correct the problems identified with obligations and undelivered orders. The planned actions included correcting abnormal balances, clarifying procedures, and performing a comprehensive reconciliation of about 1,200 contracts comprising over 95 percent of our September 30, 2006 undelivered orders balance. With tremendous support from across the Department, this phase of the remediation is now complete. Contractual arrangements have been made to have the auditors re-test the ending FY 2006 balances, and the auditors' re-test is underway. We are optimistic that this audit work will confirm the propriety of our undelivered orders balance and clear the qualification on the FY 2006 ending balances, setting the stage for regaining our unqualified audit opinion on the full set of consolidated financial statements this fiscal year.

**Summary**

Implementing a core financial system, establishing and operating under a new chart of accounts, and reorganizing financial services operations are never easy undertakings. Doing them in the same fiscal year created a major financial management challenge for the Department. Decisions to implement these initiatives were made with the best of intentions. While we did not fully anticipate all the challenges that we encountered, the Department's response to these challenges has been aggressive, effective, and has positioned us for improved financial management. We look forward to regaining our unqualified audit opinion this fiscal year and restoring financial management credibility with our customers and stakeholders.

This concludes my prepared statement, and I will be pleased to respond to any questions you or the Subcommittee may have.

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

**STATEMENT OF WILLIAM MAHARAY**

Mr. MAHARAY. Mr. Chairman and members of the subcommittee, I am pleased to be here at your request to testify on issues associated with the 2005 and 2006 audits of the Department of Energy's financial statements. Over the years, the Office of Inspector General has conducted and overseen a number of reviews of the accounting and financial operations of the Department, addressing issues such as accounting information systems, financial statement reporting, and remediation efforts.

Prior to 2005, as Mr. Campbell has indicated, the agency received unqualified audit opinions on its financial statements. This changed when the Department embarked on a mid-year implementation of a new accounting system known as STARS. The Department undertook the system development effort during a time when it was also reorganizing its financial services organization. The reorganization resulted in the consolidation of financial recording and reporting processes previously performed at many separate locations. The centralization caused a significant loss of skilled personnel and changed the manner in which the Department's accounting system interfaced with its major contractors and ancillary systems.

Because of concerns with completing these major initiatives simultaneously, my office performed two pre-implementation reviews of STARS. The first of these reviews identified a number of personnel and internal control issues that increased the likelihood the Department would not be prepared to launch a fully capable system as scheduled in October 2004. Based upon our review and other factors, the Department decided to delay implementation until mid-year April 2005.

The second pre-implementation review completed by my office in January 2005 cautioned, "the planned mid-year implementation of STARS poses special challenges that could impact successful deployment of the system." In particular, we noted: one, two separate accounting systems would have to be used to produce the consolidated financial systems; two, accelerated reporting schedule would provide only a limited time to correct implementation problems; and, three, the burden of auditing two separate systems would severely stress both accounting and auditing resources.

The Department decided to move forward with the mid-year implementation in April 2005. Soon thereafter, our audit work revealed a significant number of issues in the new system and accounting operations. In particular, the audit identified issues with data conversion and with developing new accounting processes and reports. These problems detracted from the ability of the accounting staff to complete routine accounting reconciliations and impacted the ability of Department officials to monitor and control their budgets.

Despite significant effort by senior leadership, financial managers, and staff, the Department was unable to correct many of these problems by year-end. Consequently, the independent public accounting firm employed by the Office of the Inspector General issued a disclaimer of opinion on the Department's 2005 financial

statements and reported a material weakness in financial management and reporting controls.

A previously identified reportable condition on unclassified information and security systems continued from prior years.

Given the extent and significance of the problems identified, we initiated a series of reviews in January 2006, to determine whether the Department's planned corrective action would address critical financial management weaknesses. Our review found problems with timing and completeness to plan corrective actions, recording of obligations, and completing key reconciliations.

The Office of Chief Financial Officer agreed with our suggestion of realigning resources and refocused its efforts on financial management issues.

When conducting our 2006 audit of the agency's balance sheet, we found the Department had made significant progress in addressing deficiencies that surfaced in the prior year. However, actions needed on a number of issues associated with obligations and undelivered orders had not been completed, leading to a material weakness in internal controls and a qualified opinion on the 2006 audit.

Additionally, problems with unclassified system security continued, and a new reportable condition related to performance measure was identified.

Since the issuance of our 2006 financial statement audit, we have coordinated with the Department and have begun another focused review on actions to remediate problems associated with obligation on undelivered orders. Should this effort be successful and no new material weaknesses emerge, the Department would be in a position to obtain an unqualified opinion on the 2007 audit.

In summary, we believe that strong financial management is essential to the Department. Based upon our experience, the Department's senior leadership, to include both the Secretary and the Deputy Secretary, is committed to maintaining strong controls and has been fully invested in resolving weaknesses. We will continue to assist in that effort, as we have in the past, by devoting a significant portion of our resources to providing independent assessments of the accounting and financial management operation of the Department.

Thank you, Mr. Chairman and members of the subcommittee. That concludes my statement.

[The prepared statement of Mr. Maharay follows:]

**TESTIMONY OF WILLIAM S. MAHARAY**
**DEPUTY INSPECTOR GENERAL**
**FOR AUDIT SERVICES**
**U.S. DEPARTMENT OF ENERGY**
**WASHINGTON D.C.**

**BEFORE THE**
**SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,**
**ORGANIZATION AND PROCUREMENT**
**COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM**
**U.S. HOUSE OF REPRESENTATIVES**

**MARCH 20, 2007**

Mr. Chairman and members of the Subcommittee, I am pleased to be here at your request to testify on issues associated with the FY 2005 and 2006 Audits of the Department of Energy's Financial Statements. Over the years, the Office of Inspector General has conducted and overseen a number of reviews of the accounting and financial operations of the Department. Our reviews related to the audits of the year-end financial statements have covered accounting information system issues, financial statement reporting, and actions to remediate financial accounting and reporting weaknesses. Prior to discussing these subjects, I would like to provide some background information on the Department's financial information management system.

The Department's system, which is relatively unique in the Federal sector, is a hybrid in that it combines summary data from its major contractors with transaction data generated by the business activities of numerous Departmental organizations and sites. Rather than being included in Departmental records, detailed contractor transaction data is maintained by – and audited at – each of the contractor locations. As a control measure, both contractors and Federal officials are required to ensure that the summary data transmitted

from and accepted by the Department's accounting information system is periodically reconciled to the contractors' systems. Over 70 percent of the Department's budget is ultimately expended by its integrated contractors.

**Changes to Accounting Operations**

The Department was able to sustain unqualified audit opinions on its financial statements until Fiscal Year (FY) 2005. This changed when the Department embarked on the mid-year implementation of a new financial accounting information system known as the Standard Accounting and Reporting System (STARS). The change in accounting system was necessary to (1) ensure that the Department could implement the U.S. Government Standard General Ledger (SGL) at the transaction level and, (2) prevent operational disruption when the legacy hardware vendor stopped supporting its product, and (3) comply with requirements to establish and maintain a modern financial management system that would permit the systematic measurement of performance; the development of cost information; and the integration of program, budget, and financial information for management reporting.

The Department undertook the system development/replacement effort during a period of significant organizational change associated with a Competitive Sourcing Initiative required by OMB Circular A-76. To conform to the structure established through that initiative, the Department's financial services organization was extensively reorganized during Fiscal Years 2004 and 2005. The reorganization resulted in consolidating the financial recording and reporting processes that were previously performed at many

separate locations into three sites. The centralization had a negative effect on financial accounting staffing levels and skills mix in that many key accounting personnel were reassigned and many others were lost through attrition. Centralization also changed the manner in which the Department's financial accounting system interfaced with its major contractors, budgetary and other ancillary systems.

**Pre-Implementation Reviews**

Because of concerns with completing these major initiatives simultaneously and potential problems related to planning and system development activities, the Office of Inspector General performed two pre-implementation reviews of STARS. The first of these reviews, completed in August 2004, identified a number of challenges that increased the risk that the Department would not be prepared to launch a fully capable system on schedule. Specifically:

- Demands on existing staff would increase substantially and it was uncertain whether resources would be available to complete implementation and testing;
- Critically important training was behind schedule;
- Integrated contractor interface testing had not been completed; and,
- Proper cleanup and conversion of field site data to STARS were not expected to be completed prior to implementation.

We made a number of suggestions to prioritize and resolve critical issues before implementation of the new system. Based on our review and other factors, the Department made the decision to delay its original October 2004 implementation until April 2005.

During the intervening period, our Office conducted a follow-up review, completed on January 11, 2005, that identified additional challenges. While progress was made on certain fronts, we observed that the "planned mid-year implementation of STARS poses special challenges that could impact successful deployment of the system." In particular, we noted that: two separate accounting systems would have to be used to produce the consolidated financial statements; the accelerated reporting schedule for year-end financial statements would provide only limited time to correct any problems that occurred during implementation; and, the burden of auditing two separate systems of controls (both the legacy system and STARS) would severely stress both accounting and audit resources.

**FY 2005 Financial Statement Audit**

In April 2005, the Department decided to move forward with the mid-year implementation of its new financial accounting system and the adoption of a new chart of accounts. Following deployment, our FY 2005 financial statement audit revealed implementation issues related to converting data from its legacy accounting system, developing new accounting processes to effectively use the new system, and identifying related reporting requirements. Notably:

- Reports needed for management, control, and audit purposes were not available following system deployment;
- Accounting processes had not been fully documented; and,
- Operational control procedures were not yet being performed routinely.

Despite substantial effort, the Department was unable to correct many of the problems associated with the reorganization of its accounting function and conversion to STARS by 2005 Fiscal Year end. As of September 30, 2005, a number of significant issues and challenges had not been resolved. Reports needed for management, control, and audit purposes were not available and a number of system reconciliations remained incomplete. These problems (1) delayed preparation of the FY 2005 financial statements and supporting data, and, (2) impacted the ability of Department officials to monitor and control their budgets.

On November 9, 2005, the Independent Public Accounting firm (IPA) employed by the Office of Inspector General issued a disclaimer of opinion on the Department's FY 2005 consolidated financial statements and reported a material weakness in financial management and reporting controls. Additionally, because of the control deficiencies, the IPA determined that the Department's financial management systems did not substantially comply with all of the requirements of the Federal Financial Management Improvement Act. Weaknesses in the Department's unclassified information systems security, a reportable condition, also continued from prior years.

**Review of Remedial Efforts**

Given the significance of the problems with financial management and reporting controls, the Department established a special management team to develop a corrective action plan and oversee remedial actions. To assist the Department in evaluating the status of corrective actions, we initiated a series of reviews in January 2006 to determine whether

the Department's planned and completed corrective actions adequately addressed its critical financial management weaknesses.

Our reviews focused on the Department's corrective action plan and included assessments and tests of many revised controls. Our initial review found that certain corrective actions were not scheduled for completion until late in FY 2006, which would not have provided sufficient time to test the newly established controls. We also noted that in some instances, planned actions did not appear to be sufficient to ensure that weaknesses identified during the FY 2005 audit were fully addressed. Subsequent reviews by my office found that a number of key financial accounting system reconciliations had not been completed and reports were not available to permit testing of certain newly created internal controls. Significant system edit errors remained unresolved and problems with recording obligations had not been corrected. The Office of the Chief Financial Officer concurred with our suggestions and agreed to realign resources and refocus its efforts to address unresolved financial management issues.

**FY 2006 Financial Statement Audit**

Because of the disclaimer of opinion, it was possible to render an opinion only on the Department's Balance Sheet in FY 2006. During the FY 2006 audit, the Department made significant progress in addressing STARS implementation deficiencies and other problems that surfaced in FY 2005. It was, in our judgment, a significant improvement over the previous year. However, actions necessary to reconcile obligations data converted from the Department's legacy accounting system remained unfinished at year end. Data conversion

differences impacted the accuracy of undelivered orders balances at a number of field offices. In addition, many organizations had not performed periodic reviews of obligations and undelivered order balances. As a result, a number of undelivered order balances did not agree with supporting documentation, old obligations had not been deobligated, and many undelivered orders had negative balances.

The issues with obligations and undelivered orders balances resulted in a material weakness in internal controls and a qualified opinion on the Audit of the Department's FY 2006 Balance Sheet. Additionally, problems with unclassified systems security continued as a reportable condition from prior years, and a new reportable condition related to performance measurement was reported. Consistent with its remedial efforts, except for the issues associated with obligations and undelivered orders, nothing come to our attention to suggest that the Department's systems did not substantially comply with other requirements of the Federal Financial Management Improvement Act.

Since the issuance of our FY 2006 financial statement audit report, we have coordinated with the Department and have begun another focused review of its actions to remediate the problems associated with obligations and undelivered orders. Should this effort be successful at all sites, and barring any new material weaknesses in FY 2007, the Department would be in a position to obtain an unqualified opinion in the FY 2007 Audit. We recently began the FY 2007 consolidated financial statement audit and are presently performing information systems assessment and testing as part of that effort.

In summary, we believe that a strong financial management program is important to the Department of Energy. Based on our experience, the Department's current senior leadership, including both the Secretary and the Deputy Secretary, is committed to maintaining strong controls and has been fully invested in resolving weaknesses related to the change in accounting systems. We will continue to assist the Department in this effort – as we have in the past – by devoting a significant portion of our available resources to providing independent assessments of the accounting and financial management operations of the Department.

Thank you, Mr. Chairman and members of the Subcommittee. That concludes my statement and I am prepared to answer questions.

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

**STATEMENT OF DAVID NORQUIST**

Mr. NORQUIST. Thank you, Chairman Towns, Ranking Member Bilbray, and members of the subcommittee for this opportunity to testify before you today on the results of the fiscal year 2006 financial audit of the Department of Homeland Security.

I also want to thank you for House Resolution 134. Your statement of support and recognition for the DHS work force is greatly appreciated.

Regarding the audit, DHS received a disclaimer of opinion on its fiscal year 2005 and 2006 financial statement. Secretary Chertoff and I are committed to correcting this and to achieving the intended outcome of the Department of Homeland Security Financial Accountability Act. To this end, the Department has put into place corrective action plans to improve our financial management process and to address material weakness conditions such as those involving inter-agency and inter-departmental balances.

Looking back, substantial progress was achieved in our 2006 financial statement audit. Two components, U.S. Customs and Border Protection and the Federal Law Enforcement Training Center, received favorable audit outcomes. CBP obtained an unqualified opinion on its financial statement, and FLETC obtained an unqualified opinion on its first ever balance sheet audit.

Significant progress has also been made in reducing conditions that comprise the Department's material weakness structure. For example, most significantly, U.S. Immigration and Customs Enforcement eliminated five of its seven component level material weakness conditions.

In 2005, our auditors had identified inter-agency and inter-departmental accounting as a material weakness condition. The Department made progress on this front in 2006, eliminating inter-agency balances as an auditor-identified weakness.

We are proud of this progress, but much remains to be done. When I testified before this committee in September, I outlined a series of initiatives I intended to implement over the next year. I am pleased to report to you today that these efforts are well underway. I will focus on one that is of particular relevance to the audit.

We discussed creating a Department-wide corrective action plan to address the material weaknesses. That is done. Mr. Chairman, I brought you a copy of it, as well. This is the Internal Control Over Financial Reporting Playbook that outlines our strategy and process to resolve material weaknesses and build management assurances. Many of our material weaknesses were inherited and they are longstanding challenges. These challenges will not be solved in a single step, but the ICOFR Playbook details the path forward through near and long-term fixes.

But we are not stopping at simply fixing what the auditor finds. Our Playbook has two tracks. The first track includes corrective actions for weaknesses identified by the auditors, such as fund balance with Treasury or inter-governmental balances. But the Playbook also includes a second track, where we examine and test processes where no weakness was identified—this is often called the A–

123 process—because our management needs to make affirmative assurances that the controls are effective, not simply noting that the auditors couldn't find anything.

I appreciate the support we have received from our Office of the Inspector General as we developed the Playbook. Through performance audits, they have provided timely feedback on our corrective action plans, and I look forward to their continued independent advice and essential cooperation.

DHS has made progress since our last hearing, and we are on track to make more progress this year, as well.

I appreciate the support we have received from the Congress, and particularly this subcommittee. Thank you for your leadership and your continued support for the Department of Homeland Security.

[The prepared statement of Mr. Norquist follows:]

**Statement by**

David Norquist

Chief Financial Officer

Department of Homeland Security

Before the

House Oversight and Government Reform Committee

Subcommittee on Government Management, Organization, and Procurement

Hearing on

The Federal Government's Consolidated Financial Statement

March 20, 2007

**Opening Statement**

Thank you Chairman Towns, ranking member Bilbray, and members of the Committee for this opportunity to testify before you regarding the results of the Department of Homeland Security's (DHS) FY 2006 financial statement audit.

I also want to thank you for House Resolution 134. Your statement of support and recognition for the DHS workforce is greatly appreciated.

Regarding the audit, DHS received a disclaimer of opinion on its FY 2005 and FY 2006 financial statements. Secretary Chertoff and I are committed to correcting this and to achieving the intended outcome of the Department of Homeland Security Financial Accountability Act (DHS FAA), Public Law 108-330. To this end, the Department has put into action our plans to improve our financial management process and to address material weakness conditions such as those involving interagency and interdepartmental balances.

The task before us is not easy. But I am confident that working with the Congress, the Office of Management and Budget, and the Department's Inspector General, we will continue to make progress on our financial statement audit.

**FY 2006 Financial Statement Audit Results**

Substantial progress was achieved in our FY 2006 financial statement audit. Two components, U.S. Customs and Border Protection (CBP) and the Federal Law Enforcement Training Center (FLETC) received favorable audit outcomes. CBP obtained an unqualified opinion on all financial statements and FLETC achieved an unqualified opinion on its first ever balance sheet audit. Significant progress has also been achieved in reducing conditions that comprise the Department's material weakness structure. For example, most significantly the U.S. Immigration and Customs Enforcement (ICE) eliminated five of its seven component-level material weakness conditions. The Department is proud of these accomplishments and I am particularly grateful for the leadership of the Assistant Secretary for ICE, Julie Myers and the then ICE CFO Debra Bond. Their experience makes it clear that success comes from having strong

leadership support, and an effective corrective action plan. This year at the Department-wide level we have both.

**Financial Management Improvement Initiatives**

When I testified before this Committee, in September, I discussed with you the themes that I intended to build upon to achieve sustainable financial management improvement: People, Policy, Process, Systems and Assurance. I also outlined a series of initiatives I hoped to implement over the next year. I am pleased to report to you today that these efforts are well underway. For example:

- I talked about preparing the financial leaders of tomorrow and we are now concluding the first class of the CFO Mentorship program for mid-level managers. Over a four month period, these candidates have rotated through various components' CFO offices for breadth of experience and are undergoing an intensive leadership development course of study. We expect to begin a second class later this summer.
- I discussed ensuring a common set of skills and knowledge for all DHS financial management employees. Yesterday, was the first day of our New Hire training program for new financial management employees from throughout the Department. They will learn about the various parts of the Department; our core financial functions of budgeting and accounting; and the responsibilities of all financial management employees to support strong internal controls and to enforce compliance with fiscal law.
- Another initiative involved beginning the development of a financial management policy manual. This effort is well underway and we regularly conduct financial management policy workgroups with staff from across our components working together to develop Departmental level policy that will instill best practices and consistency in the execution of all DHS financial activity.
- Our plans for consolidating financial systems are moving forward. Rather than migrating all components to a new system, we are seeking to capitalize on existing compliant systems. This fall we migrated the

Domestic Nuclear Detection Agency onto the same system used by the Transportation Security Administration.

- We are currently interviewing for staff to create a management assurance team to ensure that the internal control improvements we put in place continue to work effectively and to identify and prevent waste, fraud, and abuse before it happens.

**The Path Forward**

I also discussed our intention of developing a corrective action plan to address the material weaknesses. That is also done. The Internal Controls Over Financial Reporting (ICOFR) Playbook outlines our strategy and process to resolve material weaknesses and build management assurances. Many of our material weaknesses were inherited and are longstanding challenges. These challenges will not be solved in a single step, but this ICOFR Playbook details the path forward through near and long -term fixes. The auditor's past reports highlight the challenges we face. They identified weaknesses that have occurred for a variety of reasons common to newly formed organizations, such as inconsistent processes, reliance on legacy policies, undeveloped internal controls, incomplete information, or systems that cannot properly process reliable data and information. Our Playbook has two tracks. The first track includes corrective actions for auditor identified weaknesses, such as Fund Balance with Treasury and Intragovernmental Balances. The playbook includes a second track where we examine and test the processes where no weakness was identified.

Our corrective action plans, thus address auditor-identified weaknesses. But, we are not stopping at simply fixing what the auditors find. One of the most important lessons learned from our initial years of implementing the DHS FAA involved shifting from just focusing on audit opinions or addressing auditor-identified issues to also building support for the Secretary's Assurance Statement by focusing on management-identified root causes and management-performed test work. Through our multi-year internal controls assessments, we are

documenting the design of our controls and we will then test their operating effectiveness.

I appreciate the support we have received from our Office of Inspector General as we developed and executed the Playbook. Through performance audits they have provided timely feedback on our corrective action plans and I look forward to their continued independent advice and essential cooperation.

**Interagency and Interdepartmental Accounting**

I appreciate the Subcomittee's attention to the challenge of interagency and interdepartmental Accounting, so let me spend some time on this particular challenge. DHS conducts business internally with DHS components and externally with other Federal agencies (i.e., trading partners) resulting in the reporting of interagency and interdepartmental receivables, payables, transfers, revenues and expenses. Federal accounting and reporting regulations require Federal agencies to routinely identify and reconcile these balances and transactions with trading partners to ensure balances properly eliminate in the government-wide and DHS consolidated financial statements.

The challenge is that the accountants normally do not have enough information about the transaction to quickly or easily determine which office in another government agency they need to go to, in order to reconcile or "eliminate" the transaction. It is referred to as elimination because when an agency reports an amount it is due, the respective paying agency must report the same amount owed to that agency. If the respective agency items match, the balances will eliminate or "net-out", when their respective financial statements are consolidated at a Departmental and then again at a Government-wide level. Given the thousands and thousands of transactions involved, numerous reporting methods, and the size of the agencies, reconciling interagency balances across the Federal government is a daunting and labor intensive task.

In FY 2005, our auditor identified a material weakness condition within interagency and interdepartmental accounting. The Department made progress on this front in FY 2006 by improving out-of-balance account conditions between

DHS components eliminating it as an auditor identified weakness, however much remains to be done to improve this internal effort. The challenge of reconciling transactions with other Departments is an even greater challenge.

This past summer we held a corrective action planning workshop to identify the root causes of interagency and interdepartmental accounting material weakness conditions. This included a lack of policies and procedures, an insufficient number of properly trained staff and systems that did not record transactions at the trading partner level. We have outlined the path forward in the ICOFR Playbook.

Interagency and interdepartmental accounting is an area we expect to substantially remediate in FY 2007. We have hired a subject matter expert on the issue from the Department of Treasury and we will actively participate in the Chief Financial Officers Council's Interagency Dispute Resolution Committee to resolve interagency transaction problems and we are grateful for the strong and continued leadership by OMB and the Department of Treasury.

**Conclusion**

DHS has made progress since our last hearing, and we are on track to make more progress this year as well. I appreciate the support we have received from our Office of the Inspector General. I also appreciate the support we have had from the Congress and this Committee. Thank you for your leadership and your continued support of the Department of Homeland Security.

Mr. TOWNS. Thank you very much, Mr. Norquist.
Mr. Taylor.

**STATEMENT OF JAMES TAYLOR**

Mr. TAYLOR. Thank you, Chairman Towns, Mr. Bilbray, I am Jim Taylor. I am the Deputy IG at Homeland Security, and I appreciate the opportunity to discuss today the status of financial management at DHS and efforts to implement the Department of Homeland Security Financial Accountability Act.

The Office of the Inspector General partners with the Secretary of Homeland Security and his executive staff to ensure that the Department accomplishes its mission in the most effective, efficient, and economic manner possible. Our goal is to provide independent, objective information and identify issues and opportunities for improvements in financial management and other areas.

Strong financial management and accountability are essential to the achievement of DHS' mission. The Accountability Act recognizes this and has very specific requirements with respect to internal controls over financial reporting, by requiring the Secretary to include in DHS' performance and accountability report an assertion of internal control over financial reporting.

DHS met this requirement in both 2005 and 2006, with the Secretary asserting that the Department was unable to provide reasonable assurance that internal control over financial reporting was effective.

The act further requires the Secretary to include an audit opinion on the Department's internal controls over financial reporting in DHS' accountability report beginning in fiscal year 2006. The Department met this requirement, as well, with the Inspector General issuing a disclaimer opinion on the audit of the Department's internal control of financial reporting.

To promote internal control improvements, the Office of the Inspector General has gone beyond simply issuing these opinions. Working closely with the CFO Office, we have conducted a series of performance audits that focus on the Department's corrective action plans to address internal control weaknesses. Our objective was to measure the Department's progress in preparing well-developed corrective action plans to support internal control improvements.

We provided recommendations to the CFO to strengthen these plans as they were being developed. We will continue with this effort in 2007.

For 2006, the financial management within the Department continued to falter, however. The department was, again, able to receive an opinion on its financial statements, and 10 material weaknesses were recorded for the 3rd straight year. KPMG, under contract with the Office of the Inspector General, issued a disclaimer of opinion. The reasons for this disclaimer included management at the Coast Guard and TSA were unable to represent that their balance sheets, as of September 30, 2006, were fairly stated in conformity with U.S. generally accepted accounting principles. The office of the CFO, ICE, and FEMA were unable to support the accuracy of certain accounts, and the DHS' Office of Financial Management was unable to reconcile inter-governmental transactions and

balances with other Federal trading partners totaling approximately $3.5 billion in 2006 and $1.5 billion in 2005.

The Department's 10 material weaknesses ranged from financial management oversight and reporting at the Department level to controls surrounding the recording of individual account balances within DHS bureaus.

Our four performance audits reports issued between July 2006, and February 2007, assessed the effectiveness of DHS' corrective action plans to address internal controls weaknesses. These audits focused on the corrective action plans at Department level, as well as at the Coast Guard and ICE, given their importance to the overall success of the Department.

We identified weaknesses related to financial management oversight and financial reporting relating primarily to resource capabilities within the Office of the CFO at Coast Guard, whose activities impact virtually every one of DHS' material weaknesses. Our primary recommendations are for the Coast Guard to improve its corrective action plans by performing a thorough root cause analysis of weaknesses and develop a detailed list of tasks and milestones based upon this analysis.

A positive development in 2006 was at the Immigration and Customs Enforcement. ICE began its corrective action planning process early and was able to close out 37 of 49 weaknesses identified during the 2005 financial statement audit, including material weaknesses relating to fund balance at Treasury. It is also evident that senior leadership at ICE are actively engaged in developing overall financial management strategy, corrective action plans, and developing systems to monitor overall internal control improvements.

Additionally, ICE senior leadership has set a positive tone for financial management improvements and actively monitors progress. However, the Federal Protection Service and ICE have encountered problems during the financial management transition that they are still working to resolve. In addition to inadequate funding, poor administrative support for FPS has been a transition to DHS.

In October 2006, it was reported the FPS was not paying invoices for its contract guard services nationwide in a timely manner resulted in a violation of the Prompt Payment Act, largely due to systems problems. Of the 25,557 invoices paid between October 1, 2004, and November 2005, 88 percent were not paid within 30 days, as required by the Prompt Payment Act. This resulted in over $1.2 million in interest penalties. This is largely due to problems of transition from the GSA financial management system to the ICE Federal financial management system.

In conclusion, Mr. Chairman, we feel that there has recently been significant progress at DHS under the CFO's leadership, particularly in developing strategies and the Playbook with specific milestones to improve financial management throughout the Department. The CFO has initiated efforts to address staffing and skills limitations and identified a process to maintain senior management focus on achieving the milestones identified. However, the Department has not realized the fruits of these efforts to date, and it remains largely at the same place in terms of financial management as it was when it was first created, with financial systems and processes so in need of corrective actions that we cannot rely

on the information they produce. It will take years of focused effort and committed resources to successfully address these issues.

We intend to continue taking a corrective and engaged approach in collaboration with the CFO to monitor the financial management improvement efforts, and we look forward to working with the Department and the Secretary, as well as with Congress.

Mr. Chairman, this concludes my prepared remarks. I would be happy to answer any questions you or the subcommittee may have. Thank you.

[The prepared statement of Mr. Taylor follows:]

**STATEMENT OF JAMES TAYLOR**

**DEPUTY INSPECTOR GENERAL**

**U.S. DEPARTMENT OF HOMELAND SECURITY**

**BEFORE THE**

**SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,**

**ORGANIZATION, AND PROCUREMENT**

**COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM**

**U.S. HOUSE OF REPRESENTATIVES**

**"OVERSIGHT OF THE FEDERAL GOVERNMENT'S CONSOLIDATED FINANCIAL STATEMENT"**

**MARCH 20, 2007**

Good afternoon Mr. Chairman, and Members of the Subcommittee.

I am James Taylor, Deputy Inspector General for the Office of Inspector General (OIG) at the Department of Homeland Security (DHS). Thank you for the opportunity to discuss the status of financial management at DHS, efforts to address the department's internal control weaknesses, and implementation of the *Department of Homeland Security Financial Accountability Act*, P.L. 108-330 (Accountability Act).

**Office of Inspector General Partnerships**

The Office of Inspector General partners with the Secretary of Homeland Security and his executive team to ensure that the department accomplishes its mission in the most effective, efficient, and economical manner possible. Key to achieving these objectives is sound financial management. Through our audits, we provide independent, objective information and identify issues and opportunities for improvements in financial management and other areas.

We share with the Chief Financial Officer (CFO) a vision of world-class financial management that delivers reliable, timely, and useful information to support the critical mission of DHS. Financial management is a high-priority area for our office it is an area where we plan an ongoing and proactive presence. Our goal is to provide the department with real-time analysis and feedback to assist them as they are developing and executing financial improvement plans.

**The DHS Financial Accountability Act and Internal Control**

Strong financial management and accountability are essential to the achievement of DHS' mission. The Accountability Act recognizes this and emphasizes effective financial management leadership and internal control as essential elements of a sound financial management program. To this end, the Accountability Act has very specific requirements with respect to internal control over financial reporting by requiring the Secretary to include in the DHS Per*formance and Accountability Report* an assertion on internal control over financial reporting. DHS met this requirement in both 2005 and 2006 with the Secretary asserting that the department was unable to provide reasonable assurance that internal control over financial reporting was effective.

The Act further requires the Secretary to include an audit opinion on the department's internal control over financial reporting in DHS' Accountability Report, beginning in fiscal year (FY) 2006. The department met this requirement, with our office issuing a Disclaimer of Opinion on the audit of the department's internal control over financial reporting.

To promote internal control improvements, we have conducted a series of performance audits focusing on the department's corrective action plans to address internal control weakness. Our objective is to measure the department's progress in preparing well-developed corrective action plans to support internal control improvements. We provided

recommendations on a real-time basis to strengthen plans as they were being developed, and we plan to continue this effort in FY 2007.

**Status of Financial Management at DHS**

***Creating a Financial Management Capacity***
Financial management has been a major challenge for DHS since its creation in 2003. DHS was created by consolidating 22 domestic agencies, many of these agencies brought to DHS different business processes and pre-existing internal control weaknesses. In addition, DHS needed to create a department-level capacity to lead, manage, and oversee financial management. We have reported in our financial audit report that this has proven to be a challenging task for the department. Specifically, in our past audits, we have identified resource and capability deficiencies in department-level financial management oversight and reporting.

***2006 Financial Audit Results***
For FY 2006, financial management within the department continued to falter. The department was again unable to receive an opinion on its financial statements and ten material weaknesses were reported for the third straight year. KPMG, LLP, under contract with the OIG, issued a Disclaimer of Opinion primarily due to problems at Immigration and Customs Enforcement (ICE), the Coast Guard, Office of Financial Management (OFM), within the Office of the Chief Financial Officer (OCFO), Transportation Security Administration (TSA), and the Federal Emergency Management Agency (FEMA). These problems included:

- Management at the Coast Guard and TSA were unable to represent that their balance sheets as of September 30, 2006, were fairly stated in conformity with U.S. generally accepted accounting principles;
- OFM, ICE, and FEMA were unable to support the accuracy of certain accounts: and
- OFM was unable to reconcile intragovernmental transactions and balances with other federal trading partners totaling approximately $3.5 billion in 2006 and $1.5 billion in 2005.

In addition, Coast Guard maintains pension, medical, and post-employment travel benefit programs that require actuarial computations to record related liabilities for financial reporting purposes. The medical plan covers active duty personnel, reservists, retirees/survivors, and their dependents who are provided care at Department of Defense (DoD) medical facilities. The DoD invoices the Coast Guard for the cost of medical care as services are provided. In FY 2006, the Coast Guard's actuary identified an anomaly in certain medical expenditures paid to the U.S. Navy by the Coast Guard. As a result, the Coast Guard conducted a review of the FYs 2003, 2004, and 2005 medical expenses billed to the Coast Guard by the DoD. The review identified that medical costs incurred by Coast Guard *active* members and their dependents had been improperly classified as medical costs incurred by Coast Guard *retirees* and their dependents. The amounts improperly classified should not have been used in the actuarial calculation used to

determine the post-retirement medical liability. As a result, the Coast Guard also did not identify errors in DoD billings that, over a period of several years, resulted in an overstatement of $444 million of the FY 2005 post-retirement medical liability and required DHS to restate its published FY 2005 financial statements. Further, more than 6 months after the errors were discovered, the Coast Guard had not implemented corrective actions and had not initiated a review of all invoices from other DoD military treatment facilities to validate the accuracy and completeness, or established procedures and controls to prevent similar errors from reoccurring.

The department's ten material weaknesses ranged from financial management oversight and reporting at the department-level to controls surrounding the recording of individual account balances within DHS bureaus. The material weaknesses are pervasive throughout the department and are indicative of the challenges the department faces in producing timely and reliable financial information.

Many of these weaknesses are attributable to significant internal control problems at the Coast Guard, the OCFO, and TSA. These control weaknesses, due to their materiality, are impediments to obtaining a clean opinion and positive assurance over internal control at the department level.

***FY 2006 Activities***

To move forward, DHS must develop a comprehensive financial management strategy that addresses organizational resources and capabilities, inconsistent and flawed business processes, and unreliable financial systems. An initial step in this process is to prepare well-developed and comprehensive corrective action plans to address known internal control weaknesses.

During FY 2006, we anticipated progress in addressing internal control deficiencies. The department identified four areas where internal control weaknesses exist for improvement during the year. However, a coordinated department-wide effort to develop corrective action plans did not begin until the third quarter of 2006; as of the completion of our recent performance audits, the department did not yet have a department-wide plan in place.

Many of the department's material weaknesses, to varying degrees, are attributable to the Coast Guard. Achieving a clean financial statement audit opinion and providing positive assurance over internal control at the department level is highly dependent upon improvements at the Coast Guard.

ICE began its component corrective action plan process early, during the first quarter of 2006, and was able to close 37 out of 49 weaknesses identified during the 2005 financial statement audit, including the material weakness related to Fund Balance with Treasury. It is also evident that senior financial management leadership within the department are actively engaged in developing an overall financial management strategy, corrective action plans, and in developing systems to monitor overall internal control improvement

efforts. However, the Federal Protective Service (FPS) and ICE encountered problems during the financial management transition.

FPS faced myriad challenges when it transitioned from the General Services Administration (GSA) to the DHS and, specifically, to ICE. Under the Homeland Security Act of 2002, DHS became responsible for protecting the buildings, grounds, and property owned, occupied, or secured by the federal government under the GSA jurisdiction. In addition to GSA facilities, the Act also provides FPS with the authority to protect properties held by DHS components that are not under GSA jurisdiction.

As part of its overall strategy to ensure the physical safety of government employees and visitors, FPS uses contract guards to deter the commission of crime in and around federal buildings. Contract guard services represent the single largest item in the FPS operating budget, with an estimated FY 2006 budget of $487 million. As a result of the Oklahoma City bombing in 1995, the contract guard workforce more than doubled and now numbers around 15,000. FPS has become increasingly reliant on its contract guard force, having less than 1,000 uniformed FPS officers nationwide.

In October 2006, we reported that FPS was not paying invoices for its contract guard services nationwide in a timely manner, resulting in a violation of the Prompt Payment Act. Of the 25,557 invoices paid from October 1, 2004, to November 21, 2005, 88% was not paid within 30 days as required by the Prompt Payment Act. As a result, FPS paid more than $1.2 million in interest to guard companies that are contracted by FPS to protect federal buildings for late payments made during this time period.

A central cause for FPS' inability to pay private guard contractors timely was FPS' transition from the GSA Financial Management System to the ICE Federal Financial Management System on October 1, 2004, and occurred before the system was adapted to meet the unique financial and budgeting requirements associated with FPS' business processes.

The DHS Office of the Under Secretary for Management originally directed that the FPS transition from the GSA Financial Management System to the ICE Financial Management System be completed by October 1, 2003. Following the initial review of the unique financial management requirements needed to support the FPS offsetting collections program, the transition date was extended to October 1, 2004. FPS officials said that, despite attempts to explain FPS business processes and Federal Financial Management System needs to the ICE, problems with adapting the ICE Financial Management Support to FPS needs remained and suggested that the transition to the ICE system be postponed. However, DHS required FPS to transition to ICE system on October 1, 2004, despite concerns about the system's ability to meet FPS needs. ICE financial management staff had assured the staff of the Senate Appropriations Committee, in a briefing on February 17, 2005, that the FPS transition would be completed by March 31, 2005.

However, problems with contractor payments and the transition to ICE Financial Management System continued. In a May 6, 2005, memorandum to the Assistant Secretary for ICE, the Director of FPS outlined what he considered systemic problems and issues with the Financial Management System and reported that problems with contractor payments had, in fact, worsened since the transition. An independent auditor contracted by us to perform an audit of DHS financial statements[1] also concluded that the integration of FPS' accounting processes from GSA to ICE created numerous issues with the integrity of FPS transaction data and represented a material weakness in ICE's internal controls.

FPS Budget and Finance officials in Region 3 and FPS Headquarters officials informed us that inadequate training prior to the transition and the difficulty in using the FFMS also contributed to the invoice payment problems. These officials indicated that the system is difficult to navigate and that errors are time-consuming to correct.

**Performance Audits of Department Corrective Action Plans**

Our two most recent performance audit reports[2] issued in December 2006 and February 2007, assessed the effectiveness of DHS' corrective action plans to address internal control weaknesses. Our objective in conducting these performance audits is to assess the thoroughness and completeness of both the overall corrective action plan process and individual plans developed to address specific weaknesses. The performance audits are intended to provide ongoing feedback to the department as they are developing and implementing corrective action plans.

Our analysis and related recommendations focus on four essential elements of good corrective action plans. These areas are: identification of "root cause" problems, development of critical milestones, accountability for accomplishing corrective actions, and validation that actions taken were effective. We also looked for linkage between critical milestones in the plans with overall goals, and for integration of the corrective action plans process with other related management activities; the most significant of which is implementation of the internal control assessment requirements in OMB Circular A-123, *Management's Responsibility for Internal Control.*

**Audit Report No. 3 - Assessing Corrective Action Plans for 2006 Department Priority Areas**

Our third audit focused on assessing the department's progress in developing specific Corrective Action Plans for five internal control weaknesses it prioritized for improvement in FY 2006. These weaknesses are as follows:

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[1] DHS' *Performance and Accountability Report for Fiscal Year 2006,* November 15, 2006, Department of Homeland Security.

[2] The DHS OIG has issued 4 performance audit reports assessing DHS' CAP process for financial reporting: OIG-06-52, OIG-06-61, OIG-07-13, and OIG-07-27.

- Property, plant, and equipment,
- Operating materials and supplies,
- Undelivered orders, accounts and grants payable, and disbursements,
- Budgetary accounting, and
- Intragovernmental and intradepartmental balances.

These weaknesses are primarily attributable to five entities within the department: the OCFO, Coast Guard, ICE, TSA, and the Office of Grants and Training (G&T).

In our review we focused on the following corrective action plan elements:

- Identification of the underlying root cause(s),
- Development of an effective remediation plan,
- Accountability for establishing and successfully implementing the CAP, and
- Validation of the successful implementation of the CAP.

***Office of the Chief Financial Officer***
Weaknesses related to financial management oversight and financial reporting relate primarily to resource and capability issues within the OCFO. We have reported a need for increased OCFO oversight and financial reporting capabilities since FY 2004. Proper resourcing at the OCFO is critical to improving financial management within the department. The OCFO has developed a corrective action plan for intragovernmental and intradepartmental balances.

Our primary recommendation is that the OCFO perform a thorough root-cause analysis to determine the underlying causes of the material weakness for each element (i.e., intragovernmental and intradepartmental), including a review of financial IT systems, processes, and human resources within the OCFO and at the department's components, and the root causes should be cross-referenced to identified weaknesses. Additionally, the OCFO needs to develop guidance for the components regarding their role in the intragovernmental reconciliation process.

***Coast Guard***
The Coast Guard developed corrective action plans intended to address each of the five material weaknesses. We reported that these plans were general in nature and lacked adequate detail. Underlying root causes were limited to only those previously identified through the financial statement audit. Consequently, the corrective action plans did not include a fully developed and detailed listing of tasks to correct weaknesses, a timeframe for completion, or adequate accountability.

We made specific recommendations related to all key elements of the Coast Guard's plans. Our primary recommendations are for the Coast Guard to improve its corrective action plans by performing a thorough root-cause analysis of weaknesses that includes a review of financial systems, processes, and human resources, and develop a detailed list of tasks and milestones based upon this analysis. We also recommended the Coast Guard make a realistic assessment of the resources required to plan and execute corrective

actions. Further, in filling key financial management vacancies, the Coast Guard should ensure that the position holders have the necessary skills to execute the corrective action plans and seek sustained support for the plan from executive leadership.

***Immigration and Customs Enforcement***

ICE proactively began its corrective action plan process in the first quarter of FY 2006. Consequently, they are further along in developing and executing corrective action plans than the other DHS entities. ICE created a Program Management Office (PMO) to develop and implement a 3-year Financial Action Plan. The PMO reports directly to the ICE CFO and provides program management infrastructure, guidance, and support to staff developing and implementing corrective action plans. Additionally, ICE senior leadership has set a positive tone for financial management improvements and actively monitors progress.

For FY 2006, ICE prioritized implementation of its plans, with a goal of fully remediating its Fund Balance with Treasury material weakness. The 2006 financial statement audit underway will assess the effectiveness of ICE's implementation of its plan. As a result, the corrective action plans intended to address undelivered orders, accounts and grants payable, and disbursements (UDO), budgetary accounting; and intragovernmental and intradepartmental balances were not given the highest priority milestone completion dates through September 30, 2007. As a result, the CAPs were not fully and completely developed.

We made recommendations for ICE to continue to develop corrective action plan tasks associated with these three material weaknesses and include corrective action plan validation procedures to be performed by ICE personnel. Additionally, to improve further their corrective action plans, we recommended that ICE better define the criteria used to determine when a corrective action is complete and integrate the validation process with control testing planned for conducting management's OMB Circular A-123 assessment.

***Transportation Security Administration***

TSA has prepared a corrective action plan to address the undelivered orders (UDOs) material weakness with a timetable for corrective actions, and has assigned specific tasks with due dates to individuals. Management emphasizes the evolutionary nature of the CAP, including its intent to modify or add actions as needed to fully correct the internal control weakness by September 30, 2007. TSA did not evaluate the root cause of the UDOs material weakness within the framework of the electronic program management office (ePMO) system. However TSA believes that the root cause was a result of TSA's system migration from the Department of Transportation to the Coast Guard.

Although TSA prepared a CAP, the issue description and root-cause analysis are not adequate descriptions of the key issues surrounding the UDOs material weakness. The CAP does not address the UDOs FY 2005 audit finding in a manner specific enough to allow for corrective action to take place if the CAP were implemented by TSA.

In order for the CAP to be an effective method of implementing corrective action, specific subtasks should be included to clarify the tasks listed in the ePMO reports. A positive action by TSA is its engagement in monthly reporting dialogues with the OCFO and updates into ePMO. Additionally, TSA provides updates to the TSA Management Control Council, and there is open communication between the process owners and the Office of Financial Management as to the progress and status of CAP milestones.

We made recommendations for TSA to implement milestones in the UDOs CAP that require review of TSA's accounting for UDOs, to determine their accuracy within TSA, and to implement milestones in the UDOs CAP that require the implementation of policies and procedures to annually validate that the methodology used to estimate its grant accrual provides a reasonable estimate of the actual amount owed. Additionally, to improve further their CAPs; we recommended that TSA integrate the validation process with control testing planned for conducting management's OMB Circular A-123 assessment.

***Grants and Training***

G&T developed a CAP with some key performance measures to address the UDO material weakness. However, due to lack of documentation, G&T was unable to substantiate that a comprehensive and thorough root-cause analysis was performed. While the issues cited in the CAP are, in fact, possible root causes, without adequate supporting documentation of the root-cause analysis, we were unable to determine whether management validated the control deficiency condition and if the actual root cause of the material weakness being addressed was properly identified. Additionally, critical milestones for this material weakness are not sufficient enough to provide reasonable assurance that the weakness has been corrected. Though progress can be noted, G&T has not implemented sufficient measures to test and validate key milestones.

Our primary recommendation is that the G&T perform a thorough root-cause analysis to determine the underlying causes of the material weakness, including a review of financial IT systems, processes, and human resources, and the root causes should be cross-referenced to identified weaknesses. Additionally, G&T's CAPs should be prioritized for action, to minimize duplication of effort where corrective actions overlap. Also G&T should not rely on independent auditors to determine all significant causes of control weaknesses. To improve further their corrective action plans; we also recommended that TSA integrate the validation process with control testing planned for conducting management's OMB Circular A-123 assessment.

**Performance Audit Report No. 4 - Assessing Corrective Action Plans for 2006 Department Priority Areas**

Our fourth performance audit focused on assessing the Coast Guard's development of four CAPs:

- Entity-Level Controls,
- Financial Reporting,

- Fund Balance with Treasury, and
- Actuarial Liabilities.

In addition, we performed an assessment of how well contractor support plans aligned with the efforts necessary to resolve the Coast Guard's material weaknesses, and included a review of the Financial Management Transformation Task Force (FMTTF) to assess if milestones had been met as outlined in the Commandant's Intent Action Order #5 (the Order) dated July 3, 2006.

Our assessment of the integrity of the Coast Guard CAPs (as of September 30, 2006) focused on an evaluation of the following CAP elements:

- Identification of the underlying root cause(s),
- Development of an effective remediation plan,
- Accountability for establishing and successfully implementing the CAP, and
- Validation of the successful implementation of the CAP.

The Coast Guard developed CAPs intended to address each of the material weaknesses. For each of the CAPs with respect to root-cause identification, the process included internal workshops and management-level discussions to determine the root causes of the material weakness. However, ongoing root-cause identification continues to reveal weaknesses in the initial root-cause exercise used to develop the CAPs.

The Coast Guard was not able to provided evidence that a formal analysis to include walkthroughs of business processes and related systems was performed to identify all deficiencies or validate known or perceived deficiencies. This type of analysis would be necessary to evaluate the integrity of the completeness of the root-cause identification used to create the CAPs. As a result, it remains difficult to determine whether all conditions of the material weaknesses have been identified and whether the root causes identified are adequate to assist management with developing effective remediation plans.

Coast Guard management did not consider business risks, materiality, or cost versus benefit analysis when developing the remediation plans. The plans included high-level work breakdown structure but not resource estimates for each subtask of the milestones or a formal process for reporting progress against each CAP's milestones. Detailed work breakdown structures below the major milestone level were not available for our review. Critical milestones appear to have been identified for each CAP; however, specific implementation steps or activities have not been assigned to each milestone.

The availability of qualified government resources continues to be a factor for the Coast Guard's inability to develop detailed plans and implement CAP activities.

With respect to all four CAPs, we recommended that the Coast Guard validate the CAP root-cause analysis using contractor support to review the identification of root causes for the CAPs and the analysis prepared to support the development of the remediation plans

according to A-123; update the current work breakdown structures; and develop a risk-based plan for each of the four CAPs to prioritize tasks and assist with aligning resources to high-value tasks. Additionally, CAPs should address alternatives for addressing resource constraints and include a matrix to identify and prevent the duplication of effort and to help ensure that effort is aligned to assist the Coast Guard in addressing specific weaknesses and issues.

***Contractor Support Plans***

The Coast Guard requires human resources to effectively execute and provide oversight for the execution of remediation activities. However, the Coast Guard is constrained by low head count and by the lack of personnel with deep financial management and project management experience and capabilities. As a result, the Coast Guard has issued five contracts to assist with addressing material weaknesses identified in the FY 2005 independent auditors' report. The contracts covered system improvement, project management, internal control policy development and testing, and financial reporting review and Generally Accepted Accounting Practices (GAAP) compliance.

We assessed the performance work statement (PWS) and its relationship to the material weaknesses, reviewed the contract development process, and whether accountability for contract oversight was established.

While the Coast Guard has taken considerable steps to engage contractors to improve financial management and financial reporting business processes, the contracts lack specificity and direction, which increases the risks of wasting resources and failing to achieve desired results. Additionally, the root cause of the financial systems material weaknesses were not specifically addressed during contract development. These conditions support the need for the root-cause analysis and crosswalk discussed earlier, and it remains difficult to determine whether the contracts are properly aligned to address all deficiencies resulting in material weaknesses.

Additionally, the contracts were put into effect prior to delivery of the plan of action and milestones (POA&M) developed by the Financial Management Transformation Task Force (FMTT), and as a result, the contracts may need future modifications to align with the strategic direction of the POA&M.

While the use of contractors helps alleviate the resource constraints, there appears to be an inadequate number of experienced and trained government staff to oversee the work. For example, the oversight of the estimated 150 contractors in the Financial Systems Division is shared among six Coast Guard staff. In addition, the government personnel providing oversight for the contracts do not have the credentials or experience in financial management oversight of complex organizations to direct or evaluate the quality of the work provided by the contractors. Additionally, it is not evident how the Coast Guard will assess the success of these efforts.

We recommended that the Coast Guard define specific expectations for the contracts, considering the root cause of the material weaknesses and notice of finding and

recommendation (NFR), and review the existing PWS. In addition, the Coast Guard needs to coordinate and align contract support plans with the POA&M and consider modifications, if necessary, to align them with necessary remediation efforts. The Coast Guard also needs to ensure that project plans are approved by appropriate Coast Guard personnel and provide adequate government human resources for contract oversight.

***Commandant's Intent Action Order #5 (the Order): Financial Management Transformation and CFO Audit Remediation Plans***

The Commandant issued the Order, which directed the establishment of a team to plan for transformation of the Coast Guard's financial management organization into a model of excellence. Accordingly, in July 2006, the Coast Guard chartered the Financial Management Transformation Task Force with providing short-term win plans and a long(er)-term strategic POA&M to advance the goal of earning sustainable, clean audit opinions.

We evaluated the actions taken in response to the Order and determined that the Financial Management Transformation Task Force was substantially staffed and functioning by July 15, 2006. However, the duration of their assignments was limited and the group was standing down during our performance audit. Although the Coast Guard engaged contractor support, it occurred 1 month later than planned. The short-term win plan was completed by the due date, but initial due dates for items identified in the plan were not realistic and needed to be changed. The status quo analysis and project approach were submitted in a reasonably timely fashion.

Although the POA&M was to be submitted by October 1, 2006, the completion date was revised due to the level of effort needed to complete the task by November 9, 2006. After delivery of the POA&M, the FMTTF will stand down. The POA&M proposes that, in its place, the Financial Management Transformation organization (CG-8T) be charged and tasked with completing the planning, implementing the actions identified in the POA&M, and identifying the actions necessary to achieve and sustain clean audit opinions. Additionally, the Coast Guard Leadership Team/FMTTF briefings were held regularly, and the FMTFF activities and progress were communicated Coast Guard-wide via e-mail.

We recommend that the Coast Guard secure adequate human resources to complete the planning and implement actions identified in the POA&M, as well as identify actions necessary to achieve and sustain clean audit opinions. The Coast Guard should document in writing any changes to directives and include written approval by the appropriate authority, and ensure that the POA&M is integrated with the CAPs.

***2007 Activities***

The Coast Guard has developed the Financial Strategy for Transformation and Audit Readiness (FSTAR), which identifies root causes and planned actions to fix those root causes in each of the 15 initiatives. FSTAR is a 4-year plan with a remediation on specific initiatives each year. Although the FSTAR initiatives contain detailed

milestones to remediate deficiencies, currently the majority of the milestones occur during the fourth quarter of each year. As a result, our office may not be able to complete our independent verification and validation testing to determine whether the deficiency has been corrected due to time constraints associated with completing the financial statement audit in order for the department to meet its accelerated reporting requirement. Although the Coast Guard has identified the milestones that have been already been completed for the FY 2007 initiatives, the FSTAR plan was not issued until March 2007 and has not been subjected to a performance audit.

During FY 2006, the OCFO began the development of the Internal Controls Over Financial Reporting (ICOFR) Playbook. This Playbook outlines the OCFO's short- and long-term strategy and process to resolve material weaknesses and build management assurances. The Playbook has two tracks. The first track focuses on corrective action strategies for material weakness conditions. The second track focuses on building support for the Secretary's ICOFR assurance statement through management-performed testing on areas that were not identified as a material weakness condition by the auditor. The DHS Secretary is expected to approve and sign this Playbook during March 2007.

**Corrective Action Plan Performance Audits**

We are currently working on the Statement of Work to have a contractor conduct four performance audits to assist the department with evaluating and improving bureau and departmental corrective action plans, and assessing the design of ICOFR to develop better corrective action plans. The four planned performance audits follow:

- Assess the status and effectiveness of the department's overall plan,
- Assess the status and effectiveness of the Coast Guard's overall plan,
- Assess the status and effectiveness of ICE's overall plan,
- Report and evaluate the status and effectiveness of the department's overall plan to consolidate its financial systems according to OMB's Financial Management Line of Business Migration Planning Guidance and DHS and NIST System Development guidelines and standards.

We look forward to briefing this Committee on these reviews in the future.

However, these steps alone probably will not be sufficient to turn the corner and reduce the number of material weaknesses for FY 2007. Weaknesses within the OCFO rooted in resources and capabilities continue to exist along with the work of remediation of most other weaknesses. Given these weaknesses and the lack of progress in addressing them, producing a PAR, including consolidated financial statements, on an accelerated schedule remains a considerable challenge. Existing internal control weaknesses at the Coast Guard, OCFO, and TSA remain the primary reasons.

**Conclusion**

We intend to continue taking a proactive and engaged approach to overseeing DHS' financial management improvement efforts through our financial statement audits and performance audits covering DHS' financial systems, corrective action plans, and the implementation of OMB Circular A-123. We look forward to conducting these audits and providing the results to the Secretary and the Congress.

Mr. Chairman, this concludes my prepared remarks. I would be happy to answer any questions that you or the Members might have.

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

Let me begin. I pose this question to both DOE and DHS. After DOE received a disclaimer of opinion in its 2005 financial statements, the Secretary and Deputy Secretary noted that the agency's financial problems were not solely related to the inefficiencies at the CFO level, but rather it resulted from the Department-wide inefficiencies. Would you both agree with that assessment? In other words, would you agree that a system-wide effort is necessary to direct the financial management?

Mr. CAMPBELL. Sir, I think, as I recall, the Secretary said that it was the responsibility of the entire leadership team to participate in the resolution of this significant management challenge that was presented as a result of audited financial statements, and we have been doing that religiously for the last year and a half. This is a subject at the Secretary's leadership meetings every other week in terms of briefing the senior leadership team on our progress.

Part of the reason why this is a broader responsibility than just the CFOs is the resources across the Department of Energy report through the Assistant Secretarial organizations, and therefore there is a line responsibility from the Assistant Secretaries to those field offices and those resources, and, if you will, a dotted line from the CFO to the field CFOs.

I think that the reason we have been as successful in making the progress we have is because everyone has participated in their various roles in our remediation efforts.

Mr. MAHARAY. I don't disagree with a thing Mr. Campbell said, but let me give some background information. When we issued our disclaimer, we indicated that the reporting system the Department used to consolidate information was not sufficient to allow us to state the accounts were properly stated; however, historically the Department has had a strong financial management system, particularly using contractors reporting into the Department's system. Throughout our audit work those accounting system contractor systems reporting into the Department's general ledger system, we have found basically no problems with those.

So it is basically a top level reporting problem that needs to be solved, and I believe the Department is presently doing that.

Mr. NORQUIST. Mr. Chairman, I completely agree that this is not solely at the CFO level. In fact, if you attempt to only address it at that level you won't be successful.

Our experience has been, for example, that ICE, which was very successful last year, Assistant Secretary Julie Myers, the head of the entire organization, took a very active leadership role, supported her CFO, but recognized that to eliminate the weaknesses she needed the participation of all of the different parts.

Likewise, as we put together our corrective action plans, we reached out to have all the components put together. I mean, there are assets in here. It is not simply reporting financial transactions handled by a CFO. There is the value of assets, there is operations, supplies, things that are managed and run by other parts of the Department. It is, after all, the Department's financial statement, not simply the CFO's. So only by reaching out and including that broader organization and getting that strong senior leadership sup-

port can you be successful in this area, so I think you are exactly right on this.

Mr. TAYLOR. Mr. Chairman, I have been on both sides of this. I spent most of my career on the CFO side at different departments and agencies. The places where you are most successful, the leadership is at the top. The CFO cannot succeed in making the changes required to get clean audit opinions, to implement financial systems, without the direct support and very vocal support of senior management, so I totally agree.

Mr. TOWNS. Mr. Norquist, you mentioned the corrective action plan. What does that really entail?

Mr. NORQUIST. The corrective action plan, to begin with an effective corrective action plan you go back to identify what is the root cause. One of the signs of an ineffective corrective action plan is they simply take the specific incident the auditor found and said we are going to fix that. So what we did to build it was we had workshops and we said what is the underlying reason. You know, it is like if you find that someone comes in and says there are bees in your attic and you just kill the 10 bees, you are not going to be surprised that they are back. You have to find the nest. You have to go after the root cause of the problem.

So you go through that, and then you say what do we need to fix. Are there policies that are missing? Do people need to be hired and trained? Does the system not record the data at the right level? In order to be effective, the corrective action plan has to clearly lay out who is going to do what by when, and so you have milestones, you have accountable officials, and then behind it you have a senior leader who expects to know on a regular basis where you stand on that corrective action plan so they can help by holding people accountable.

I think those are the key components. What we have is we have laid out our corrective action plan to address the material weaknesses identified by the auditors, laid out the milestones we intend to follow, as well as the actions we are going to take where they are beyond where the material weaknesses are to be able to satisfy that requirement for management assurance that the controls are effective.

Mr. TOWNS. Thank you very much.

I yield to Mr. Bilbray.

Mr. BILBRAY. Thank you, Mr. Chairman.

Mr. Chairman, I think the one thing we can work together on this issue, and it is huge, but we can agree that this is a problem that has been around a long time. It seems like no matter what the party affiliation of the executive branch, it is a problem that we confront.

Gentlemen, in all fairness, you know, as a former mayor I look at this and pretty well figure people would be going to jail in California with the kind of reports I have seen come down, but then, again, as a mayor I didn't have 500 prima donnas running around Capital Hill worried more about votes than balancing the budget, and we weren't exchanging the executive branch every few years just to keep the system moving.

In all fairness, I think that the challenge really runs a lot deeper than any of us really understand. The Founding Fathers developed

a separate and conflicting process, and now we start understanding more why they didn't want us to have a whole lot of money to shift around. I think it has become obvious.

How long have you guys been with your departments?

Mr. CAMPBELL. I have been with the Department of Energy for 29 years, sir.

Mr. MAHARAY. For 28 years, sir.

Mr. NORQUIST. I was confirmed in June of last year.

Mr. TAYLOR. I have been Deputy IG at DHS for a year and a half. I spent 20 years at FEMA earlier in my career.

Mr. BILBRAY. OK. Well, you are on the borderline. You and Norquist get over. The rest of you are going to line up on the gallows.

Mr. NORQUIST. In that case, I just got there, sir. [Laughter.]

Mr. BILBRAY. The issue really comes down to a little word that you use, and that is accountability. Raising degree of concern, raising the urgency, holding people accountable, that really does matter. I guess it really starts with us here on this subcommittee to get to the committee and take it to Congress. It matters. It damn well matters.

I think that we all agree that we don't want to go around the world setting the rest of the world free and then enslaving our children to a debt. We don't want to ask our children to have to decide between feeding their children or throwing us out into the cold when we are senior citizens.

How do we make the system more accountable, though, under the Civil Service structure that we have? What is the ability at your level or below you, let alone above you, to make people more accountable? Let's just say how do we initiate a sensitivity program to the fact that the budget really does matter and expenditure accountability really is an important thing?

Mr. NORQUIST. I think there are a number of ways——

Mr. BILBRAY. The guy who doesn't have job security yet.

Mr. NORQUIST. A couple of ways. The first is in performance standards. One of the effective things to do is put specific accomplishments in people's performance standards so when their job is up for review, when they are looking at what sort of bonus or whether rewards or compensations, it is specifically addressed. Did they, in fact, accomplish the goals that were laid out for them? I think that is absolutely essential.

The other one is people have to be trained to understand what they are accountable for. In DHS, for example, one of the initiatives we started was a training program for every new hire there in financial management, so whether you are hired by ICE or CVP or the Coast Guard, we had a class this week—it was the first one—where we are going to take all those new hires in DC and we are training them this week, and one of the things we are covering is fiscal law and internal controls. Everyone out there who calls themselves a member of the financial community should recognize a potential Anti-Deficiency Act violation, should recognize a breakdown in controls, internal controls, and should understand it is up to them to stand up and flag it.

Often the types of weaknesses you are after is because somebody who came in who was properly trained looks at a process and says

this doesn't seem to match with what I was trained to do and raises the alarm. That is what we need to make sure. And by training the right folks that we have to look for that, we can increase our ability to enforce the rules and to make sure people are accountable for how they spend taxpayers' money.

Mr. BILBRAY. Does that accountability have the ability to go down through the system? I know the Commandant, we can nail the Commandant of the Coast Guard, but when it comes down to it, how far down can he then make accountability and is everyone down the line basically vulnerable to repercussions? Or is there a threshold we would reach at mid-management that the defense system, basically the Civil Service system, is protecting not just good, hard-working people, but also those that should be held accountable?

Mr. TAYLOR. There is absolutely some of that, but there is the ability, if you have defined the requirements, to hold people accountable at much lower levels, rather than saying the accountability is only at the Commandant level or at the Secretarial level or the CFO level, that you have components and you have managers who need to accept responsibility for their piece of the activity.

I think it goes beyond that, though, sir. I think that management has to recognize that financial management, itself, and managing the fiduciary, taking care of your fiduciary responsibilities is not a CFO function. It is a management function. Every manager who runs every program should be directly responsible and accountable. That is when things start changing.

Mr. BILBRAY. I appreciate that. You guys know where the term decimation came from?

Mr. NORQUIST. No, sir.

Mr. MAHARAY. No, sir.

Mr. BILBRAY. Anybody a history major?

Mr. NORQUIST. Kill off 1 in 10? Is that it?

Mr. BILBRAY. That is it.

Mr. NORQUIST. If they lose a battle?

Mr. BILBRAY. Actually, if they turn it around or if they didn't show bravery, if they did not do their job, 1 in 10 was chosen by lot and then the other 9 beat him to death. I am not proposing that for bureaucracy, but, looking at this debt, it may be one of those things. Rome had to do it to save themselves from the invasion by Hannibal.

We may be wanting to save our grandchildren from the debt. I will just tell you that we really need to have a degree of urgency brought right down to the rank and file troops to understand they have a vested interest in this.

In city government and county government you tend to start laying people off when you reach these kind of reports. We haven't done that at the Federal Government, and maybe that is one of those things we need to talk about is actually a fiscal decimation, 1 in 10 down the line.

Thank you very much. On that bright subject, I will yield back.

Mr. TOWNS. Let me talk about information security then. Last year we saw in the Department of Veteran Affairs where a laptop computer and hard drive containing sensitive data was stolen from an employee's home. Security is also a financial management issue,

because you need to guarantee that your systems are protected against tampering and limit access to financial records. You know, from a financial management perspective, what steps have been taken to advance security, data security?

Mr. MAHARAY. Let me talk from the Department of Energy's standpoint about what the Office of the Inspector General has reported on. We have identified information security as a continuing, reportable condition or weakness at the Department of Energy. We have found problems in terms of passwords being easily guessed, we found problems in terms of patchwork, in terms of security patchworks not being installed, we have found problems in terms of contingent planning and access.

The Department is moving forward, from what we can see, in terms of strengthening its process, but it is a long way. As it implements enhanced controls, people get smarter and smarter on how to thwart those controls, so this is a continuing challenge for the Department of Energy.

Mr. CAMPBELL. I would agree with that.

Mr. NORQUIST. I don't have the percentages, but I will provide them for the record, but our CIO Committee has done a strong job in improving the certification of our systems. We also have regular meetings where I and the CIO for the Department will get together with the components' CFO and CIO and discuss the audit findings, what their corrective actions are. The Under Secretary for Management attends and helps emphasize the importance of resolving this.

One of the points that Mr. Walker raised and I think is correct, as well, here is that we have to be aware of the differences between ourselves and the private sector. Well, the auditors may latch on to the ability of whether or not you have a weakness to somebody affecting your financial statement, no one is going to doctor our financial statements so they can sell our stock short on the market.

That is not why they are going to try and break in. So we shouldn't just fix a weakness with that label on it, because, while that is a symptom of the problem, that is not the underlying root cause and that is not the weakness we are trying to prevent. We are trying to prevent fraud, we are trying to prevent waste, prevent abuse. There are other systems they would want to get to.

So the solution has to address the overall control and the different systems they can get to, not simply the ones the auditor found, so we are making that a priority as we go through these, to make sure we are getting to the root cause and addressing the potential implications of any weakness in addressing those.

I will provide you the percentage for the record, but our CIO has made a strong emphasis on this area and in strengthening system security.

[The information referred to follows:]

Insert for Hearing Record
Subcommittee on Government Management,
Organization, and Procurement
Hearing on Federal Financial Statements
March 20, 2007

Chairman Towns Question to David Norquist

As you may recall at the March 20th hearing with DHS-CFO David Norquist, he was asked by the Chairman for an example of progress in information security. The CFO told him DHS has made progress, particularly in C&A but he wasn't sure of the percentages and would provide for the record.

The answer is:

"When we held our first IT security conference (Fall 2005), certification & accreditation (C&A) completion was approximately 22%. We have since increased C&A completion to 95% (Fall 2006)"

Respectfully,

Jeffrey T. Readinger
Assistant Director
Office of Legislative Affairs
U.S. Department of Homeland Security
Phone: 202-447-5462
Fax: 202-447-5437

Mr. TOWNS. Any additional steps?

Mr. MAHARAY. Additional steps? There is a process in terms of the IT security called C and A, creditation and accountability. This is a systematic process by which you go and you evaluate your IT systems, and we have found deficiencies in the way the Department of Energy has implemented, and I suspect that all agencies need to go through the systematic process to enhance its IT security.

Mr. TOWNS. Any other comments?

Mr. TAYLOR. Yes, Mr. Chairman. At DHS our Inspector General considers information security so seriously that we have an office under the Assistant IG just for IT audits, so we have 35 people. Their only function is to do IT reviews within the Department.

Information technology is a material weakness throughout the Department, not just for financial management, but across the board. We do think that certification and accreditation process at DHS has taken strides forward and we think they are making progress, but to date we think there is a lot of vulnerability within the Department that we need to address.

Mr. CAMPBELL. I would just add that the certification and accreditation process that we have employed in our CFO systems has been strong. We have put in a tremendous amount of work to make sure that those systems are secure, and we have reported to our CIO that we have completed all of that effort as it relates to the CFO systems.

Mr. TOWNS. What steps can be taken by the Department to reduce the amount of interest that the Government pays on delinquent payments?

Mr. CAMPBELL. Let me try first. Actually, our experience there has been pretty good. We are pretty close to what OMB's metric is, which is 98 percent of payments on time. With every metric we have to be careful to make sure that, in achieving the metric, we haven't spent more money to get payments made on time than the benefit of getting payments made on time. That said, I think the answer is more effective systems, more effective approval of invoices by the contracting officers. It is an area where we struggled initially when we implemented our new system, and we have made monumental improvement from that point forward. So I think it is a combination of good systems and a good system of approvals and good coordination back and forth between the contracting organizations and the financial management organizations and program organizations.

Mr. TOWNS. Any other comments?

Mr. NORQUIST. One of the things that is happening during that time window is the contracting officer technical representative is validating, before you make the payment, that the Government did, in fact, get the services that it ordered in order to make sure that we are only paying the contractor what they are entitled to.

So part of making sure you are not late on the payment is having a well-defined process that moves efficiently so that you don't want to end up telling the contracting officer to hurry it up, because their job is to protect the taxpayer. That is an important internal control. You want to give them enough time to do it, but have an efficient enough process that once they are done you can still make

the payment on time. So it is a balance you are trying to strike, and the only way to effectively do that is try and automate or make a more standardized process.

You will see, when an organization goes through change, they will frequently have a problem in this area because they won't want to make a payment necessarily improperly if they can avoid it, and they take more of an interest payment penalty. When they have the process down, you should see that decline, you should see the timeliness of the payments improve and the penalties decline, as well.

Mr. BILBRAY. But don't we have a problem with Homeland Security of not being reimbursed by our own people?

Mr. NORQUIST. There was some challenge. I believe this related to——

Mr. BILBRAY. Security.

Mr. NORQUIST [continuing]. The Federal Protective Service, which works on a reimbursable basis.

Mr. BILBRAY. Yes.

Mr. NORQUIST. So it depends on payments from others. If they don't have the documentation that the other organization has ordered and paid for the service, they can't easily go ahead and make payment. I don't know that they were late on making payments to DHS. I am not familiar with——

Mr. BILBRAY. I heard they were late and that was causing them to be then having to pay interest, and it was all basically within our internal operations, though I know you guys are all separate. But the problem was that Homeland Security wasn't getting paid by the other guys for services provided, and then have to basically hang out, pay interest based on the fact that somebody else wasn't reimbursing them for the services provided.

Mr. NORQUIST. I am not familiar with that, Mr. Chairman. What I do know is that when they changed the business process, trying to make sure you have all the documentation to validate, yes, we reserved the service, yes, this is in accordance with the contract, and yes, the customer has the money, they moved slower than we would like them to. They have improved that.

They have taken steps, for example, centralized the receipt of contractor invoices so all the bills coming in for payment come in to one control place, which makes it much more efficient in paying them, and to handle things electronically rather than moving stacks of paper. So I know ICE is working to make progress and to centralize those things, but the transition was a challenge.

I think one of the things you will find from the testimony is organizations going through changes, reorganizations, new financial systems, run into a challenge, and it is the matter of addressing and implementing corrective actions to fix those that right the ship. But those are always a point of risk, and so you have to be attentive when you have an organization either being transferred or going through a change, to look for these types of problems.

Mr. BILBRAY. I appreciate your effort to save trees.

Mr. TOWNS. Thank you very much.

Let me thank all the witnesses for coming today and sharing with us. We appreciate that.

At this point this subcommittee is adjourned.

[Whereupon, at 4:35 p.m., the subcommittee was adjourned.]

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