

OVERSIGHT OF FEDERAL FINANCIAL MANAGEMENT

HEARING

BEFORE THE
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
ORGANIZATION, AND PROCUREMENT
OF THE
COMMITTEE ON OVERSIGHT
AND GOVERNMENT REFORM
HOUSE OF REPRESENTATIVES
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OVERSIGHT OF FEDERAL FINANCIAL MANAGEMENT

WEDNESDAY, July 8, 2009

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 p.m., in room 2247, Rayburn House Office Building, Hon. Diane E. Watson (chairwoman of the subcommittee) presiding.

Present: Representatives Watson, Cuellar, and Bilbray.

Staff present: Bert Hammond, staff director; Valerie Van Buren, clerk; Adam Bordes and Deborah Mack, professional staff; Adam Fromm, minority chief clerk and Member liaison; Christopher Hixon, minority senior counsel; Jonathan Skladany, minority counsel; and Brien Beattie, minority professional staff member.

Ms. WATSON. The Subcommittee on Government Management, Organization, and Procurement of the Committee on Oversight and Government Reform will now come to order. Today's hearing will review the outcomes of the Government Accountability Office's [GAO's], audit of the Federal Government's consolidated financial statement for the fiscal year 2008.

I am so sorry to announce that we have a vote on the floor and our key witness, Mr. Cuellar, is down voting. I am going to recess for the next 20 minutes. I think we have three votes, so please be patient. Thank you so much for coming. As soon as we finish, we shall return. Thank you so much. We appreciate your attendance.

[Recess.]

Ms. WATSON. We want to come out of our recess. Since we are working against the clock, I am going to go on and make my opening statement while my staff tries to find our first witness. If we don't get the first witness, we will go to the second panel.

I thank you for your patience. I want to welcome you to this afternoon's hearing on the Federal Government's consolidated financial statements for 2008 and the subcommittee's review of Federal agencies' progress to date in modernizing their management systems and internal controls. I welcome our distinguished witnesses and look forward to hearing all of your testimonies.

As you know, we had this hearing scheduled for a previous date. We had to postpone that because of conflicts.

I am pleased to state that some progress has been made since last year and for the second year running, GAO was able to offer unqualified opinions on the 2008 Statement of Social Insurance. In

2008, a total of 21 out of 24 CFO Act agencies received unqualified opinions for an increase of one additional clean audit opinion over last year. This is the highest total reported in the last 6 years. Also, I am happy to share that for the 4th year in a row, all major Federal agencies satisfied the 45 day financial audit deadline as mandated by the stringent reporting guidelines established by the OMB.

Across the Government, the overall number of material weaknesses decreased from 39 to 32, or 18 percent, mostly due to a decline in material weaknesses related to deficiencies in agency financial systems and security. The outstanding material weaknesses are linked to deficiencies in financial management and reporting; financial systems and security; property, plant, and equipment; and budgetary recording. Some of the changes needed to improve these areas are related to the financial preparation process; changes in information technology security; the receipt and the tracking of property, plant, and equipment; and funds control.

The good news is that for the fifth consecutive year, there has been an almost 50 percent decrease in material weaknesses since the year 2001.

However, throughout the Federal Government, agencies continue to demonstrate deficiencies that prevent the GAO from rendering an opinion on the U.S. Government's consolidated financial statement. For the 12th year in a row, GAO was unable to render an opinion on the Federal Government's consolidated financial report statement, mostly due to material weaknesses in financial reporting. This is an area where change must occur without delay.

We recognize that the Federal Government has recently undertaken drastic steps to stabilize the Nation's financial markets and the long term effects of these actions in the midst of a recession are unknown. This is all the more reason why Federal agencies must be more aggressive in streamlining their management systems and operations.

Mr. Dodaro, I will be interested in hearing your comments regarding the status of Federal agencies' efforts to put in place effective management systems and internal controls in this time of limited resources and how Federal agencies can expedite their efforts to address weaknesses related to financial reporting, systems management, and improper payments.

I also look forward to hearing Mr. Gregg's comments regarding the impact of the ongoing recession and last year's action by the Federal Government to stabilize the markets on our Nation's future financial condition.

In addition, we will hear from Ms. Sherry and Mr. Spoehel regarding the changes their agencies are making to improve their protocols related to financial reporting and management systems.

As we review the performance of our Federal agencies today, we will also hear from Congressman Henry Cuellar about the legislation he has sponsored—if we can find him—H.R. 2142: The Government Efficiency, Effectiveness, and Performance Improvement Act of 2009. The intent of Mr. Cuellar's legislation is to build upon the Government Performance and Results Act of 1993 by requiring that every Federal program be assessed at least once every 5 years. The

legislation also requires the Performance Improvement Council and agency improvement officers to comply.

Once again, I would like to thank the panelists for joining us today. We look forward to your testimony.

Ms. WATSON. Members who come in, without objection we will have them put their statements on the record. I will allow the minority member, the ranking member, to make an opening statement. We hope that we get other Members, and if so, they can make a very short statement.

But what I am going to do is call up the second panel. So I am going to ask the second panel to come up. We will start with Mr. Dodaro and then he will be followed. You can sit in the order that you see your name tags.

Now, it is the committee's policy that witnesses be sworn in. I would like the members of the panel to now stand. I will administer the oath. Would you please raise your right hands?

[Witnesses sworn.]

Ms. WATSON. Thank you. Let the record show that the witnesses have answered in the affirmative. You may now be seated.

Mr. Dodaro is the Acting Comptroller General of the United States and the head of the Government Accountability Office, the investigative and auditing agency for the Congress. He has held such positions as Chief Operating Officer and the head of the GAO's Accounting and Information Management Division over the course of his distinguished career with the agency.

I ask that each of the witnesses now give a brief summary of their testimony. Keep this summary under 5 minutes if you can. Your complete written statement will be included in the hearing record.

Let me go on and introduce Mr. Richard L. Gregg who has served at the Department of Treasury with distinction for 36 years. Prior to his retirement, Mr. Gregg was the Commissioner of the Financial Management Service for 9 years. Before that, he served as the Commissioner of the Bureau of the Public Debt for 10 years. Mr. Gregg has also held numerous other management positions at the Treasury Department during his long career.

So let us start now with Mr. Dodaro. Please proceed.

STATEMENTS OF GENE L. DODARO, ACTING COMPTROLLER GENERAL OF THE UNITED STATES; AND RICHARD L. GREGG, ACTING FISCAL ASSISTANT SECRETARY, U.S. DEPARTMENT OF THE TREASURY

STATEMENT OF GENE L. DODARO

Mr. DODARO. Good afternoon, Madam Chairwoman. I appreciate the opportunity to be with you today to discuss GAO's audit of the consolidated financial statements for the Federal Government for fiscal year 2008.

As you pointed out in your opening statement, this year for 2008 like prior years, we were unable to give an opinion on the overall consolidated financial statements on accrual basis largely due to a wide range of serious deficiencies. But two that I would single out, one would be serious and longstanding problems at the Department of Defense, and two is the inability to reconcile transactions that

take place among Federal Government agencies. Those have been problems from the very beginning and remain problems today, although progress is being made.

As you noted in your opening statement, 21 departments and agencies were able to get clean opinions this past year. That is clearly notable progress and we are pleased to see that. That compares to only 6 of the 24 agencies when the CFO Act implementation requirements were made Government-wide back in 1996. So that is clear progress.

The issues that remain, however, are significant. The three that do not have clean audit opinions are three of the largest Federal departments: DOD, the Department of Homeland Security, and NASA. So those agencies need to continue to work on their problems and make progress like the rest of the Federal agencies across the Government.

Now as you mentioned, last year since we prepared our audit on Treasury's financial statements, there have been significant efforts made through the Economic Stabilization Act to create the Troubled Asset Relief Program and also the American Recovery and Reinvestment Act. Both of those programs authorize huge sums of money, in one case \$700 billion and in the case \$787 billion. They bring new financial management challenges to the Federal departments and agencies, so those issues will have to be worked on this year.

But they also bring new requirements to Treasury to finance the Government's operations. If I could direct your attention to the charts, I would like to show the impact that it is having on the Federal Government's financial position. We are going to use the first one, please.

The first one shows debt held by the public and how that has changed, Madam Chairwoman. The debt held by the public in fiscal year 2001 was \$3.3 trillion or about 33 percent of the gross domestic product. By fiscal year 2008, that had jumped to \$5.8 trillion and almost 41 percent of the gross domestic product. That is before some of these huge new initiatives had been approved. Next year's projection is that the debt held by the public will go to \$8.5 trillion or almost 60 percent of the gross domestic product. Also, the current debt ceiling for the Federal Government is \$12.1 trillion. That is likely going to have to be raised again this year to accommodate financing these operations.

The next chart shows what the future could look like. The blue line projection is the CBO's baseline extended which shows that we are headed to historical high levels. The largest debt that we have ever had as a percent of gross domestic product occurred during World War II. At that point it was 109 percent of the gross domestic product. Our projections show that it could reach that level again as early as around 2020, between 2020 and 2025, unless some action is taken.

The last chart I will show gives you some idea of the magnitude of the gap that is occurring. Basically, the Federal Government is on an unsustainable long term fiscal path. This shows right now in 2008 the revenue that is expected to be collected, represented by the line, is not enough to fund the entire Federal Government's activities and so we borrow the rest of the money. That borrowing is

going to go up in 2019 and by 2020, unless some action is taken, we would only have enough money to pay interest on the national debt. That is the blue bar at the bottom. The green bar is Social Security payments to individuals. The red bar is Medicare and Medicaid. We wouldn't even have enough money to pay that. And the orange is all the rest of the Federal Government, including the Department of Defense. So this is a very serious issue.

Clearly, our Government had to move to deal with stabilizing the banking system. Clearly, the Government had to move to deal with the economic downturn, which is very serious. But that same level of intensity needs to be focused on a long term plan to bring the Federal Government's financial situation on a more sustainable long term path.

That concludes my opening statements, Madam Chairwoman. I would be happy to answer questions at the appropriate time.

[The prepared statement of Mr. Dodaro follows.]

GAO

United States Government Accountability Office

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
Wednesday, July 8, 2009

**FISCAL YEAR 2008
U.S. GOVERNMENT
FINANCIAL STATEMENTS**

**Federal Government Faces
New and Continuing
Financial Management and
Fiscal Challenges**

Statement of Gene L. Dodaro
Acting Comptroller General of the United States



July 6, 2009



Highlights of GAO-09-805T, 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 annually audits the consolidated financial statements of the U.S. government (CFS). The Congress and the President need reliable, useful, and timely financial and performance information to make sound decisions and conduct effective oversight of federal government programs and policies.

Except for the 2008 and 2007 Statements of Social Insurance, GAO has been unable to provide assurance on the reliability of the CFS due primarily to inadequate systems and lack of sufficient, reliable evidence to support certain material information in the CFS. Unless these weaknesses are adequately addressed, they will, among other things, (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; and (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.

This testimony presents the results of GAO's audit of the CFS for fiscal year 2008 and discusses federal financial management challenges and the long-term fiscal outlook.

What GAO Recommends

Over the years, GAO has made numerous recommendations directed at improving federal financial management. The federal government has generally taken or plans to take actions to address our recommendations.

View GAO-09-805T or key components. For more information, contact Jeanette M. Franzel at (202) 512-2600 or Susan J. Irving at (202) 512-6806.

FISCAL YEAR 2008 U.S. GOVERNMENT FINANCIAL STATEMENTS

Federal Government Faces New and Continuing Financial Management and Fiscal Challenges

What GAO Found

For the second consecutive year, GAO rendered an unqualified opinion on the Statement of Social Insurance; however, three major impediments continued to prevent GAO from rendering an opinion on the federal government's accrual basis 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. In addition, as of September 30, 2008, the federal government did not maintain effective internal controls over financial reporting and compliance with significant laws and regulations due to numerous material weaknesses. Moreover, financial management system problems continue to hinder federal agency accountability.

The federal government still has a long way to go, but over the years, progress has been made in improving federal financial management. For example, audit results for many federal agencies have improved; federal financial system requirements have been developed; and accounting and reporting standards have continued to evolve to provide greater transparency and accountability over the federal government's operations, financial condition, and fiscal outlook. In addition, the federal government issued a summary financial report which is intended to make the information in the *Financial Report of the U.S. Government* more understandable and accessible to a broader audience.

The federal government's response to the financial markets crisis and economic downturn has created new federal accountability, financial reporting, and debt management challenges. Such challenges will require utmost attention to ensure (1) that sufficient internal controls and transparency are established and maintained for all market stabilization and economic recovery initiatives; (2) that all related financial transactions are reported on time, accurately, and completely; and (3) these initiatives are effectively and efficiently financed. Moreover, while policymakers are currently understandably focused on efforts directed toward market stabilization and economic growth, once stability in financial markets and the economic downturn are addressed, attention will have to be turned with the same level of intensity to the serious longer-term challenges of addressing the federal government's large and growing structural deficits and debt.

Finally, the federal government should consider the need for further revisions to the current federal financial reporting model to recognize its unique needs. A broad reconsideration of issues, such as the kind of information that may be relevant and useful for a sovereign nation, could lead to reporting enhancements that might help provide the Congress and the President with more useful financial information to deliberate and monitor strategies to address the nation's long-term fiscal challenges.

Madam Chairwoman, Ranking Member Bilbray and Other Members of the Subcommittee:

I appreciate the opportunity to be here today to discuss our report on the U.S. government's consolidated financial statements for fiscal years 2008 and 2007. The need for continued progress in improving federal financial management and accountability to the American people is more critical now than ever given the unprecedented actions that the federal government has taken and continues to take to address the economic downturn and restore stability to financial markets. I would like to commend you for continuing the annual tradition of oversight hearings on this important subject. The involvement of your subcommittee is critical to ultimately assuring such progress.

Importantly, the ultimate effect of recent unprecedented actions on the federal government's financial condition are not yet fully known and will not be fully reflected in the U.S. government's consolidated financial statements and *The Budget of the United States Government* until fiscal year 2009 and beyond. However, the breadth and magnitude of such actions will likely have a significant effect. Under the American Recovery and Reinvestment Act of 2009,¹ hundreds of billions of dollars are slated for, among other things, new or additional spending for investments in infrastructure and science, education and training, health programs, investments in energy infrastructure and programs, assistance to unemployed workers, health insurance assistance, health information technology, and state fiscal relief. In addition, under the Housing and Economic Recovery Act of 2008 and the Emergency Economic Stabilization Act of 2008,² additional hundreds of billions of dollars of federal funding will include capital and loans to support and sustain key financial institutions and other businesses, loans to assist certain borrowers in trouble on their mortgages, and insurance for certain securitized loans. The federal government's response to the current economic downturn and financial crisis has created additional accountability, financial reporting, and debt management challenges.

While there are new and many existing challenges to federal accountability and reporting, we also cite in our reports improvements made over the past decade. With this backdrop, our testimony today

¹Pub. L. No. 111-5 (Feb. 17, 2009).

²Pub. L. No. 110-289 (July 30, 2008) and Pub. L. No. 110-343 (Oct. 3, 2008), respectively.

discusses (1) the major issues relating to the consolidated financial statements for fiscal years 2008 and 2007, including the significant remaining impediments to an opinion on the consolidated financial statements; (2) financial management systems problems that continue to hinder federal agency accountability; (3) new federal accountability, financial reporting, and debt management challenges created by the federal government's fiscal response to the financial crisis and economic downturn; (4) challenges posed by the federal government's current long-term fiscal outlook; and (5) the need for an improved federal financial reporting model.

Both the consolidated financial statements and our related audit report are included in the fiscal year 2008 *Financial Report of the United States Government (Financial Report)*.³ Our audit report would not be possible without the commitment and professionalism of Inspectors General throughout the federal government who are responsible for annually auditing the financial statements of individual federal agencies. The *Financial Report* was issued by the Department of the Treasury (Treasury) on December 15, 2008.⁴ At that time, Treasury and the Office of Management and Budget (OMB) in coordination with GAO also issued, for the second year, a summary financial report, entitled *The Federal Government's Financial Health: A Citizen's Guide to the 2008 Financial Report of the United States Government*. This guide, which is included in the printed *Financial Report*, as well as printed separately, is intended to make the information in the *Financial Report* more understandable and more accessible to a broader audience. Both of these reports are available through GAO's Internet site, at <http://www.gao.gov/financial/fy2008financialreport.html> and Treasury's Internet site, at <http://www.fms.treas.gov/fr/index.html>.

³Our audit work on the U.S. government's consolidated financial statements was conducted in accordance with U.S. generally accepted government auditing standards.

⁴Also, see GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-05-958SP (Washington, D.C.: September 2005), which was prepared to help those who seek to obtain a better understanding of the *Financial Report*.

Summary

Certain material weaknesses⁵ in financial reporting and other limitations on the scope of our work resulted in conditions that for the 12th consecutive year prevented us from providing the Congress and the American people an opinion on the federal government's financial statements other than the 2008 and 2007 Statements of Social Insurance.⁶ However, since the enactment of key financial management reforms in the 1990s, the federal government has made significant progress in improving financial management activities and practices. As shown in appendix I, 21 of 24 Chief Financial Officers (CFO) Act agencies were able to attain unqualified audit opinions on their fiscal year 2008 financial statements.⁷ In contrast, only 6 CFO Act agencies received unqualified audit opinions for fiscal year 1996. In addition, federal financial systems requirements have been developed. Also, accounting and financial reporting standards have continued to evolve to provide greater transparency and accountability over the federal government's operations, financial condition, and fiscal outlook. Further, fiscal year 2008 marked the third year in which the Statement of Social Insurance has been provided as a basic financial statement.⁸ The Statement of Social Insurance displays the present value⁹ of projected revenues and expenditures for scheduled

⁵A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

⁶The consolidated financial statements other than the Statement of Social Insurance are referred to as the accrual basis consolidated financial statements. Most revenues reported in these financial statements are recorded on a modified cash basis.

⁷The 21 agencies include the Department of State. As of the date of our audit report, the auditors had disclaimed an opinion on the Department of State's fiscal year 2008 financial statements; however, because the department subsequently provided the auditors with sufficient evidential material to support the amounts reported on its financial statements, the auditors issued a second report, replacing the first, with an unqualified opinion of the Department of State's fiscal year 2008 financial statements.

⁸We disclaimed an opinion on the fiscal year 2006 consolidated financial statements, including the Statement of Social Insurance. Social insurance programs included in the Statement of Social Insurance are Social Security, Medicare, Railroad Retirement, and Black Lung.

⁹Present 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.

benefits of certain benefit programs that are referred to as social insurance (e.g., Social Security, Medicare). Importantly, we were able to render unqualified opinions on the 2008 and 2007 Statements of Social Insurance.

The federal government, however, still has a long way to go to address several principal challenges to fully achieving an exemplary level of federal financial management.¹⁰ For example, three major impediments continue to prevent GAO from rendering an opinion on the federal government's accrual basis consolidated financial statements: (1) serious financial management problems at the Department of Defense (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. Further, in our opinion, the federal government did not maintain effective internal controls over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2008, due to numerous material weaknesses. Moreover, financial management system problems continue to hinder federal agency accountability.

The problems and challenges identified by our audit need to be viewed in conjunction with new challenges that have emerged from more recent developments. Of particular importance is the fact that as of June 26, 2009, federal debt held by the public as reported by Treasury was over \$1 trillion greater than what it had reported as of the end of fiscal year 2008. The increase in federal debt held by the public, which resulted largely from the federal government's fiscal response to the crisis in our financial markets and the economic downturn, create new federal accountability, financial reporting, and debt management challenges. While we acknowledge that the new President, the new Congress, and the American people have been understandably focused on addressing current problems with financial markets and responding to the economic downturn, and the increased borrowing such efforts entail, the nation's long-term fiscal challenge must be addressed. As we reported in our March 2009 fiscal outlook update,¹¹ our projections continue to show escalating and persistent debt that

¹⁰GAO, *Critical Accountability and Fiscal Stewardship Challenges Facing Our Nation*, GAO-07-542T (Washington, D.C.: Mar. 1, 2007).

¹¹GAO, *The Nation's Long-Term Fiscal Outlook: March 2009 Update*, GAO-09-405SP (Washington, D.C.: March 2009).

illustrates the long-term fiscal path is unsustainable. We believe that the nation will need to apply the same level of intensity to this long-term fiscal challenge as is being directed to addressing the economic downturn and the current problems with financial markets.

Given the federal government's current financial condition and the nation's longer-term fiscal challenges, the need for the Congress and federal policymakers and management to have reliable, useful, and timely 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. Information included in the *Financial Report*, such as the Statement of Social Insurance along with long-term fiscal simulations and fiscal sustainability reporting, can help increase understanding of the federal government's long-term fiscal outlook.

Highlights of Major Issues Related to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2008 and 2007

As has been the case for the previous 11 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 accrual basis consolidated financial statements. The underlying material weaknesses in internal control, as summarized on the following page, which generally have existed for years,¹² contributed to our disclaimer of opinion on the U.S. government's accrual basis consolidated financial statements for the fiscal years ended 2008 and 2007.¹³

¹²We 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 2006 and on the accrual basis consolidated financial statements of the U.S. government for fiscal year 2007.

¹³A more detailed description of the material weaknesses that contributed to our disclaimer of opinion, including the primary effects of these material weaknesses on the accrual basis consolidated financial statements and on the management of federal government operations, can be found on pages 178 through 184 of the *Financial Report*.

In summary, the material weaknesses that contributed to our disclaimer of opinion on the accrual basis consolidated financial statements were the federal government's inability to:

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by the DOD, were properly reported in the accrual basis 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 accrual basis consolidated financial statements were (1) consistent with the underlying audited agency financial statements, (2) properly balanced, and (3) in conformity with generally accepted accounting principles (GAAP); and
- identify and either resolve or explain material differences that exist between certain components of the budget deficit reported in Treasury's records, which are 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 accrual basis consolidated financial statements that have not been identified.

In addition to the material weaknesses that contributed to our disclaimer of opinion, which are discussed above, we found three other material weaknesses in internal control as of September 30, 2008.¹⁴ These other material weaknesses were the federal government's inability to:

- determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken to cost-effectively reduce improper payments,
- identify and resolve information security control weaknesses and manage information security risks on an ongoing basis, and
- effectively manage its tax collection activities.

¹⁴A more detailed discussion of these weaknesses, including the primary effects of the material weaknesses on the accrual basis consolidated financial statements and on the management of federal government operations, can be found on pages 185 through 187 of the *Financial Report*.

Further, our audit report discusses certain significant deficiencies in internal control at the governmentwide level.¹⁶ These significant deficiencies involve the following areas:

- implementing effective credit reform estimation and related financial reporting processes for loans receivable and loan guarantee liabilities at certain federal credit agencies, and
- preparing the Statement of Social Insurance for certain programs.

Individual federal agency financial statement audit reports identify additional control deficiencies, which were reported by agency auditors as either material weaknesses or significant deficiencies at the individual agency level. We do not consider these additional control deficiencies to represent material weaknesses or significant deficiencies at the governmentwide level. Also, due to the issues noted throughout our audit report, additional material weaknesses and significant deficiencies may exist that were not identified and reported.

Addressing Major Impediments to an Opinion on the Accrual Basis Consolidated Financial Statements

Three major impediments to our ability to render an opinion on the U.S. government's accrual basis 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, Treasury officials, and OMB officials will be needed to resolve these serious obstacles to achieving an opinion on the U.S. government's accrual basis 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. Reported weaknesses in DOD's business operations, including financial management, adversely affect the reliability of financial data, and the economy, efficiency, and effectiveness of its operations, and prevent DOD from producing auditable financial statements.

¹⁶See page 188 of the *Financial Report* for more details on these significant deficiencies.

DOD continues to dominate GAO's list of high-risk programs designated as vulnerable to waste, fraud, abuse, and mismanagement, bearing responsibility, in whole or in part, for 15 of 30 high-risk areas.¹⁶ Eight of these areas are specific to DOD and include DOD's overall approach to business transformation, as well as business systems modernization and financial management.

The National Defense Authorization Act (NDAA) for Fiscal Year 2008,¹⁷ codified Chief Management Officer (CMO) responsibilities at a high level in the department—assigning them to the Deputy Secretary of Defense—and establishing a full-time Deputy CMO (DCMO) and designating CMO responsibilities within the military services. While both of these positions are now in place at DOD, the CMO is not a separate, full-time position, and the DCMO, although full-time, does not have decision-making authority.

Importantly, DOD has taken steps toward developing and implementing a framework for addressing the department's long-standing financial management weaknesses with the goals of enabling the department to (a) provide timely, reliable, and accurate financial management information to decisionmakers; (b) sustain improvements; and (c) achieve financial statement auditability. Specifically, this framework, which is discussed in both the department's Enterprise Transition Plan (ETP)¹⁸ and the Financial Improvement and Audit Readiness (FIAR) Plan,¹⁹ includes the department's Standard Financial Information Structure (SFIS) and Business Enterprise Information System (BEIS). DOD intends this framework to define and put into practice a standard DOD-wide financial management data structure as well as enterprise-level capabilities to facilitate reporting and comparison of financial data across the department. DOD's most recent FIAR plan update indicates that it has

¹⁶GAO, *High-Risk Series: An Update*, GAO-09-271 (Washington, D.C.: January 2009).

¹⁷Pub. L. No. 110-181, Div. A, title IX § 904 (Jan. 28, 2008).

¹⁸The ETP is intended to describe how DOD will transition from its current or "as is" operational environment to its intended or "to be" operational capabilities. The Business Transformation Agency is the DOD agency responsible for DOD's business transformation and the development and implementation of the ETP.

¹⁹DOD's FIAR Plan, initially issued in December 2005 and updated twice annually, is intended to provide DOD components with a framework for resolving problems affecting the accuracy, reliability, and timeliness of financial information and obtaining clean financial statement audit opinions.

implemented SFIS in legacy accounting systems for several components, including the Air Force and Marine Corps.

We recently analyzed DOD's FIAR Plan, and found the plan does not yet provide the department or its components with clear, consistent, and specific guidance for implementing, measuring, and sustaining corrective actions, and for reporting incremental progress. Our report made several recommendations designed to increase the FIAR Plan's effectiveness as a strategic and management tool for guiding, monitoring, and reporting on financial management improvement efforts and increasing the likelihood of meeting the department's goal of financial statement auditability.²⁰ DOD management concurred with our recommendations and has begun initiatives to address our concerns.

While further improvement is needed, DOD's recent FIAR plans indicate many continuing efforts to achieve financial statement auditability, as well as new initiatives, including the following:

- Focusing on improvements in end-to-end business processes, or segments,²¹ that underlie the amounts reported on the financial statements.
- Updating auditability assertion criteria to require that only personnel with sufficient objectivity assess the readiness of a segment for audit.
- Ensuring sustainability of corrective actions and auditability by fully implementing the requirements of OMB Circular No. A-123, Appendix A, which requires an annual assessment and statement of assurance regarding the continued effectiveness of internal control over financial reporting.
- Forming working groups to address issues in areas such as real property cost management and imputed cost, and Fund Balance with Treasury.
- Implementing the Defense Agencies Initiative, with the goal of achieving an auditable standardized system for smaller other defense organizations.

²⁰GAO, *Financial Management: Achieving Financial Statement Auditability in the Department of Defense*, GAO-09-373 (Washington, D.C.: May 6, 2009).

²¹DOD defines a segment as a component of an entity's business and financial environment. A segment can include (1) complete or partial business processes; (2) financial systems, business systems, or both; or (3) commands or installations. According to DOD, the environment's complexity, materiality, and timing of corrective actions are all factors that are taken into consideration when defining a segment.

A recent notable success for the department was the U.S. Army Corps of Engineers (USACE), Civil Works' ability to achieve an unqualified audit opinion for fiscal year 2008. This accomplishment was the result of a sustained commitment on the part of management to improve USACE's business systems, processes, and controls. In contrast to this success, however, other DOD components' recent assertions of audit readiness have failed to withstand auditor scrutiny.

We are encouraged by DOD's efforts and will continue to monitor DOD's efforts to transform its business operations and address its financial management challenges. In the near future, we plan to review DOD's:

- process and controls over budgetary execution and accounting;
- component enterprise resource planning efforts for adherence to budget and schedule and the identification of common issues among these efforts that have impeded successful implementation;
- integration of strategic plans within the department that are intended to address, monitor, and report progress and status of financial management weaknesses;
- component design and implementation of financial improvement plans; and
- component corrective plans and actions designed to bring financial reporting segments to audit readiness.

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. 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. GAO has identified and reported on numerous intragovernmental activities and balances issues and has made several recommendations to Treasury and OMB to address those issues. Treasury and OMB have generally taken or plan to take actions to address these recommendations.

A substantial number of the agencies did not adequately perform the required reconciliations for fiscal years 2008 and 2007. For these fiscal years, based on trading partner information provided to Treasury through agencies' closing packages, 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. Based on our analysis of the "Material Difference Reports" for fiscal year 2008, 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 2008 and 2007, amounts reported by federal agency trading partners for certain intragovernmental accounts were not in agreement by significant amounts. In addition, there are hundreds of billions of dollars of unreconciled differences between the General Fund and federal agencies related to appropriation and other intragovernmental transactions. The ability to reconcile such transactions is hampered because only some of the General Fund is reported in the Department of the Treasury's financial statements. As a result of the above, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual basis consolidated financial statements is significantly impaired.

In 2006, OMB issued Memorandum No. M-07-03, *Business Rules for Intragovernmental Transactions* (Nov. 13, 2006), and Treasury issued the Treasury Financial Manual Bulletin No. 2007-03, *Intragovernmental Business Rules* (Nov. 15, 2006). This guidance added criteria for resolving intragovernmental disputes and major differences between trading partners for certain intragovernmental transactions and called for the establishment of an Intragovernmental Dispute Resolution Committee. OMB is currently working with the Chief Financial Officers Council to create the Intragovernmental Dispute Resolution Committee.²² OMB is also using a "Watch List" that lists federal agencies with large intragovernmental imbalances. The Watch List was developed to facilitate reductions in some of the largest intragovernmental imbalances, bring federal agency reporting into alignment with the Intragovernmental Business Rules, bring the appropriate representatives together from the respective agencies, and document the issues and resolutions.

Treasury is also taking steps to help resolve material differences in intragovernmental activity and balances. For example, Treasury is requiring federal agencies to provide documentation on how and when the agencies are resolving certain of their unresolved material differences.

²²The U.S. Chief Financial Officers 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.

Preparing the Consolidated
Financial Statements

Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong commitment by federal agency leadership to fully implement the required business rules and continued strong leadership by OMB and Treasury.

While further progress was demonstrated in fiscal year 2008, 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, properly balanced, and in conformity with U.S. GAAP.²³ Treasury's process for compiling the consolidated financial statements demonstrated 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 also consistent with federal agencies' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process did not ensure that the information in the remaining three principal financial statements was fully consistent with the underlying information in federal agencies' audited financial statements and other financial data. During fiscal year 2008, Treasury, in coordination with OMB, continued implementing corrective action plans and made progress in addressing certain internal control deficiencies we have previously reported regarding the process for preparing the consolidated financial statements. Resolving some of these internal control deficiencies will be a difficult challenge and will require a strong commitment from Treasury and OMB as they continue to implement their corrective action plans.

Federal Agencies'
Financial
Management Systems

Under the Federal Financial Management Improvement Act of 1996 (FFMIA), as a part of the CFO Act agencies' financial statement audits, auditors are required to report whether agencies' financial management systems comply substantially with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3)

²³Most of the issues regarding the preparation of the consolidated financial statements that we identified in fiscal year 2008 existed in fiscal year 2007, and many have existed for a number of years. In April 2009, we reported the issues we identified to Treasury and OMB and provided new recommendations for corrective action and discussed the status of certain previously issued recommendations in GAO, *Financial Audit: Material Weaknesses in Internal Control Continue to Impact Preparation of the Consolidated Financial Statements of the U.S. Government*, GAO-09-387 (Washington, D.C.: Apr. 21, 2009). Treasury and OMB have generally taken or plan to take actions to address the recommendations we have made in this area.

the *U.S. Government Standard General Ledger* (SGL) at the transaction level.²⁴ These factors, if implemented successfully, help provide a solid foundation for improving accountability over federal government operations and routinely producing sound cost and operating performance information. Over a decade has passed since FFMIA was enacted and the majority of agencies still do not have reliable, useful, and timely financial information with which to make informed decisions and ensure accountability on an ongoing basis. In fiscal year 2008, auditors reported 14 out of 24 CFO Act agencies' financial management systems were not in substantial compliance with one or more of the three FFMIA requirements and the lack of compliance with federal financial management systems requirements was the most frequently cited deficiency of the three FFMIA requirements.

In addition, on January 9, 2009, OMB issued a revised Circular No. A-127, *Financial Management Systems*, which redefines federal financial management systems requirements. We are concerned that the revised circular substantially reduces the scope and rigor of compliance testing for agency financial management systems, omits compliance with the SGL from the compliance indicators, and eliminates existing federal financial management systems requirements for the financial portion of mixed systems. Without independent auditor assessments of the financial portion of mixed systems' capabilities and compliance with these requirements, the Congress and agency management cannot be assured that data in these systems and not included in agency financial statements are reliable, resulting in increased risk of making operating, budget, and policy decisions based on faulty data reported in the financial portion of mixed systems—such as benefit payment, logistics, and acquisition systems—which are the source of data for the core financial system. Because of the importance of such data to routinely providing reliable, useful, and timely financial information for managing day-to-day operations, we believe it is important to retain financial management systems requirements for the financial portion of mixed systems and require auditors to assess compliance against such requirements. Further, the revised circular raised additional concerns because it does not definitively establish

²⁴FFMIA defines financial management systems as the financial systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions. The term mixed system means an information system that supports both financial and nonfinancial functions of the federal government or components thereof.

responsibilities for the agency, service provider, and auditor for assessing compliance with FFMA when utilizing a shared service provider under OMB's financial management line of business (line of business) initiative.

To reduce the cost and improve the outcome of federal financial management systems implementations, OMB continues to move forward on the line of business initiative, by leveraging common standards and shared solutions. OMB anticipates that the line of business initiative will help achieve the goals of improving the cost, quality, and performance of financial management operations. As we reported in May 2009,²⁵ although OMB has made progress in implementing the line of business initiative, the initiative focuses mainly on core financial systems and extensive work remains before the goals of the initiative are achieved.²⁶ For example, as we previously recommended in 2006, OMB has yet to finalize a financial management system concept of operations, which provides the foundation to guide line of business-related activities.²⁷ In addition, development of a migration timeline reflecting agencies' commitment for migrating to shared service providers has not yet been completed. Consistent and effective implementation of FFMA will be needed to improve the capability of agencies' financial management systems to produce reliable, useful, and timely information for management to efficiently and effectively manage the day-to-day operations of the federal government and ultimately provide accountability to taxpayers and the Congress—a key goal of the CFO Act and FFMA.

²⁵GAO, *Financial Management Systems: OMB's Financial Management Line of Business Initiative Continues, but Future Success Remains Uncertain*, GAO-09-328 (Washington, D.C.: May 7, 2009).

²⁶According to OMB, the goals of the line of business initiative are to (1) provide timely and accurate data for decision making; (2) facilitate stronger internal controls that ensure integrity in accounting and other stewardship activities; (3) reduce costs by providing a competitive alternative for agencies to acquire, develop, implement, and operate financial management systems through shared service solutions; (4) standardize systems, business processes, and data elements; and (5) provide for seamless data exchange between and among federal agencies by implementing a common language and structure for financial information and system interfaces.

²⁷GAO, *Financial Management Systems: Additional Efforts Needed to Address Key Causes of Modernization Failures*, GAO-06-184 (Washington, D.C.: Mar. 15, 2006).

Federal Actions Create New Challenges

The Emergency Economic Stabilization Act of 2009 (EESA), which authorized the Troubled Asset Relief Program (TARP); the Housing and Economic Recovery Act of 2008 (HERA); and the American Recovery and Reinvestment Act of 2009 (Recovery Act), enabled the federal government to take certain unprecedented actions involving hundreds of billions of dollars to stabilize the financial markets and promote economic recovery.²⁸ The nature and magnitude of these actions have created new challenges for federal accountability, financial reporting, and debt management. Such challenges will require utmost attention to ensure (1) that sufficient internal controls and transparency are established and maintained for all stabilization and recovery initiatives; (2) that all related financial transactions are reported on time, accurately, and completely; and (3) these initiatives are effectively and efficiently financed.

Federal Accountability and Financial Reporting Challenges

According to data provided by Treasury, as of June 26, 2009, the federal government had disbursed about \$339 billion of the approximate \$700 billion limit on TARP funds for a number of initiatives, which included among other things, preferred stock purchases of certain financial institutions, loans to automotive companies, and funding to certain financial institutions to facilitate home loan modifications.²⁹ Under HERA, the federal government placed the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) into conservatorship. As of July 2, 2009, the Federal Housing Finance Agency had reported that the federal government had provided about \$85 billion of capital to the entities through the first quarter of calendar year 2009 under senior preferred stock purchase agreements.³⁰ In addition,

²⁸Other legislation to address the financial markets crisis or the economic downturn include the Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22 (May 20, 2009), and the Economic Stimulus Act of 2008, Pub. L. No. 110-185 (Feb. 13, 2008).

²⁹According to data provided by Treasury, as of June 26, 2009, numerous financial institutions participating in the TARP Capital Purchase Program (CPP) had repurchased their preferred stock from Treasury for a total of about \$70 billion. CPP preferred stock repurchases by financial institutions are deposited into the General Fund of the U.S. Treasury that is used to repay the debt that was issued to fund Treasury's original purchases. The proceeds received from the repurchases reduce the outstanding balance under the almost \$700 billion TARP limit. Treasury then may issue new debt to purchase new financial instruments if it so chooses.

³⁰The \$85 billion excludes \$1 billion in liquidation preference on the senior preferred stock position obtained by Treasury from each entity upon initiation of the Senior Preferred Stock Purchase Agreement. The initial \$1 billion is not a draw on the Treasury's commitment under the agreement.

according to Treasury, the federal government held about \$146 billion of the entities' mortgage-backed securities as of May 31, 2009.³¹

Regarding TARP, we have reported on actions needed and the status of efforts to address transparency and accountability issues, and have made related recommendations to help ensure these issues are adequately addressed. In our most recent report on TARP, we acknowledged Treasury's efforts to continue to improve the integrity, accountability, and transparency of TARP transactions; however, we concluded that some areas require ongoing attention.³² Among the challenges is the need to properly measure and report each related purchase and loan transaction. The challenges of estimating and managing costs and measuring and reporting asset and liability values under TARP and other recent initiatives are likely to be even greater than those associated with more traditional federal lending activities given the fact that little, if any, historical information is available for certain transactions from which to base expected future cash flows. While contractual provisions may set forth required payments for certain transactions such as preferred stock purchases and debt obligations, for a substantial number of federal transactions under TARP and HERA there is a significant amount of uncertainty regarding the extent to which actual repayments to the federal government will be made. There is simply little or no history for certain of these large and unprecedented transactions. Moreover, the instability and dramatic changes in financial markets, such as occurred within the last year, make it very difficult to estimate the values of these assets and liabilities with any level of certainty. Therefore, it is critically important for adequate internal controls to be in place to help ensure that the cost of all TARP and other loans and loan guarantees are properly measured and reported and losses to the federal government minimized.

Regarding Recovery Act programs, major accountability and reporting challenges stem from the fact that nearly half of the approximate \$580 billion of additional federal spending associated with the Recovery Act will flow to nonfederal entities. In our April 2009 report on the Recovery Act, we reported that certain states and the District of Columbia are taking various approaches to ensure that internal controls exist to manage risk

³¹HERA (Pub. L. No. 110-289) authorizes Treasury to purchase, for a limited amount of time, any amount of Fannie Mae or Freddie Mac securities, whether debt or equity.

³²GAO, *Troubled Asset Relief Program: June 2009 Status of Efforts to Address Transparency and Accountability Issues*, GAO-09-658 (Washington, D.C. June 17, 2009).

including assessing known risks associated with spending under the Recovery Act and developing plans to address those risks.³³ However, officials in most of the states we reviewed and the District of Columbia expressed concerns about the lack of Recovery Act funding provided for accountability and oversight. Such concerns are important given that the Recovery Act includes many programs that are new or new to the recipient and, even for existing programs, the sudden increase in funds is outside of normal cycles and processes. Given that the majority of Recovery Act funding was initially projected to be made available to states and localities in 2009, 2010, and 2011, with lesser amounts available beyond that, actions taken now would significantly improve the ability of nonfederal entities to provide effective accountability over federal funding under the Recovery Act. We made several recommendations to OMB in April 2009 to help improve accountability and oversight of Recovery Act spending, including modifying the single audit process to be a more timely and effective audit and oversight tool for the Recovery Act. We are also issuing our July 2009 report on the Recovery Act today.³⁴ Going forward, it will be important for qualified personnel at all levels of government to implement proper controls and accountability measures to help ensure separate tracking and clear reporting of this spending from the federal level to the nonfederal recipients.

Over \$200 billion of the Recovery Act stimulus effort takes the form of tax expenditures—reductions in tax liabilities that result from preferential tax provisions such as tax exclusions, credits, and deductions. GAO has long been concerned that tax expenditures represent a substantial federal commitment yet lack the level of transparency and accountability associated with federal outlays.³⁵ As we move forward, the federal government needs to ensure that adequate information is obtained and analyzed about these provisions to inform judgments about the success of the entire stimulus package.

³³GAO, *Recovery Act: As Initial Implementation Unfolds in States and Localities, Continued Attention to Accountability Issues Is Essential*, GAO-09-580 (Washington, D.C.: Apr. 23, 2009).

³⁴GAO, *Recovery Act: States' and Localities' Current and Planned Uses of Funds While Facing Fiscal Stresses*, GAO-09-829 (Washington, D.C.: July 8, 2009).

³⁵GAO, *American Recovery and Reinvestment Act: GAO's Role in Helping to Ensure Accountability and Transparency*, GAO-09-453T (Washington, D.C.: Mar. 5, 2009).

Federal Debt and Long-Term Fiscal Challenges

The nature and magnitude of the aforementioned actions to stabilize the financial markets and promote economic recovery have also created debt management challenges. As this Subcommittee knows, the Congress has assigned to Treasury the primary responsibility to borrow funds needed to finance any gap between cash in and cash out subject to a statutory limit. Since the onset of the current recession in December 2007, the gap between revenues and outlays has grown—even before any policy response. Because Treasury must borrow the funds disbursed, actions taken to stabilize financial markets—including aid to the auto industry— increase borrowing and so add to the federal debt. In addition, the revenue decreases and spending increases enacted in the Recovery Act also add to borrowing. Further, all of this takes place in the context of the longer-term fiscal outlook, which will present Treasury with continued management challenges even after the return of financial stability and economic growth.

The federal government faced large and growing structural deficits—and hence rising debt—even before the instability in financial markets and the economic downturn. The current debt limit, which has been raised 8 times since 2001, is at \$12.1 trillion. As you can see from table 1 below, it likely will have to be raised again this year.

Table 1: Debt Held by the Public and Debt Subject to the Limit

	Actual Fiscal Year 2001 (as of 9/30/01)	Actual Fiscal Year 2005 (as of 9/30/05)	Actual Fiscal Year 2008 (as of 9/30/08)	Projected Fiscal Year 2009 (President's FY 2010 Budget)
Debt held by the public (trillions of dollars)	\$3.3	\$4.6	\$5.8	\$8.5
Debt held by the public (percent of GDP)	33.0%	37.5%	40.8%	59.9%
Debt subject to the limit (trillions of dollars)	\$5.7	\$7.9	\$10.0	\$12.8

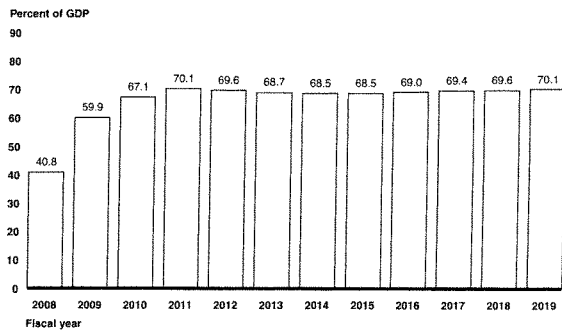
Source: Treasury and OMB.

Note: The current debt limit is \$12.1 trillion.

These immediate challenges, however, have eliminated the window for planning before the impending further ramp up in debt. As shown in figure 1, the President's budget projects debt held by the public growing

from 40.8 percent of gross domestic product (GDP) in fiscal year 2008 to 60 percent by the end of fiscal year 2009 and 67 percent by the end of fiscal year 2010.

Figure 1: Debt Held by the Public Under the President's Fiscal Year 2010 Budget

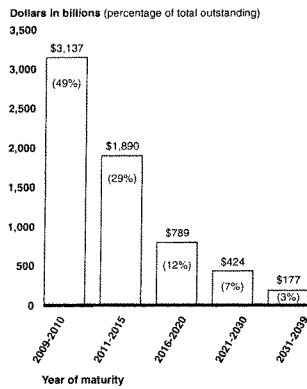


Source: OMB.
 Note: The data are from *Budget of the United States Government, Fiscal Year 2010: Updated Summary Tables, May 2009*.

The near-term debt management challenge can be seen through several measures. At the end of May 2009, Treasury's outstanding marketable securities stood at \$6,454 billion—an increase of \$657 billion since December 31, 2008, and an increase of \$1,918 billion since December 2007.³⁶ Interest rates have dropped dramatically since the start of the financial crisis, particularly for short-term debt. Although these relatively low interest rates have reduced Treasury's borrowing costs to date, the amount of debt that must be rolled over in the short-term presents challenges. As shown in figure 2, as of May 31, 2009, approximately \$3,137 billion will mature in 2009 and 2010 and will have to be refinanced; this is 49 percent of the total outstanding marketable securities. Another 29 percent matures in 2011 through 2015. If the economy improves, Treasury may have to refinance significant amounts of debt at higher rates.

³⁶Marketable securities, which comprise the vast majority of debt held by the public, consist of Treasury bills, notes, bonds, and Treasury inflation-protected securities.

Figure 2: Marketable Securities by Year of Maturity, as of May 31, 2009 (Total Outstanding—\$6,454 billion)



Source: GAO analysis of Treasury data.
 Note: Figure 2 does not include \$14 billion in marketable securities outstanding for the Federal Financing Bank, \$22.53 billion in matured notes, and \$47 million in matured bonds.

Treasury's primary debt management goal is to finance the federal government's borrowing needs at the lowest cost over time. Issuing debt through regular and predictable offerings lowers borrowing costs because investors and dealers value liquidity and certainty of supply. The mix of securities, which changes regularly as new debt is issued, is important because it can have a significant influence on the government's interest payments. Longer-term securities typically carry higher interest rates—or cost to the government—primarily due to concerns about future inflation. However, they can also offer the Treasury certainty about what its payments will be.

We believe the large share of the debt that must be rolled over in the next few years is cause for concern. Market experts generally believe that Treasury needs to increase the average maturity of its debt portfolio. Large and growing borrowing needs put a premium on understanding both current and future demand for U.S. Treasury securities. To support Congress' oversight of the use of TARP funds, we have work under way

looking at how Treasury has financed borrowing associated with the financial market instability and analyzing additional ideas for debt management that might assist Treasury going forward. We encourage Treasury to explore a range of borrowing options that could support its lowest-cost-over-time borrowing objective and to take a strategic approach to the analysis of various options—recognizing that the federal government faces a long-term sustained increase in borrowing needs.

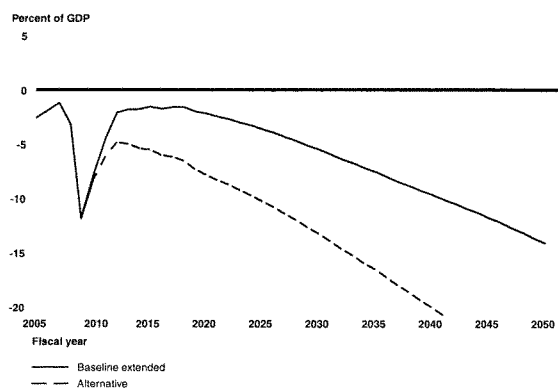
As I noted, the actions to restore financial market stability and economic growth take place within the context of the already serious longer-term fiscal condition of the federal government. While policymakers have been understandably focused on dealing with these financial market and economic growth challenges, attention also needs to be given to the long-term challenges of addressing the federal government's large and growing structural deficits and debt.

As discussed in the *Financial Report*, the federal government is on an unsustainable long-term fiscal path. The Statement of Social Insurance, for example, shows that projected scheduled benefits exceed earmarked revenues for social insurance programs (e.g., Social Security and Medicare) by approximately \$43 trillion³⁷ in present value terms over the 75-year projection period. GAO also prepares long-term fiscal simulations that are based on the Social Security and Medicare Trustees' projections, but provide a more comprehensive analysis of fiscal sustainability because they include revenue and expenditure projections for all other government programs. Our most recent long-term fiscal simulation was issued in March 2009.³⁸ Figures 3, 4, and 5 below show the results of GAO's March 2009 simulations.

³⁷On an open group basis (current and future participants).

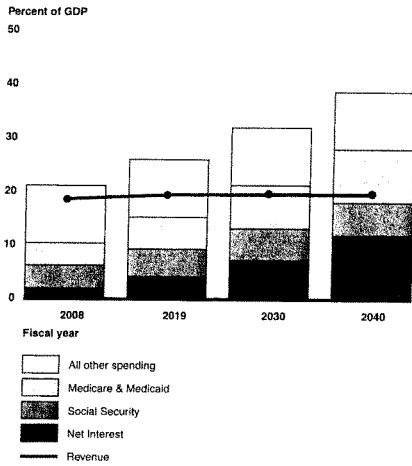
³⁸GAO, *The Nation's Long-Term Fiscal Outlook: March 2009 Update*, GAO-09-405SP (Washington, D.C.: March 2009).

Figure 3: Deficits as a Share of GDP under GAO's Two Different Fiscal Policy Simulations



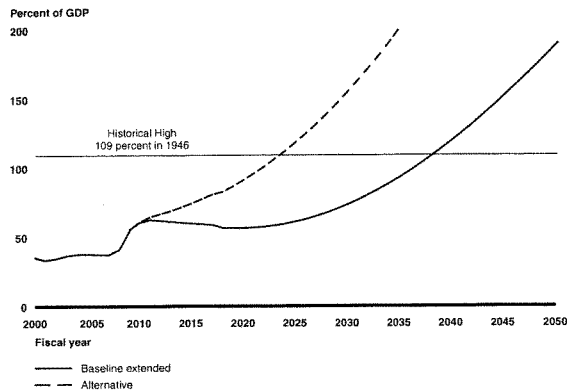
Source: GAO's March 2009 analysis based on the Trustees' assumptions for Social Security and Medicare.
Note: See GAO-09-405SP.

Figure 4: Revenues and Composition of Spending as a Share of GDP Under GAO's Alternative Simulation



Source: GAO's March 2009 analysis based on the Trustees' assumptions for Social Security and Medicare.
 Notes: Data are from GAO's March 2009 simulations based on the 2008 Trustees' assumptions for Social Security and Medicare. Discretionary spending other than Recovery Act provisions grows with GDP after 2009; Recovery Act provisions are included but assumed to be temporary. Expiring tax provisions are extended, except for expiring provisions enacted in the Recovery Act. After 2019, revenue as a share of GDP is brought to its 40-year historical average of 18.3 percent of GDP plus expected revenues from deferred taxes (i.e., taxes on withdrawals from retirement accounts). Medicare spending is adjusted based on the assumption that physician payments are not reduced as specified under current law.

Figure 5: Debt Held by the Public as a Share of GDP Under GAO's Two Different Fiscal Policy Simulations



Source: GAO's March 2009 analysis based on the Trustees' assumptions for Social Security and Medicare.
 Note: Information presented for fiscal years 2000 through 2008 is based on historical data and for fiscal years 2009 through 2050 is derived from fiscal policy simulations. See GAO-09-405SP.

A quantitative measure of the long-term fiscal challenge measure is called the "fiscal gap." The fiscal gap is the amount of spending reduction or tax increases that would be needed today to keep debt as a share of GDP at or below today's ratio. The fiscal gap is an estimate of the action needed to achieve fiscal balance over a certain time period such as 75 years. Another way to say this is that the fiscal gap is the amount of change needed to prevent the kind of debt explosion implicit in figure 5. The fiscal gap can be expressed as a share of the economy or in present value dollars.

Under GAO's alternative simulation, closing the fiscal gap would require spending cuts or tax increases, or some combination of the two, equal to 8.1 percent of the entire economy over the next 75 years, or about \$63 trillion in present value terms. To put this in perspective, closing the gap solely through revenue increases would require an increase in today's federal tax revenues of about 44 percent, or to do it solely through spending reductions would require a reduction in today's federal program spending (i.e., in all spending except for interest on the debt held by the

public, which cannot be directly controlled) of about 31 percent to be maintained over the entire 75-year period.

The Federal Financial Reporting Model

The *Financial Report* 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 challenge 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.

Accounting and financial reporting standards have continued to evolve to provide greater transparency and accountability over the federal government's operations, financial condition, and fiscal outlook. However, it is appropriate to consider the need for further revisions to the current federal financial reporting model, which could affect both consolidated and agency 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:

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

In addition, further enhancements to accounting and financial reporting standards are needed to effectively convey the long-term financial condition of the U.S. government and annual changes therein. 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 (1) a Statement of Fiscal Sustainability²⁹ that provides a long-term look at the

²⁹The Statement of Fiscal Sustainability would show the relationship between the present value of projected receipts and spending for social insurance and for all other federal programs.

fiscal sustainability of all federal programs including social insurance programs, and (2) other sustainability information, including intergenerational equity and an analysis of changes in sustainability during the year.⁴⁰ Recently, the Federal Accounting Standards Advisory Board (FASAB) unanimously approved a proposed new standard on fiscal sustainability reporting.⁴¹ Also, FASAB is currently considering possible changes to accounting for social insurance.⁴²

In addition, there is a need for a combined report on the performance and financial accountability of the federal government as a whole. This report would include, among other things, key outcome-based national indicators (e.g., economic, security, social, and environmental), which could be used to help assess the nation's and other governmental jurisdictions' position and progress.

Engaging in a reevaluation of the federal financial reporting model 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 on strategies to address the federal government's challenges, including its long-term fiscal challenge.

Closing Comments

In closing, it is important that the progress that has been made in improving federal financial management activities and practices be sustained by the new administration. Across government, financial management improvement initiatives are under way, and if effectively implemented, they have the potential to greatly improve the quality of financial management information as well as the efficiency and

⁴⁰Intergenerational equity assesses the extent to which different age groups may be required to assume financial burdens to sustain federal responsibilities.

⁴¹Unless OMB or the Comptroller General of the United States object by September 28, 2009, the proposed standard, Statement of Federal Financial Accounting Standards No. 36, *Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government*, will take effect for fiscal year 2010.

⁴²On November 17, 2008, an exposure draft was issued on accounting for social insurance, *Accounting for Social Insurance, Revised*.

effectiveness of agency operations. However, the federal government still has a long way to go before realizing strong federal financial management. For DOD, the challenges are many. We are encouraged by DOD's efforts toward addressing its long-standing financial management weaknesses and its efforts to achieve auditability. Consistent and diligent top management oversight toward achieving financial management capabilities, including audit readiness, will be needed. The civilian CFO Act agencies must continue to strive toward 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. Federal agencies need to improve the government's financial management systems to achieve this goal.

The nature and magnitude of actions the federal government has taken to stabilize the financial markets and promote economic recovery have created new challenges involving accountability, financial reporting, and debt management. A great amount of attention will need to be devoted to ensuring (1) that sufficient internal controls and transparency are established and maintained for all stabilization and recovery initiatives; (2) that all related financial transactions are reported on time, accurately, and completely; and (3) these initiatives are effectively and efficiently financed. Importantly, the recent increase in federal debt that has resulted largely from the federal government's response to the crisis in financial markets and the economic downturn must be viewed within the context of the nation's unsustainable long-term fiscal path. The longer action is delayed to address long-term fundamental fiscal problems, the greater the likelihood that actions to address such problems will be disruptive and destabilizing. The federal government faces increasing pressures to address the fiscal problems of Social Security and Medicare, yet a shrinking window of opportunity for phasing in adjustments. GAO is committed to sustained attention to this critically important matter.

Given the federal government's current financial condition and the nation's serious long-term fiscal challenge, the need for the Congress and federal policymakers and management to have reliable, useful, and timely financial and performance information is greater than ever. Sound decisions on the current and future direction of vital federal government programs and policies are more difficult without such information. We also will continue to stress the need for development of more meaningful financial and performance reporting on the federal government.

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.

Madam Chairwoman and Ranking Member Bilbray, 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 Jeanette M. Franzel, Managing Director, and Gary T. Engel, Director, Financial Management and Assurance, at (202) 512-2600, as well as Susan J. Irving, Director, Federal Budget Analysis, Strategic Issues, at (202) 512-6806. Key contributions to this testimony were also made by staff on the Consolidated Financial Statement audit team.

Appendix I: Fiscal Year 2008 Audit Results

Table 1: Chief Financial Officers (CFO) Act Agencies: Fiscal Year 2008 Audit Results and Principal Auditors

CFO Act agencies	Opinion rendered by agency auditor	Agencies' auditors reported material weaknesses or noncompliance ^a	Principal auditor
Agency for International Development	Unqualified	√	OIG
Agriculture	Unqualified	√	OIG
Commerce	Unqualified	√	KPMG LLP
Defense	Disclaimer	√	OIG
Education	Unqualified	√	Ernst & Young, LLP
Energy	Unqualified		KPMG LLP
Environmental Protection Agency	Unqualified	√	OIG
General Services Administration	Unqualified	√	PricewaterhouseCoopers LLP
Health and Human Services	Unqualified	√	Ernst & Young, 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	^c	Clifton Gunderson LLP
Nuclear Regulatory Commission	Unqualified	√	Urbach Kahn & Werlin LLP
Office of Personnel Management	Unqualified		KPMG LLP
Small Business Administration	Unqualified		KPMG LLP
Social Security Administration	Unqualified		PricewaterhouseCoopers LLP
State	Unqualified ^d	√	Leonard G. Birnbaum and Company, LLP
Transportation	Unqualified	√	KPMG LLP
Treasury	Unqualified	√	KPMG LLP
Veterans Affairs	Unqualified	√	Deloitte & Touche LLP

Source: GAO.

^aReported noncompliance with applicable laws and regulations and/or substantial noncompliance with one or more of the Federal Financial Management Improvement Act requirements.

^bFor fiscal year 2008, only the Consolidated Balance Sheet and the related Statement of Custodial Activity of the Department of Homeland Security were subject to audit; the auditor was unable to express an opinion on these two financial statements.

^cThe auditors reported no material weaknesses, no noncompliance with FFMA, and no noncompliance with laws and regulations, except for a potential matter of noncompliance with respect to the Anti-Deficiency Act.

Appendix I: Fiscal Year 2008 Audit Results

^aAs of the date of our audit report, the auditors had disclaimed an opinion on the Department of State's fiscal year 2008 financial statements; however, because the Department subsequently provided the auditors with sufficient evidential material to support the amounts reported on its financial statements, the auditors issued a second report, replacing the first, with an unqualified opinion of the Department of State's fiscal year 2008 financial statements.

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United States Government Accountability Office
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Office of the Comptroller General
of the United States

August 4, 2009

The Honorable Diane E. Watson
Chairwoman
The Honorable Brian P. Bilbray
Ranking Member
Subcommittee on Government Management,
Organization, and Procurement
Committee on Oversight and Government Reform
House of Representatives

Subject: *Responses to Posthearing Questions Related to GAO's Testimony on the U.S. Government's Consolidated Financial Statements for Fiscal Year 2008*

On July 8, 2009, I testified before your subcommittee at a hearing on our report on the U.S. government's consolidated financial statements for fiscal year 2008.¹ This letter responds to Chairwoman Watson's request for written responses to questions related to our testimony. The questions and my responses follow.

Question One: The Emergency Economic Stabilization Act of 2009 (EESA), which authorized the Troubled Asset Relief Program (TARP) and the Housing and Economic Recovery Act of 2008 (HERA), allowed the federal government to take certain unprecedented actions involving billions of dollars to stabilize the financial markets in 2008. Actions taken under TARP and programs under HERA will, at least in the short term, impact the federal government's financial condition. Therefore, all of the federal government's purchase and loan transactions must be properly measured and reported.

- **Given that GAO has consistently reported that federal agencies which account for the majority of the reported balances for direct loans and loan guarantee liabilities have internal control deficiencies related to their credit reform estimation and related financial reporting processes, what are some of your concerns regarding transactions under TARP and programs under HERA?**

¹U.S. Government Accountability Office, *Fiscal Year 2008 U.S. Government Financial Statements: Federal Government Faces New and Continuing Financial Management and Fiscal Challenges*, GAO-09-805T (Washington, D.C: Jul. 8, 2009). The fiscal year 2008 *Financial Report of the United States Government*, issued by the Department of the Treasury on December 15, 2008, is available through GAO's Web site at www.gao.gov and Treasury's Web site at www.fms.treas.gov/fr/index.html.

The challenges of estimating and managing costs and measuring and reporting asset and liability values under TARP and other recent initiatives are likely to be even greater than those associated with more traditional federal lending activities given (1) that little, if any, historical information is available for certain transactions from which to base expected future cash flows, (2) the complexities in valuing the type of assets acquired by TARP, and (3) that this is the first year of TARP operations and new systems and controls are being implemented. Most federal credit programs, such as the Department of Education's student loan programs, have years of historical data from which net cash flows to the federal government can be estimated. However, while contractual provisions may set forth required payments for certain transactions such as preferred stock purchases and debt obligations, for a substantial number of federal transactions under TARP and HERA there is a significant amount of uncertainty regarding the extent to which actual repayments to the federal government will be made. There is simply little or no history for certain of these large and unprecedented transactions. Moreover, the instability and dramatic changes in financial markets that occurred within the last year make it very difficult to estimate the values of these assets and liabilities with any level of certainty. Therefore, it is critically important for adequate internal controls to be in place to provide reasonable assurance that the cost and other accounts related to all TARP and other loans and loan guarantees are properly recorded, measured, and reported and losses to the federal government minimized.

Question Two: The 2008 Financial Report was not offered in time for GAO to complete its audit, and that the federal government failed to demonstrate adequate internal controls over financial reporting, or compliance with major laws and regulations.

- **How do you think the federal government's financial reporting model can be improved?**

The fiscal year 2008 *Financial Report of the United States Government (Financial Report)*, which was issued by the Department of the Treasury (Treasury) on December 15, 2008, provides useful information on the federal government's financial position at the end of the fiscal year and changes that 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 challenge 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.

It is important to note that accounting and financial reporting standards and the *Financial Report* have continued to evolve to provide greater transparency and accountability over the federal government's operations, financial condition, and fiscal outlook. However, further changes and enhancements to the federal financial reporting model should be considered. A broad reconsideration of the federal financial reporting model could address the following types of questions:

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

Also, further enhancements to accounting and financial reporting standards are needed to effectively convey the long-term financial condition of the U.S. government and annual changes therein. For example, the federal government's financial reporting model 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 Sustainability² that provides a long-term look at the fiscal sustainability of all federal programs including social insurance programs, and other sustainability information, including intergenerational equity³ and an analysis of changes in sustainability during the year. Recently, the Federal Accounting Standards Advisory Board (FASAB) unanimously approved a proposed new standard on fiscal sustainability reporting.⁴ Also, FASAB is currently considering possible changes to accounting for social insurance.⁵

In addition, there is a need for a combined report on the performance and financial accountability of the federal government as a whole. This report would include, among other things, key outcome-based national indicators (e.g., economic, security, social, and environmental), which could be used to help assess the nation's position and progress.

Further meaningful change and enhancement to federal financial reporting can be accomplished by engaging in a reevaluation of the federal government's financial and performance reporting needs. A wide variety of stakeholders from the public and private sectors should be consulted to understand such needs with the overarching theme being looking beyond short-term results and focusing on the overall long-term sustainability of the federal government's programs, commitments, and responsibilities in relation to expected resource availability. The ultimate goal of any re-evaluation would be reporting enhancements that can help Congress deliberate on strategies to address the federal government's challenges, including its long-term fiscal challenge.

²The Statement of Fiscal Sustainability would show the relationship between the present value of projected receipts and spending for social insurance and for all other federal programs. 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.

³Intergenerational equity assesses the extent to which different age groups may be required to assume financial burdens to sustain federal responsibilities.

⁴Unless the Office of Management and Budget (OMB) or the Comptroller General of the United States object by September 28, 2009, the proposed standard, Statement of Federal Financial Accounting Standards No. 36, *Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government*, will take effect for fiscal year 2010.

⁵On November 17, 2008, an exposure draft was issued on accounting for social insurance, *Accounting for Social Insurance, Revised*.

- **Regarding the federal government's enormous increase in debt since the events of last year, how will the federal government's borrowing costs be affected, and how will the government's ability to finance long-term commitments be impacted?**

Congress has assigned to Treasury the responsibility to borrow the funds necessary to finance the gap between cash in and cash out subject to a statutory limit. Since the onset of the current recession in December 2007, the gap between revenues and outlays has grown. Because Treasury must borrow the funds disbursed, TARP and other actions taken to stabilize the financial markets increase the need to borrow thus adding to the federal debt held by the public. Also, federal borrowing from the public typically increases during an economic downturn—largely because tax revenues decline while expenditures increase for programs to assist those affected by the downturn. In addition, the American Recovery and Reinvestment Act, enacted on February 17, 2009, contains both decreases in revenues and increases in spending.⁶

The federal government's borrowing costs are determined both by the amount of debt held by the public and the interest rates paid on that debt. As I noted in my prepared testimony, interest rates have dropped dramatically since the start of the financial crisis, particularly for short-term debt. These relatively low interest rates have reduced Treasury's borrowing costs to date. Indeed, the Congressional Budget Office's (CBO) most recent projections from March of this year show net interest payments in fiscal year 2009 would be lower than in fiscal year 2008.

The near-term increase in debt held by the public takes place in the context of the longer-term fiscal outlook, which will present Treasury with continued financing challenges even after the return of financial stability and economic growth. Both the GAO and CBO long-term simulations show that absent change the federal government faces unsustainable levels of deficit and debt.⁷ For example, by 2025, debt held by the public under GAO's alternative simulation exceeds the historical high reached in the aftermath of World War II. My prepared statement provides more details on the magnitude of the fiscal challenges. While policymakers have been understandably focused on dealing with the financial market and economic growth challenges, attention also needs to turn with the same level of intensity to the long-term challenges of addressing the federal government's large and growing structural deficits and debt.

Treasury's primary debt management goal is to finance the federal government's borrowing needs at the lowest cost over time. Issuing debt through regularly scheduled auctions lowers borrowing costs because investors and dealers value liquidity and certainty of supply. Treasury issues marketable securities that range in maturity from 1 month to 30 years and sells them at auction on a pre-announced schedule. The mix of securities that Treasury has outstanding changes regularly as

⁶Since December 2007, Congress has raised the debt limit three times. The current debt limit is \$12,104 billion.

⁷See GAO, *The Nation's Long-Term Fiscal Outlook: March 2009 Update*, GAO-09-405SP (April 30, 2009) and CBO, *The Long-Term Budget Outlook* (June 2009).

new debt is issued. The mix of securities is important because it can have a significant influence on the federal government's interest payments. Longer-term securities typically carry higher interest rates—or cost to the government—primarily due to concerns about future inflation. However, these longer-term securities offer the government the certainty of knowing what Treasury's payments will be over a longer period.

Treasury has said that it “recognizes the need to monitor short-term issuance versus longer dated issuance.” Market experts generally believe that Treasury needs to increase the average maturity of its debt portfolio in part to lock in relatively low long-term rates and to ensure adequate borrowing capacity in the coming years. We encourage Treasury to explore a range of borrowing options that could support its lowest-cost-over-time borrowing objective and to take a strategic approach to the analysis of various options—recognizing that the federal government faces a long-term sustained increase in its borrowing needs.

- **Given the current problems with financial markets, the auto industry and the ongoing recession, what steps can we take now to improve our financial condition in the future? What can be done to increase the public's awareness and understanding of the federal government's financial condition as well as the magnitude and implications of our nation's long-term fiscal challenges?**

As noted in response to the question above, policymakers understandably have been focused on dealing with financial market challenges and the economic downturn. Attention must also be given to our long-term outlook and the need to deal with the federal government's large and growing structural deficits and debt.

When the 2008 *Financial Report* was issued on December 15, 2008, Treasury and OMB, in coordination with GAO, also issued, for the second year, a summary financial report entitled *The Federal Government's Financial Health: A Citizen's Guide to the 2008 Financial Report of the United States Government*. This guide, which is both included in the printed *Financial Report* and printed separately, is intended to make the information in the *Financial Report* more understandable and more accessible to a broader audience. Both of these reports are available through GAO's Web site at <http://www.gao.gov/financial/fy2008financialreport.html> and Treasury's Web site at <http://www.fms.treas.gov/fr/index.html>.

Neither the *Financial Report* nor the budget alone—nor the budget and the financial statements together—tell the whole picture of the U.S. government's fiscal outlook. To understand the long-term implications of our current fiscal path requires more than a single year's snapshot. That is why for more than a decade GAO has been running fiscal simulations to tell more about this longer-term story. These simulations, which can be found at <http://www.gao.gov/special.pubs/longterm/> can be used to better understand the magnitude and timing of the long-term fiscal challenges.

A number of countries have begun preparing fiscal sustainability reports. The goal of these reports is to increase public awareness and understanding of the long-term fiscal outlook in light of escalating health care cost growth and population aging, to stimulate public and policy debates, and to help policymakers make more informed decisions about the overall sustainability of government finances. As noted above, FASAB recently unanimously approved a proposed new standard on U.S. fiscal sustainability reporting. The resulting reports on the federal government should further help promote understanding of the long-term fiscal challenges.

Question Three: Several agencies still lack effective financial management systems in place that are capable of producing relevant information with which informed decisions can be made on an ongoing basis. In fiscal year 2008, auditors reported that the financial systems in 14 out of the 24 Chief Financial Officers Act agencies lacked substantive compliance with at least one of the Federal Financial Management Improvement Act's (FFMIA) three requirements. These requirements state that financial systems must comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the federal government's Standard General Ledger at the transaction level.

- **Why is it of critical importance for the federal government to have financial management systems that are compliant with the FFMIA, and what is the fallout from not having a modernized, integrated financial management system?**

FFMIA⁸ builds on the foundation laid by the Chief Financial Officers (CFO) Act, which has the goal of modern financial management systems that enable the systematic measurement of performance; the development of cost information; and the integration of program, budget, and financial information for management reporting. The primary goal of FFMIA is for agencies to improve financial management systems so that financial information from these systems can be used to help manage agency programs more effectively and enhance the ability to prepare auditable financial statements. The auditors' FFMIA assessments for the 24 CFO Act agencies for fiscal year 2008 illustrate that many federal agencies still do not have effective financial management systems, including processes, procedures, and controls in place that can routinely produce reliable, useful, and timely financial information that federal managers can use for day-to-day decision-making purposes.

Auditors frequently cited the lack of integrated financial management systems in their fiscal year 2008 audit reports. Auditors for 10 of the 14 agencies with noncompliant systems in fiscal year 2008 reported nonintegrated systems as a problem. The lack of integrated financial management systems typically results in agencies expending

⁸Federal Financial Management Improvement Act of 1996, Pub. L. No. 104-208, div. A., § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996). FFMIA requires the departments and agencies covered by the CFO Act of 1990 to implement and maintain financial management systems, that comply substantially with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the *U.S. Government Standard General Ledger* at the transaction level.

major effort and resources, including in some cases hiring external consultants, to develop information that their systems should be able to provide on a daily or recurring basis. Agencies with nonintegrated financial systems are also more likely to devote significantly more time and resources to collecting information than those with integrated systems. In addition, opportunities for errors are increased when agencies' systems are not integrated.

As we previously reported,⁹ some federal agencies have been able to obtain unqualified audit opinions that, according to auditors, were obtained through extensive labor-intensive efforts, which include using ad hoc procedures, expending significant resources, and making billions of dollars in adjustments to derive financial statements. This is usually the case when agencies have inadequate systems that are not integrated and routinely reconciled. These time-consuming procedures must be combined with sustained efforts to improve agencies' underlying financial management systems and controls. Continued agency reliance on costly and time-intensive manual efforts to achieve or maintain unqualified opinions indicates that agency management lacks reliable information for day-to-day decision making and represents inefficient use of human capital and other resources that could be better used to directly support strategic decision making and ultimately improve overall performance.

Question Four: For the 12th year in a row, GAO has issued a disclaimer of opinion on the accrual basis consolidated financial statements of the United States government.

- **In fiscal year 2008, how many agencies were found to have audited financial statements that were inconsistent with the consolidated financial statements?**
- **Has GAO found that the number of agencies with such deficiencies has decreased over the past 12 years?**
- **According to GAO, which agencies' financial statements showed inconsistencies with the consolidated financial statements?**

For fiscal year 2008, 21 of the 24 CFO Act agencies received unqualified or "clean" audit opinions on their financial statements. This represents a significant improvement since our first audit of the consolidated financial statements of the U.S. government 12 years ago. Specifically, only 11 CFO Act agencies received unqualified opinions on their financial statements for fiscal year 1997. Table 1 below shows a comparison of the CFO Act agencies' fiscal years 2008 and 1997 audit results by agency. Although there has been significant improvements in CFO Act agency audit results, 3 of the 24 CFO Act agencies—Department of Defense, Department of Homeland Security, and National Aeronautics and Space Administration—continued to have serious financial management problems that prevented them from receiving opinions on their fiscal year 2008 financial statements. Also, auditors for many of the

⁹GAO, *Financial Management: Persistent Financial Management Systems Issues Remain for Many CFO Act Agencies*, GAO-08-1018 (Washington, D.C.: Sept. 30, 2008).

CFO Act agencies reported significant deficiencies regarding agencies' financial reporting processes, which, in turn, could affect the preparation of the consolidated financial statements.

Table 1: CFO Act Agencies' Audit Results for Fiscal Years 2008 and 1997

CFO Act agencies	Opinion rendered by agency auditor, fiscal year 2008	Opinion rendered by agency auditor, fiscal year 1997
Agency for International Development	Unqualified	Disclaimer
Agriculture	Unqualified	Disclaimer
Commerce	Unqualified	Disclaimer
Defense	Disclaimer	Disclaimer
Education	Unqualified	Unqualified
Energy	Unqualified	Unqualified
Environmental Protection Agency	Unqualified	Unqualified
General Services Administration	Unqualified	Unqualified
Federal Emergency Management Agency	^a	Other ^b
Health and Human Services	Unqualified	Qualified
Homeland Security	Disclaimer ^c	^d
Housing and Urban Development	Unqualified	Qualified
Interior	Unqualified	Unqualified
Justice	Unqualified	Disclaimer
Labor	Unqualified	Unqualified
National Aeronautics and Space Administration	Disclaimer	Unqualified
National Science Foundation	Unqualified	Qualified
Nuclear Regulatory Commission	Unqualified	Unqualified
Office of Personnel Management	Unqualified	Other ^e
Small Business Administration	Unqualified	Unqualified
Social Security Administration	Unqualified	Unqualified
State	Unqualified ^f	Unqualified
Transportation	Unqualified	Disclaimer
Treasury	Unqualified	Other ^g
Veterans Affairs	Unqualified	Qualified

Source: GAO.

Note: In an unqualified opinion, the auditor states that the information in the financial statements and accompanying notes is presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles (GAAP). A qualified opinion discloses exceptions to an unqualified opinion, such as inadequate disclosures or selected nonconformities with GAAP. However, in a qualified opinion, the exceptions are not considered material enough to affect the fairness of the statements taken as a whole. A disclaimer of opinion may result when the auditor is unable to obtain sufficient information upon which to base an opinion. The circumstances related to a disclaimer are described in the auditor's report.

⁴The Federal Emergency Management Agency (FEMA) was transferred to the Department of Homeland Security effective March 1, 2003, and was no longer required to prepare and have stand-alone audited financial statements under the CFO Act.

⁵For fiscal year 1997, FEMA received an unqualified opinion on a financial statement for a part of the agency. Financial statements were not prepared for the whole agency. FEMA prepared its first agencywide financial statements for fiscal year 1998, which received an unqualified opinion.

⁶For fiscal year 2008, 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.

⁷The Department of Homeland Security Financial Accountability Act added the Department of Homeland Security to the list of CFO Act agencies, beginning fiscal year 2005.

⁸The Office of Personnel Management (OPM) did not prepare fiscal year 1997 consolidated financial statements. OPM's Retirement Fund and Life Insurance Fund received unqualified opinions; revolving funds, health benefits, and salaries and expenses received disclaimers. OPM prepared its first consolidated financial statements for fiscal year 2000, which received an unqualified opinion.

⁹As of the date of our audit report, the auditors had disclaimed an opinion on State's fiscal year 2008 financial statements; however, because the department subsequently provided the auditors with sufficient evidential material to support the amounts reported on its financial statements, the auditors issued a second report, replacing the first, with an unqualified opinion on State's fiscal year 2008 financial statements.

¹⁰For fiscal year 1997, Treasury received an unqualified opinion on its administrative financial statements and a qualified opinion on its custodial schedules.

- **When do you believe that the federal government will be able to reconcile its intra-governmental activities and balances, and thus receive a clean audit?**

Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong and sustained commitment by federal agency leadership and continued strong leadership by OMB and Treasury. Given the long-term nature and extent of the problem, it is not possible at this point to determine when intragovernmental activities and balances will be adequately accounted for and reconciled. As we stated in our fiscal year 2008 consolidated financial statements audit report, a substantial number of federal agencies did not adequately perform the required reconciliations for fiscal years 2008 and 2007.

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. 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. For fiscal years 2008 and 2007, based on trading partner information provided to Treasury through agencies' closing packages, 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. Based on our analysis of the "Material Difference Reports" for fiscal year 2008, 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 2008 and 2007, amounts reported by federal agency trading partners for certain intragovernmental accounts were not in

agreement by significant amounts. In addition, there are hundreds of billions of dollars of unreconciled differences between the General Fund and federal agencies related to appropriation and other intragovernmental transactions.

In 2006, OMB issued Memorandum No. M-07-03, *Business Rules for Intragovernmental Transactions* (Nov. 13, 2006), and Treasury issued the Treasury Financial Manual Bulletin No. 2007-03, *Intragovernmental Business Rules* (Nov. 15, 2006). This guidance added criteria for resolving intragovernmental disputes and major differences between trading partners for certain intragovernmental transactions and called for the establishment of an Intragovernmental Dispute Resolution Committee. OMB is currently working with the Chief Financial Officers Council to create the Intragovernmental Dispute Resolution Committee.¹⁰ OMB is also using a "Watch List" that lists federal agencies with large intragovernmental imbalances. The Watch List was developed to facilitate reductions in some of the largest intragovernmental imbalances, bring federal agency reporting into alignment with the Intragovernmental Business Rules, bring the appropriate representatives together from the respective agencies, and document the issues and resolutions. Treasury is also taking steps to help resolve material differences in intragovernmental activity and balances. For example, Treasury is requiring federal agencies to provide documentation on how and when the agencies are resolving certain of their unresolved material differences.

Although OMB and Treasury have undertaken steps to address our recommendations to improve the reconciliation of intragovernmental activities and balances, eight recommendations to OMB and Treasury related to the intragovernmental differences and reconciliations area are still open. Some of these recommendations address issues such as enforcement of OMB's Business Rules, resolution of significant differences between trading partners, and implementation of a process by Treasury and OMB to obtain information from individual federal agencies regarding their out-of-balance condition.

Three major impediments to our ability to render an opinion on the U.S. government's accrual basis 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. As such, resolution of the intragovernmental transactions problem would be a major improvement but that alone would not result in an unqualified or "clean" audit opinion on the U.S. government's accrual basis consolidated financial statements.

¹⁰The U.S. Chief Financial Officers 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.

If you or your staff have questions about the responses to the questions above, please contact me at (202) 512-5500 or Gary T. Engel, Director, Financial Management and Assurance, at (202) 512-3406 or engelg@gao.gov.

A handwritten signature in black ink that reads "Gene L. Dodaro". The signature is written in a cursive style with a large, prominent "D" at the end.

Gene L. Dodaro
Acting Comptroller General
of the United States

Ms. WATSON. Thank you so much. Mr. Gregg, you can proceed.

STATEMENT OF RICHARD L. GREGG

Mr. GREGG. Thank you, Chairwoman Watson. It is a pleasure to be here today to discuss the Financial Report of the U.S. Government and the related audit by the Government Accountability Office.

The Financial Report, incorporating the consolidated Government-wide financial statements, is designed to report on the financial position and condition of the Federal Government following U.S. Federal generally accepted accounting principles. Your interest in improving Federal financial management is greatly appreciated.

The Financial Report reflects the Treasury's and OMB's longstanding responsibility to provide the Congress and the public with timely and reliable information on the cost of Government's operations, the source of funds used to fund them, and the implications of the Government's financial responsibilities.

The Government's net operating cost for fiscal year 2008 was just over \$1 trillion, more than triple the net operating cost of the prior fiscal year. This increase resulted from Government revenues that stayed relatively flat while costs increased. The Government's budget deficit for the fiscal year ending on September 30, 2008 was \$455 billion, which is more than double the deficit for the prior year.

Appropriately, the Financial Report discusses the key fiscal challenges facing the Federal Government. At the end of fiscal year 2008, the Government had just begun to initiate a number of unprecedented actions to deal with the economic downturn. As such, the Financial Report discusses the financial impact on the Government's operations stemming from those steps and the steps the Government took to restore stability in the U.S. financial system. While these events had minimal impact on the fiscal year 2008 statements, they will almost certainly play a more substantial role in fiscal year 2009.

Although the economy and market stabilization issues arose in 2008 and of course remain ongoing concerns, the longer term issues of fiscal sustainability cannot be overlooked. Accordingly, the Report also discusses the Government's long term fiscal challenges funding Social Security, Medicare, and Medicaid.

For fiscal year 2008, GAO was again unable to express an opinion on most of the Government-wide financial statements that appear in the Financial Report. The lone exception was a second consecutive unqualified or clean audit opinion on the Statement of Social Insurance which shows the estimated net present cost of the Government's exposures of its social insurance programs, primarily Social Security and Medicare, over 75 years.

The disclaimer on the remainder of the statements stems from three longstanding material weaknesses: First is serious financial management control issues at the Department of Defense. Second is the Government's inability to adequately account for and reconcile intragovernmental activity and balances between agencies. Third is the Government's deficiencies in the process for preparing the consolidated financial statements.

DOD continues to work toward resolution of many accounting issues including those pertaining to property, inventory, accounts payable, and several other areas. DOD faces no small challenge in trying to integrate and modernize hundreds of financial systems. But the Department did show progress in fiscal year 2008 as the Corps of Engineers obtained a clean opinion for the first time.

The Treasury Department, working with OMB and other Government agencies, has made considerable progress toward resolving the intragovernmental transactions and consolidation weaknesses. Intragovernmental transactions imbalances occur when two agencies conducting business with each other as trading partners record and report the same transaction differently.

We continue to make progress on the third material weakness, the need to improve the process for preparing and consolidating the Financial Report. We have made significant strides in the Financial Report's preparation and consolidation by developing short term and long term strategies. These include improving data collection, better disclosure requirements, and more information from the agencies on an ongoing basis.

In all, Treasury's and OMB's efforts to date have resulted in the reduction of GAO findings and recommendations by more than two thirds from over 150 just a few years ago to just over 40 for the fiscal year 2008 audit. During 2008 we continued to make significant progress, leading to the closure of 16 of 56 recommendations that were outstanding from the previous audit reports. We have implemented major strategies to address these remaining 40 findings through contractor support, targeted task groups, and extensive engagement of the CFO and audit community.

In fiscal year 2009, we expect to resolve 14 of those remaining 40 findings. GAO identified only four new issues in the fiscal year 2008 audit, all of which we anticipate will be resolved in fiscal year 2009.

Decision makers not only need reliable information but they also need timely information. While Treasury and other agencies continue to work toward systems and process solutions, they continue to meet ambitious deadlines. Agencies continue to meet the OMB accelerated reporting deadline of November 15th, just 45 days after the end of the fiscal year, while Treasury continues to successfully compile the Government-wide report from the many agency reports just 30 days later. In addition, as you mentioned, 21 of 24 CFO agencies earned an unqualified opinion.

A common critique of the Financial Report of the U.S. Government is that, despite the fact that it contains more than 180 pages of detailed information on the Government's financial position and condition, it is not a practical document for communicating with American citizens or the Congress. In response, beginning in fiscal year 2007, the Treasury Department and OMB in cooperation with GAO developed and issues a summary report entitled, "The Government's Financial Health: A Citizen's Guide to the Financial Report of the U.S. Government." This guide, which is included in the Financial Report, provides a summary of the key data and issues addressed in the full Report in a user friendly manner to the public.

Despite our recent accomplishments and progress, much work remains. We will continue to work toward resolution of the Government's reporting process weaknesses. However, these reports are of limited or even minimal value if they go unread. As such, in addition to addressing process issues, we will continue to seek ways to make the Financial Report and the information that it contains more relevant and useful to the general public.

Thank you, Chairwoman Watson. That concludes my opening remarks.

[The prepared statement of Mr. Gregg follows:]

EMBARGOED UNTIL DELIVERY*Remarks as Prepared for Delivery*

Acting Fiscal Assistant Secretary of the Treasury Richard L. Gregg
Written Statement - For Submission to the
House Committee on Oversight and Government Reform
Subcommittee on Government Management, Organization and Procurement
June 18, 2009

Thank you for inviting me to the Committee's hearing to discuss the Financial Report of the United States Government (Financial Report) for Fiscal Year 2008 and the related audit by the Government Accountability Office (GAO). The Financial Report, incorporating the consolidated government-wide financial statements, is designed to report on the financial position and condition of the Federal Government following U.S. Federal generally accepted accounting principles (GAAP). Your interest in improving Federal financial management is greatly appreciated. The Financial Report reflects the Treasury and the Office of Management and Budget's long-standing responsibility to provide the Congress and the public with timely and reliable information on the cost of the Government's operations, the sources used to fund them, and the implications of the Government's financial responsibilities.

Financial Highlights

The Government's net operating cost for fiscal year (FY) 2008 was just over \$1 trillion—more than triple the net operating cost for the prior fiscal year. This increase resulted from Government revenues that stayed relatively flat, while costs increased due to the economic slowdown and significant revaluations of the Government's liabilities for post-employment benefits. The Government's budget deficit, for the fiscal year ended September 30, 2008, was \$455 billion, which was more than double the deficit for the prior year.

The Government's balance sheet shows that its liabilities exceed its assets by more than \$10 trillion dollars. Much of this difference is attributed to: 1) the Government's debt to the public of nearly \$6 trillion and 2) more than \$5 trillion in anticipated Federal employee and veterans' post-employment benefits and commitments for which funding (i.e., employee and employer contributions) has not yet been obtained.

The Government's Financial Challenges

Appropriately, the Financial Report discusses the key fiscal challenges facing the Federal Government. At the end of FY 2008, the Government had just begun to initiate a number of unprecedented actions to deal with the economic downturn. As such, the Financial Report discusses the financial impact on the Government's operations stemming from those steps that the Government took to restore stability in the U.S. financial system. While these events had minimal impact on the FY 2008 statements, they will almost certainly play a more substantial role in the FY 2009 statements.

Although the economy and market stabilization issues arose in FY 2008 and, of course, remain ongoing concerns, the longer-term issue of fiscal sustainability cannot be overlooked. Accordingly, the Report also discusses the Government's long-term fiscal challenges of funding the Social Security, Medicare, and Medicaid programs—programs which will account for a large and growing portion of total Government spending in both the near term and long term. The Report examines the projected expenditures and related revenues for these programs, as well as their potential impact on the Federal debt in the future. As reported in the Statement of Social Insurance, which is derived largely from Social Security's and Medicare's annual trust fund reports, the Government projects a revenue shortfall of \$43 trillion for these programs, in present value terms, over the next 75 years.

Audit Results

For Fiscal Year 2008, GAO was again unable to express an opinion on most of the governmentwide financial statements that appear in the Financial Report. The lone exception was a 2nd consecutive unqualified or "clean" audit opinion on the Statement of Social Insurance, which shows the estimated net present value cost of the Government's exposures of its social insurance programs, primarily Social Security and Medicare, over 75 years. The disclaimer on the remainder of the statements stems from three long-standing and significant material weaknesses:

1. serious financial management control issues at the Department of Defense (DoD),
2. the Government's inability to adequately account for and reconcile intragovernmental activity and balances between agencies, and
3. the Government's deficiencies in the process for preparing the consolidated financial statements.

DoD continues to work toward resolution of its many accounting issues, including those pertaining to property, inventory, accounts payable and several other areas. DoD faces no small challenge in trying to integrate and modernize hundreds of financial systems, but the Department did show progress in FY 2008, as the Army Corps of Engineers obtained a clean audit opinion for the first time.

The Treasury Department, working with OMB and other Government agencies, has made considerable progress towards resolving the intragovernmental transactions and consolidation weaknesses. Intragovernmental transaction imbalances occur when two agencies conducting business with each other, as trading partners, record and report the same transaction differently. We are addressing this issue on several fronts, including requiring more detailed agency reporting, developing and using more precise tracking and monitoring tools, and using multi-agency committees to develop business rules, identify best practices for resolving differences, and facilitate actual resolution of intragovernmental imbalances.

We continue to make progress on the third material weakness, the need to improve the process of preparing and consolidating the Financial Report. We have made significant strides in the Financial Report's preparation and consolidation by developing and following detailed corrective action plans, including short-term and long-term strategies; enhancing our data collection systems to meet disclosure requirements prescribed by generally accepted accounting principles, improving and

fully documenting our standard operating procedures by developing a more robust internal control program; and enhancing and clarifying reporting guidance to Federal agencies to assure consistency with their underlying data.

In all, Treasury and OMB's efforts to date have resulted in the reduction of GAO findings and recommendations by more than two-thirds—from over 150 just a few years ago to just over 40 for the FY 2008 audit. During FY 2008, we continued to make significant progress, leading to the closure of 16 of 56 recommendations that were outstanding from previous audit reports. We have implemented major strategies to address these remaining 40 findings through contractor support, targeted task groups and extensive engagement of the CFO and audit community. In FY 2009, we expect to resolve 14 of these remaining 40 findings. GAO identified only 4 new issues in the FY 2008 audit, all of which we anticipate will be resolved within FY 2009.

I recognize that until our financial statements can withstand audit scrutiny, we will not benefit from the Financial Report's full value in informing the Congress and the public about the Government's fiscal position and condition. However, I am encouraged by the progress that we have seen to date, at both the agency and government-wide reporting levels, and we will continue to seek improvements to the immensely complex process required to produce a report that entails trillions of dollars and encompasses the operations of hundreds of Government entities.

Decision makers need not only reliable, but also timely information. While Treasury and the other agencies continue to work towards systems and process solutions, they continue to meet ambitious deadlines. Agencies continue to meet the OMB accelerated reporting deadline of November 15—just 45 days after fiscal year end, while Treasury continues to successfully compile the government-wide report from the many agency reports just 30 days later. In addition, 21 of 24 CFO agencies earned a unqualified opinion.

The Citizens' Guide

A common critique of the Financial Report of the U.S. Government is that, despite the fact that it contains more than 180 pages of detailed information on the Government's financial position and condition, it is not a practical document for communicating with the American citizen or the Congress. In response, beginning in FY 2007, the Treasury Department and OMB, in cooperation with GAO, developed and issued a summary report entitled, *The Government's Financial Health—A Citizen's Guide to the Financial Report of the U.S. Government*. This Guide, which is included in the Financial Report, provides a summary of the key data and issues addressed in the full Report in a "user-friendly" manner to the general public.

Conclusions

The process of producing the Financial Report of the U.S. Government and annual agency financial reports can have a significant impact on ensuring effective management and control of the Government's finances. The financial systems and business processes improvements that many agencies have made as a result of audited financial statements and accelerated timelines has led to better underlying financial data. We are now looking toward improving efficiency through standard systems and processes and a common language and structure for exchanging information and financial data among agencies and between agencies and Treasury.

Despite our recent accomplishments and progress, much work remains, and we will continue to work towards resolution of the Government's reporting process weaknesses. However, these reports are of limited or even minimal value if they go unread. As such, in addition to addressing process issues, we will also continue to seek ways to make the Financial Report and the information that it contains more relevant and useful to the general public.

Thank you, Mr. Chairman. This concludes my testimony. I look forward to your questions.

Hearing on Oversight of Federal Financial Management

Follow up Questions

Chairwoman Watson's Questions for the Record for Mr. Richard L. Gregg, Acting Fiscal Assistant Secretary, Department of the Treasury (written responses with as much detail as possible would be appreciated).

Question One: The Treasury Department's findings have decreased from more than 150 to about 40 for the 2008 fiscal year audit, and it is also stated that the agency is expected to resolve 14 of the remaining findings in fiscal year 2009.

- What is the estimated timetable for eliminating the remaining 26 findings?

Response: There were four new audit findings last year for a total of 44 for FY 2008. We anticipate that we will close all four of the new findings plus 14 prior years' findings. Although the remaining audit findings are the most complex and difficult to address, we estimate that we will close 10 findings in 2010, 12 findings in 2011 and the last four findings in or after 2012.

Question Two: In 2006, the Treasury Department amended the Business Rules for Intergovernmental Transactions and the rules now call for a "Material Difference Report" at the end of the fiscal year for each agency. With this report, it is now evident when an agency and its trading partners have major differences.

- How effective have these new rules been in resolving disputes between agencies?

Response: Agencies are working more closely with OMB, Treasury, and their trading partners to resolve disputes and adopt similar accounting methodologies that have resulted in the reduction of intragovernmental imbalances. We have, however, observed recurring departures from the business rules, the majority of which are due to the application of different accounting treatments by agencies for the same transaction, or lack of detail in agency legacy accounting systems to meet the requirements. Although the business rules have had a positive impact on defining requirements and providing guidance to agencies, it will require ongoing monitoring by Treasury and OMB as well as recognition by the agencies on the importance of this issue.

- What further changes might be called for to prevent, or at least, greatly reduce such disagreements from occurring at all?

Response: We have already taken significant actions and will continue critical activities to prevent and greatly reduce intragovernment disagreements through facilitating collaboration, providing reports for the agencies, and making internal improvements within Treasury. We established multiple workgroups to resolve

the largest differences through specific identification of problems and trends. Through these workgroups, we have assisted agencies in reconciling their differences with their partners; determined additional required data elements, accounting reporting needs, and potential system changes; and gathered feedback on the possible modifications to the business rules. To further assist agencies, we developed and made reports available on the Financial Management Service's (FMS) website for agencies to meet the new reconciliation requirement to balance agency data to centrally reported data at the Department of the Treasury. We are also enhancing our Intragovernmental Reporting and Analysis System (IRAS) and the Intragovernmental Fiduciary Confirmation System to provide agencies with more information to assist them with their reconciliations.

- When do you foresee the federal government becoming equipped to eliminate discrepancies in intergovernmental transactions?

Response: Treasury, OMB, and the Federal agencies are working together to eliminate differences in intragovernmental transactions. We anticipate that we will further reduce intragovernmental differences by standardizing agency agreements and processes. FMS has developed an Intra-agency Agreement (IAA) that will be incorporated into the standards for reimbursable agreements that will be issued by the Federal Systems Integration Office (FSIO) this winter. Additionally, we will continue facilitating our workgroups to further define processes, identify areas for automation, and encourage collaboration.

- On occasion, there have been differences in figures between those cited in reports prepared by Treasury and those prepared by OMB in the President's budget request. What actions might be taken to get rid of such differences?

Response: Both Treasury and OMB reports are prepared from agency-submitted data. Certain differences are the result of varying accounting methodologies being used. The Financial Report of the U.S. Government, prepared by Treasury and OMB, is based on Federal generally accepted accounting principles and is generally on an accrual basis. In contrast, amounts reflected in the President's Budget are derived from primarily cash-based transactions. Since they are not prepared on the same basis, differences are inevitable between the two sets of data. Since two distinctive accounting approaches are used for the Financial Report and the President's Budget, we provide an analysis explaining the major differences.

Differences that arise as a result of inconsistent accounting practices within agencies' financial systems are not acceptable. The Department of Treasury is addressing such differences by requiring agency submitted data to pass certain validity and data integrity checks at year end. In 2012, as our internal systems are enhanced, we will require agencies to submit their proprietary and budgetary data quarterly.

Ms. WATSON. We certainly want to thank the two of you. I would like you to say in place and we are going to go back to panel one.

We are going to submit the questions we had to you and you can respond in writing in the interests of time. There is a little game-playing going on on the floor. There are motions to adjourn. So rather than run back and forth, we are going to stay here and at least hear your presentations. You can explain your bill and then we will ask for the answers, the questions and then the answers, through mail. I am sorry we can't share the responses with the audience but we are busy on the floor as you can see.

Mr. Cuellar, please. Stay in place; he can use the third mic.

**STATEMENT OF HON. HENRY CUELLAR, A REPRESENTATIVE
IN CONGRESS FROM THE STATE OF TEXAS**

Mr. CUELLAR. Thank you very, very much for allowing me to be here with you. I want to join the Members that have helped me out in this particular bill.

One of the things I have always believed is that the Federal Government can do two things to become more efficient, more effective, and more accountable. That is, we can implement program assessment standards and we can use those standards to conduct legislative oversight. But in order to perform both tasks, we must have accurate financial information from our agencies. That is a necessity.

The piece of legislation that I have introduced is H.R. 2142: The Government Efficiency, Effectiveness, and Performance Improvement Act. Improving the performance of our agencies is a bipartisan issue, which is a hallmark of good government. Also, adequate program assessments will provide agencies with data that can help them in the formulation of accurate financial information.

Certainly, I want to thank my colleague Dennis Moore for his significant contributions to this legislation as well as other Members that have cosponsored this legislation. Also, I want to thank Bernice Steinhardt from the Government Accountability Office. She and her colleagues have written extensively on this area. I certainly ask you all to take a look at her work.

What gets measured gets done. This is the focus of this particular focus that we have. It is basically looking at results oriented government, setting goals and performance targets for our agencies, and making sure that those measures become results that we are looking at.

There was a book that was written more than 10 years ago, back in 1992, by David Osborne and Ted Gaebler. It is a book that they called Reinventing Government. There they talk about certain principles. I think, Madam Chair, that this is very important. They talk about how what gets measured gets done.

If you don't measure results, you can't tell success from failure. If you can't see success, you can't reward it. If you can't reward success, you are probably rewarding failure. If you can't recognize failure, you can't correct it. If you can demonstrate results then you can win public support.

To summarize this, I would like to just give you a little bit of show and tell. The rest of my testimony is here. I would ask you to look at bill patterns. Bill patterns for appropriations have been

transformed across the States. As you know, most States have done what we call results oriented government. The Federal Government did a little bit in 1993 under President Clinton, but I am using Texas as the pattern just as an example.

What you see is that the bill pattern that a lot of States have gone to is what we call, first, the line item pattern. What you see there is basically that they say one item like travel, this is how much they get. This is how much they get for, let us say, services that they provide. You can see it is a very simple way. You don't get much information. That was in the 1970's.

You move into the 1980's and move more into what we call a program type of bill pattern. You look at it and it sets up a little bit more of the programs instead of very detailed items. You can see a little bit of evolution.

Then you move into the modern, and I am using Texas as an example. Basically, here what you would see is that you have the amount of services but you also have, if you keep going down on the area, you see goals there. You see outcomes. You see strategies. You get the efficiencies and how much it costs to do certain things, outputs.

When you look at this type of information, the financial information that is provided is put in a particular area in a particular way that provides you more information and therefore provides better legislative oversight. Madam Chair, you will see there that you will have a goal for the agency and you will see what results you want to see. Instead of measuring activity, you will measure the results that you want to see.

Finally, as the last thing, let me show you the next one. Basically, the next one is what the Federal Government looks like. If you look at the Federal budget, this is what we have. In many ways, it reminds me of what we were doing in the 1970's in a lot of States. You see there that it basically will say this program gets X amount of dollars and this next program gets X amount of dollars.

It is basically what States were doing in the 1970's. Here we are already in the 21st century and our Federal Government has not gone to measuring results, measuring the information that we need to look at. We are still in the 1970's in many ways, or before that at the Federal Government.

I think this committee, Madam Chair, has a great opportunity, especially now when we are spending a lot of money, to start looking at results instead of saying here is \$1 billion to do this.

There is a lot more detail but I think it is all in my testimony. I think the show and tell was probably the best way to show where we are as the Federal Government and how we are probably light years behind what a lot of the States have gone to. Most of the States have moved into these performance measures. I know the GAO and other organizations have done a great job at talking about this.

Madam Chair, I present this in a short period of time because we have to go vote but I would ask you to take a look at this information. Hopefully we can spend more time at a later time discussing this particular topic.

[The prepared statement of Hon. Henry Cuellar follows:]

Testimony of United States Congressman Henry Cuellar
Texas District 28

Before the

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

United States House of Representatives

June 18, 2009

**Need for a Results-Oriented Philosophy in the
Congressional Budgeting Process
Strengthening Congressional Budget Oversight and
Improving Available Financial Information**

Chairwoman Watson, Ranking Member Bilbray and members of the Committee, we are here today in pursuit of making government more efficient, effective, and accountable. I believe that the federal government can do two things to become more efficient, effective, and accountable: we can implement program assessment standards and we can use these standards to conduct legislative oversight. In order to perform both tasks we must have accurate financial information from our agencies is a necessity.

I have introduced a piece of legislation that would implement a structure for continuous program assessments, HR 2142, the Government Efficiency, Effectiveness, and Performance Improvement Act. Improving the performance of our agencies is a bipartisan issue that is a hallmark of good government. Also, adequate program assessments will provide agencies with data that can help in the formulation of accurate financial statements.

I would like to thank Representative Dennis Moore for his significant contributions to this legislation as well as the other Members who have cosponsored this bill. I would also like to thank the many individuals and organizations that have contributed to this effort including Bernice Steinhardt of the Government Accountability Office. Ms. Steinhardt and her colleagues have written extensively on this subject, and we continue to use their research as guidance.

What Gets Measured, Gets Done

I address you today in order to shed further light on our responsibility to provide a continuous level of government improvement for our fellow citizens. The answer is not complicated or expensive; in fact it streamlines government, encourages efficiency, and rewards effectiveness. The concept that I refer to is Performance Based Budgeting. PBB is a results oriented budget tool that sets goals and performance targets for agencies, and measures their results. PBB not only increases the capacity for legislative oversight, but it also helps to increase the quality of services that our citizens receive. It is important for our legislative body to remain representative and responsive to the needs of our citizens.

David Osborne and Ted Gaebler summarized the need for measurement in their book, *Reinventing Government: How the Entrepreneurial Spirit is Transforming the Public Sector* (1992):

- What gets measured, gets done
- If you don't measure results, you can't tell success from failure
- If you can't see success, you can't reward it
- If you can't reward success, you're probably rewarding failure
- If you can't recognize failure, you can't correct it
- If you can demonstrate results, you can win public support (Osborne and Gaebler 1992, 146-155)

This perspective is important, because measuring the performance of government agencies is a fundamental part of our responsibility as a responsible Congress.

A Congress Exercises Four Fundamental Functions:

- Lawmaking and public policy making. Congress makes laws and sets public policy for the United States. This function includes fact-finding and analysis related to both governmental and non-governmental activities.
- Raising revenues. Congress has authority to levy taxes, fees, and authorize the sale of bonds.
- Budgeting. Congress determines the activities and purposes for which government may spend money.
- General oversight of government. The Constitution prohibits Congress from executing or enforcing the law. But the Congress independently gathers information about the executive and judicial branches to aid it in its policy-making functions.

And Congress Exercises its Oversight Powers to:

- Protect the public health and welfare,
- Protect citizens' freedoms and assure access to the government,
- Preserve public property, and
- Assure itself that public funds are properly spent and controlled.
- Performance Management in State Governments

Performance Budgeting is not a new idea. Most state governments have undertaken the challenge of implementing Performance Based Budgeting in their own agency institutions. Many of these innovative programs have led to improved efficiency, transparency and effectiveness. This push has also allowed state legislatures to become more accountable in their oversight activities. States experiencing budget shortfalls have used PBB principals to

increase the quality of services given to the public. A lot of wisdom has been gained through the trials in our states, and almost all of them are ahead of the Federal Government in PBB implementation. We need to implement policy examples from the best states, and we need to avoid our past mistakes. The information is at our fingertips, we owe our citizens their due diligence.

Bill Pattern Evolution

One of the most important changes occurring through the performance budgeting process is the inclusion of performance information in the budget itself. Having performance information included in a manner that is appropriately organized and easily understandable is an important first step. When we have this type of information we have a useful tool for formulating benchmarks. This information can also be valuable in determining the true budgetary costs of each individual type of service that we provide to our citizens.

Agencies can use this information to justify funding levels for any specific amount of output. Appropriators will also have a better idea of the connection between funding and the impact of their programs.

Need for Program Assessment

As mentioned earlier, adequate legislative oversight cannot happen without adequate program assessment. My legislation, HR 2142 would do the following:

- **Program Assessments** – Require that every federal program be assessed at least once every five years by teams of analysts from agencies and OMB to evaluate: the clarity of the program's purpose and objectives, the quality of the program's management and organizational design, the quality of the program's strategic and performance planning and goals, and the effectiveness of the program in meeting its strategic objectives.
- **Assessment Reports** – Require that assessment reports summarizing the findings of each assessment be submitted along with the President's budget every year. These reports will provide critical information on program strengths and weaknesses to policymakers and managers.

- **Improvement Plans** – Require agencies to submit, within 90 days after the submission of assessment reports, improvement plans that lay out the management, organizational, and operational reforms the agency will implement to respond to the issues raised in the assessment report and to improve the performance of the program. Improvement plans will help ensure that agencies take necessary follow up actions to address weaknesses identified during an assessment.
- **Agency Performance Improvement Officers and the Performance Improvement Council** – Establish “agency performance improvement officers” to supervise the performance management activities of agencies, and the Performance Improvement Council, to assist in the development of performance standards and evaluation methodologies, identify best practices in performance management practices, and facilitate the exchange of information on performance among agencies. This will ensure that each agency has at least one executive to focus solely on performance issues.

Conclusion

Performance-based budgeting is a results-driven method which encourages managerial improvement and better program results. We have a responsibility to our citizens, and the dialogue must start with us.

Program assessment is crucial to the development of data needed to identify weak points and improve program performance. What we want to have is a program assessment tool that is Non-Partisan. It should not change when one Administration changes over to another and performance measures should not be under the influence of partisan trends.

We need to Stand Together and do what is best for our citizens. It is for this reason that we need to bring all of Congress together in the support of these necessary solutions.

Thank you for the opportunity to testify. I will look forward to answering your questions.

Congress of the United States
Washington, DC 20515

April 28, 2009

**Cosponsor the Government Efficiency, Effectiveness, and
Performance Improvement Act of 2009**

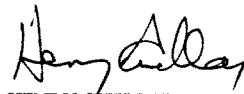
Dear Colleague:

Over the years there have been many attempts to streamline the operations of the federal government so that agencies operate in an efficient manner and are effective in achieving their objectives. Many advocates of good government believe that efficiency, effectiveness and accountability in the operations of government agencies can be improved if there is an enhanced focus on performance results, as well as the integration of performance information into budgetary and operational decision making.

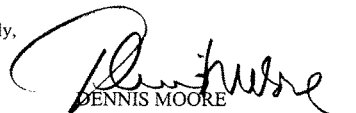
To improve the federal government's performance management process, and increase the availability and transparency of performance information, we have introduced the Efficiency, Effectiveness, and Performance Improvement Act of 2009. The Government Efficiency, Effectiveness, and Performance Improvement Act would:

- **Program Assessments** – Require that every federal program be assessed at least once every five years to evaluate the clarity of the program's purpose and objectives, the quality of the program's management and organizational design, the quality of the program's strategic and performance planning and goals, and the effectiveness of the program in meeting its strategic objectives.
- **Assessment Reports** – Require that comprehensive assessment reports summarizing the findings of each assessment be submitted along with the President's budget every year.
- **Improvement Plans** – Require agencies to submit, within 90 days after the submission of assessment reports, improvement plans that lay out the managerial, organizational, and operational reforms the agency will implement to respond to the issues raised in the assessment report and to improve the performance of the program.
- **Agency Performance Improvement Officers and the Performance Improvement Council** – Create "agency performance improvement officers" to supervise the performance management activities of agencies, and the Performance Improvement Council, which will assist in the development of performance standards and evaluation methodologies, identify best practices in federal performance management practices, and facilitate the exchange of information on performance among agencies.

By using improving the federal performance management process and increasing the accessibility of performance information, congressional policy makers will be able to conduct more effective oversight, make better-informed authorization and appropriation decisions, identify and eliminate duplicative programs, and help improve the performance of federal programs. Please join us in this effort to make our government more effective, efficient and accountable.


HENRY CUELLAR
Member of Congress

Sincerely,


DENNIS MOORE
Member of Congress



Congressman Henry Cuellar 28th Congressional District, TX

A Legislator's Guide to Using Performance Information

Basic questions to ask agencies in budget and program review hearings:

- What is your program's (or agency's) primary purpose? Which citizens are affected?
- What key results are expected from this use of taxpayers' funds?
- * • What key performance indicators do you use to track progress in attaining these results?
- What were the results in the most recent years?
- How do these results compare to your targets? Have any results been unexpectedly good or unexpectedly poor?
- How do the results compare to other benchmarks, e.g., other states?
- For which citizen groups have the results been less than desired? (Examples: Groups by location, gender, income, age, race/ethnicity, disability, etc.)
- If any targets were missed, why were those targets missed?
- What is currently being done to improve deficiencies?
- What actions does your new/proposed budget include that would improve results?
- How would the results change if funding is increased by 5 percent? Decreased by 5 percent?
- Which groups of citizens might benefit? Which might lose? To what extent?
- What other programs and agencies are partners in producing desired results?

Source: Legislating for Results, Action Brief 9. National Conference of State Legislatures and the Urban Institute,

Bill Pattern Evolution

Bill Pattern Comparison for the Texas Department of Insurance 1970-1971

Personal Service—			
Board Members at \$23,500	\$	70,500	\$ 70,500
Commissioner of Insurance		23,000	23,000
Liquidator and Conservator		16,016	16,016
Administrative Assistant		14,000	14,000
Fire Prevention Coordinator		13,248	13,248
Salaries of Classified Positions		3,865,914	3,997,355
Seasonal Help		25,000	25,000
Total, Personal Services	\$	4,027,678	\$ 4,159,119
Other Expenses—			
Travel		398,710	398,710
Consumable Supplies and Capital Outlay		326,458	325,138
Out-of-State Examinations		90,000	90,000
Burial Rate Board		2,500	2,500
Director of Personnel, Assistant Executive Director		16,000	16,000
Tuberculosis		15,500	15,500
Staff Officer and Planning Assistant		15,500	15,500
All other expenses		27,447,795	29,641,065

Bill Pattern Evolution

Bill Pattern Comparison for the Texas Department of Insurance 1982-1983

Operating Fund No. 36:

1.	Board Officers:				
a.	Board Members (3)	153,900	\$	167,400	
b.	Board Administration	253,215		269,993	
c.	Information Services	254,970		278,006	
2.	Commissioner's Offices:				69
a.	Commissioner	49,600		53,900	
b.	Administration	231,234		217,994	
c.	Hearings	167,213		175,159	
d.	Legal Selection	410,886		446,927	
e.	Personnel	213,340		232,047	
f.	General Support Service	905,454		933,422	
g.	Data Processing	1,671,931		1,518,631	
h.	Company Conservation and Rehabilitation	175,824		186,926	
3.	Business Practices, Enforcement				
a.	General Management	423,916		459,082	
b.	Licensing and Regulation (IA,A,PFC)	647,503		698,337	
c.	Claims, Complaints, and Investigations	822,862		893,937	
d.	Administration of (L,A,andH) Insurance, Health Maintenance Organizations and prepaid legal services	998,456		895,808	

Bill Pattern Evolution

Bill Pattern Comparison for the Texas Department of Insurance 1998-1999

A. Goal: Encourage Fair Competition		
Encourage fair competition in the insurance industry		
Outcomes:		
Percent of Agent License Filling Completed in 15 days	92%	92%
Percent of Stationary Rate and Form Fillings Completed Within 90 Days	50%	55%
Number of Automobiles Covered by Voluntary Policies a Percent of Total Private Passenger Automobiles in Underserved Markers	45.1%	46.5%
Percent of MAP Applications Eligible for Referral Resulting in the Insurance of a Residential Property Insurance Policy	50%	50%
Percent of Contested Cases Finalized in 180 Days	80%	80%
Estimated \$ Amount (in Millions) of Insurance Fraud Eliminated	23	25

(Continued)

Strategy: Promote Competition \$ 9,390,159 \$ 9,388,959

Collect and analyze market data, provide information to consumers and industry, and process rates, forms and other required filings.

Outputs:

Number of Inquiries Answered	275,000	275,000
Number of Rate Guides Distributed	130,000	130,000
Number of Life/Health Insurance Filings Completed	23,500	23,500
Number of HMO Form Filling Completed		

71

Efficiencies:

Average Costs per Rate Guide Distributed

Explanatory:

Total Number of Licensed Agents	171,000	176,000
Number of Texas-Based Required Companies	805	807
Number of Non-Texas Based Required Companies	1,885	1,890
Number of License HMOs	65	70

DEPARTMENT OF AGING AND DISABILITY SERVICES
(Continued)

Texas State Budget FY
2010 and FY 2011

Professional Fees and Services	27,995,960	27,995,962
Fuels and Lubricants	1,437,450	1,437,450
Consumable Supplies	6,372,901	6,372,901
Utilities	13,602,578	13,602,576
Travel	12,734,957	12,919,598
Rent - Building	298,042	298,052
Rent - Machine and Other	4,283,953	4,283,953
Other Operating Expense	232,892,408	176,310,295
Client Services	5,462,633,408	5,661,264,223
Food for Persons - Wards of State	9,854,454	9,854,454
Grants	206,682,226	198,242,799
Capital Expenditures	12,868,615	15,658,087

Total, Object-of-Expense Informational Listing \$ 6,548,409,069 \$ 6,686,398,470

Estimated Allocations for Employee Benefits and Debt Service Appropriations Made Elsewhere in this Act:

Employee Benefits

Retirement	\$ 28,621,627	\$ 29,050,952
Group Insurance	120,270,824	130,706,628
Social Security	38,966,041	39,550,532
Benefits Replacement	3,823,878	3,632,684

Subtotal, Employee Benefits \$ 191,682,370 \$ 202,940,796

Debt Service

TPFA GO Bond Debt Service	\$ 13,613,674	\$ 15,360,232
Lease Payments	151,175	151,612

Subtotal, Debt Service \$ 13,764,849 \$ 15,511,844

Total, Estimated Allocations for Employee Benefits and Debt Service Appropriations Made Elsewhere in this Act \$ 205,447,219 \$ 218,452,640

1. **Performance Measure Targets.** The following is a listing of the key performance target levels for the Department of Aging and Disability Services. It is the intent of the Legislature that appropriations made by this Act be utilized in the most efficient and effective manner possible to achieve the intended mission of the Department of Aging and Disability Services. In order to achieve the objectives and service standards established by this Act, the Department of Aging and Disability Services shall make every effort to attain the following designated key performance target levels associated with each item of appropriation.

	2010	2011
A. Goal: LONG-TERM SERVICES AND SUPPORTS		
Outcome (Results/Impact):		
Percent of Long-term Care Individuals Served in Community Settings	74.15%	74.3%
Average Number of Individuals Served Per Month: Medicaid Non-waiver Community Services and Supports	110,754	110,971
Average Number of Clients Served Per Month: Waivers	52,131	56,651
Number of Persons Receiving Services at the End of the Fiscal Year: Waivers	54,375	58,896
A.1.1. Strategy: INTAKE, ACCESS, & ELIGIBILITY		
Output (Volume):		
Average Monthly Number of Individuals with Mental Retardation (MR) Receiving Assessment and Service Coordination	8,023	8,023
A.2.1. Strategy: PRIMARY HOME CARE		
Output (Volume):		
Average Number of Individuals Served Per Month: Primary Home Care	52,277	52,599
Efficiencies:		
Average Monthly Cost Per Individual Served: Primary Home Care	825.48	838.46
A.2.2. Strategy: COMMUNITY ATTENDANT SERVICES		
Output (Volume):		
Average Number of Individuals Served Per Month: Community Attendant Services	40,925	40,341
Efficiencies:		
Average Monthly Cost Per Individual Served: Community Attendant Services	781.52	788.14

FY 2009 Federal
Appropriations Language

1 any other appropriation shall be used to provide meal serv-
2 ices at or for Job Corps centers.

3 VETERANS EMPLOYMENT AND TRAINING

4 Not to exceed \$205,468,000 may be derived from the
5 Employment Security Administration Account in the Un-
6 employment Trust Fund to carry out the provisions of 38
7 U.S.C. 4100-4113, 4211-4215, and 4321-4327, and
8 Public Law 103-353, and which shall be available for obli-
9 gation by the States through December 31, 2009, of which
10 \$1,949,000 is for the National Veterans' Employment and
11 Training Services Institute. To carry out the Homeless
12 Veterans Reintegration Programs under section 5(a)(1) of
13 the Homeless Veterans Comprehensive Assistance Act of
14 2001 and the Veterans Workforce Investment Programs
15 under section 168 of the Workforce Investment Act,
16 \$33,971,000, of which \$7,641,000 shall be available for
17 obligation for the period July 1, 2009 through June 30,
18 2010.

19 OFFICE OF INSPECTOR GENERAL

20 For salaries and expenses of the Office of Inspector
21 General in carrying out the provisions of the Inspector
22 General Act of 1978, \$76,326,000, together with not to
23 exceed \$5,815,000, which may be expended from the Em-
24 ployment Security Administration Account in the Unem-
25 ployment Trust Fund.

Ms. WATSON. While you are still seated there, let me just ask you this: We have had hearings on the moneys that we have sent into Iraq after the mission was accomplished and the plane loads flew. We still can't account for \$9 billion. Would this new format that you are laying out in your bill be able to tell us from the Department of Defense and the Pentagon how to trace this money and where possibly it will go? Looking for results, I don't know if we got results.

Mr. CUELLAR. Right, exactly. If you look at the Federal bill pattern, and I can—

Ms. WATSON. Is that page 27?

Mr. CUELLAR. Well, that is part of it. It is one of my attachments there.

I just gave you an example. You can put the military in the same thing with program military A, program military B, program military C, and the amounts of billions of dollars. If we would put it, go back to that one right here where you see the goals, you say we are going to give you \$1 billion and from the \$1 billion we want you to meet this particular goal. Here are the measures that we want you to meet and if you don't meet those measures then, if there is a variance, we want you to come back and tell us why.

The problem is we have been giving moneys in programs and not in setting the goals, the strategies, the outcomes that we want. Part of this is our problem, Madam Chair, as Members of Congress. We are not providing the proper oversight with the tools that will provide us this information.

I believe that if you look at this, this is just an example, imagine if we said here is the money, billions of dollars, that we are sending off to Iraq. Let us say that you look at reconstruction. Here is the goal for reconstruction. Here are the outcomes we want to see. Here is the strategy. Here are the outputs that we want to look at. That will provide us more oversight to this.

Again, Madam Chair, if you look at this, we are still stuck in a 1970's or pre-1970's format. I believe this committee has the opportunity to change the way we do business in the Federal Government. We are still setting moneys in programs. Here is the example; this is what we are doing: We are just saying program A, you get this amount of dollars. Sure, there has been some performance measures that have been done in different programs but they are not assessable in an easy way to Members of Congress.

I guess the best thing I can do to summarize is that if you look at my attachments, look at the 1970's and look at the 1980's bill patterns. Look at 2000 as the example of what Texas is doing. You can use California or you can look at other States that are doing this. Then look at what the Federal Government is doing. You will see that we are still stuck in the 1970's, pre-1970's format.

Ms. WATSON. I really want to thank you for the thought that you have put into your proposed legislation. Our oversight responsibility has not been utilized to get the best results. We have to find out where our dollars are going, particularly during the time when we have such great deficits and our debt is growing every day.

Mr. CUELLAR. I ask you to look at the statement, Madam Chair, from David Osborne. I think it summarizes it. What gets measured

gets done. If you don't measure results, you can't tell success from failure. If you can't see success, you probably are rewarding failure.

Ms. WATSON. It is how you lay out that measurement to get the kind of information you want.

Mr. CUELLAR. That is correct.

Ms. WATSON. I do thank you for your proposal in front of us. To the audience, we will go through it and we will have certain questions. We are just running out of time. But we will have certain questions we will want to ask the witnesses and then they can respond in writing. We will have another hearing so that we can share the information that we get back with the general public. Thank you so much.

We are now going to turn to the third and final panel. Again, I will have to ask you to stand and raise your right hand to be sworn in.

As they are coming up, if you will continue to stand? First there is Ms. Peggy Sherry. She is the Acting Chief Financial Officer for the Department of Homeland Security. Ms. Sherry previously served as the Deputy Chief Financial Officer for the U.S. Holocaust Memorial Museum and as an auditor for the Government Accountability Office. Let me send you our condolences on the incident that happened within an area of your responsibility.

Mr. Ronald Spoehel is the Chief Financial Officer for NASA. Mr. Spoehel has served as the executive vice president, chief financial officer, and director of ICX Technologies; as executive vice president, chief financial officer, and director of ManTech International Corp.; and as chairman and founder of Alpine Partners.

Mr. Brian Riedl is a senior policy analyst and Grover Hermann fellow in Federal budgetary affairs for the Thomas A. Roe Institute for Economic Policy Studies at the Heritage Foundation. His areas of expertise include Federal spending, appropriations, economic growth, agriculture, and welfare reform.

While you are standing, I will administer the oath of office.

[Witnesses sworn.]

Ms. WATSON. All right, you may be seated. Let the record reflect that the witnesses answered in the affirmative.

I would like to proceed with Ms. Sherry first. The briefer you could be, the better. Thank you.

STATEMENTS OF PEGGY SHERRY, ACTING CHIEF FINANCIAL OFFICER, DEPARTMENT OF HOMELAND SECURITY; RONALD SPOEHEL, CHIEF FINANCIAL OFFICER, NASA; AND BRIAN M. RIEDL, SENIOR POLICY ANALYST AND GROVER HERMANN FELLOW IN FEDERAL BUDGETARY AFFAIRS, THE HERITAGE FOUNDATION

STATEMENT OF PEGGY SHERRY

Ms. SHERRY. Thank you, Chairwoman Watson, Ranking Member Bilbray, and members of the subcommittee for the opportunity to testify before you on the results of the Department of Homeland Security's fiscal year 2008 financial statement audit.

I also thank you for enacting the DHS Financial Accountability Act. With the passage of this act, DHS launched an ambitious multi-year effort to build assurances for internal controls as well

as to execute corrective actions to improve financial accounting and reporting.

DHS received a disclaimer of opinion on its fiscal year 2008 financial statements. However, for the third consecutive year, audit results show we continue to make steadfast progress. Auditors noted the Department's progress in implementing corrective actions and improving the quality and reliability of our financial reporting. Our multi-year corrective action plans led to reducing the number of material weaknesses from 10 to 7 to 6 in the past 3 years. We also reduced the number of disclaimer conditions from 10 to 6 to 3 in the past 3 years.

In addition, the Secretary's Financial Reporting Assurance Statement has improved from a statement of no assurance in fiscal year 2005 to a statement that illustrates internal controls are well designed in fiscal year 2008. For fiscal year 2009, the Department's goal is to provide our first ever assurance that internal controls are effectively working with the exception of those in a few components.

Audit challenges do remain but in more focused areas. We are partnering with and providing oversight to the Coast Guard, the Transportation Security Administration, and FEMA to address audit disclaimer and material weakness conditions.

We continue to demonstrate progress in performance reporting. I am pleased that our 2008 Performance Report was recently ranked fourth highest in the Federal Government for providing useful information on the public benefits and outcomes that DHS delivers. This is particularly noteworthy since 2 years ago DHS was ranked 21 out of 24. We improved the link between resources and outcome oriented performance goals, and we described our improvement strategies when goals were not met.

We continue to implement initiatives aimed at increasing financial management competencies and sustaining financial management improvements throughout the Department. For instance, in the fall we released the DHS Financial Management Policy Manual. This online manual provides guidance on budget formulation, execution, financial management, accounting, and reporting while introducing standardization throughout DHS with a strong focus on internal controls.

Also, we issued the third edition of the Internal Control Playbook which outlines the Department's strategy and process to eliminate internal control weaknesses and build strong management assurances.

The most important part of building our core financial management competencies is strengthening and training our workforce. We are in our fourth series of the CFO Mentorship Program for mid-level managers to help create a pipeline of strong candidates for senior financial management leadership roles at DHS. Additionally, nearly 400 newly hired employees from across the country have attended common financial management training. They learn about the different missions within the Department, our core financial functions, and key financial management fundamentals. I also sponsor a recurring certification program to professionalize the DHS workforce.

As we make improvements in our financial reporting and strengthen the skills of our workforce, we continue moving forward to consolidate our financial systems. This initiative will greatly improve the quality of and control over DHS financial data, making financial accounting processes more efficient and serving as the foundation for standard business and financial management practices across the Department.

Financial management has come a long way at DHS and I am inspired by the extraordinary efforts of our dedicated staff at headquarters and in the components. We remain committed to improving financial management, continuing our efforts to strengthen internal controls, and to realigning business processes for improved effectiveness and efficiency in support of our mission and the American taxpayer.

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

[The prepared statement of Ms. Sherry follows:]



Statement by

Peggy Sherry

Acting Chief Financial Officer

Department of Homeland Security

Before the

House Committee on Oversight and Government Reform

Subcommittee on Government Management, Organization and Procurement

Hearing on

Oversight of Federal Financial Management

June 18, 2009

Thank you Chairwoman Watson, Ranking Member Bilbray, and members of the Committee for the opportunity to testify before you regarding the results of the Department of Homeland Security's (DHS) Fiscal Year (FY) 2008 financial statement audit.

I would like to thank Congress for enacting the Department of Homeland Security's Financial Accountability Act. With the passage of the Act, we launched an ambitious multi-year effort to build assurances for internal controls as well as executed corrective actions to improve our financial accounting and reporting. We have worked collaboratively with Congress, the Government Accountability Office, the Office of Management and Budget, the DHS Office of the Inspector General, and our Independent Auditor to ensure that we strengthen internal controls in support the Department's mission.

DHS is committed to improving financial management, continuing efforts to strengthen internal controls, and re-aligning business processes for improved efficiencies and effectiveness. Our goal is to secure the nation using resources that are both fully accounted for and effectively used.

FY 2008 Financial Statement Audit Results

For the third consecutive year, the results of the annual financial statement audit show DHS continues to make progress. When DHS was formed, we inherited 30 significant deficiencies with 18 classified as material weaknesses. These included insufficient internal controls, system security deficiencies, and incomplete policies and procedures to produce auditable financial statements.

As our independent auditors report, the Department continues to make progress implementing corrective actions and improving the quality and reliability of our financial reporting. Consider the following accomplishments:

- In FY 2006, DHS launched an ambitious multi-year effort to implement corrective actions, reducing the number of material weaknesses from 10 in FY 2006, to 7 in FY 2007, to 6 in FY 2008.

- The Secretary's Financial Reporting Assurance Statement has improved from a statement of no assurance in FY 2005 to a statement that good internal controls are in place in FY 2008. For FY 2009, the Department's goal is to provide our first ever assurance that internal controls are effectively working, with the exception of those in a few components.

The remaining audit challenges are more specific and easier to target. We continue to partner with and provide oversight to the U.S. Coast Guard, Transportation Security Administration, and Federal Emergency Management Agency to address audit disclaimer and material weakness conditions. We also continue to demonstrate progress in performance reporting. I am pleased to report that our FY 2008 Performance and Accountability Report was recently ranked by the Mercatus Center as the fourth highest in the federal government for providing useful information on the public benefit and positive outcomes DHS delivers as well as accounting for our use of tax-payers' dollars. This is particularly notable: just two years ago, DHS was ranked 21 out of 24.

Financial Management Improvement Initiatives

When our former CFO last testified before this Committee, he discussed a series of initiatives intended to build a common DHS financial management culture and achieve sustainable financial management improvement. I am pleased to update you on the substantial progress we have made in these areas.

- We are in our fourth series of the CFO Mentorship program for mid-level managers. This program helps create a pipeline of strong candidates for senior financial management leadership roles at DHS.
- We continue to ensure a common set of competencies for all DHS financial management employees. Nearly 400 employees have attended new hire training since its inception in March of 2007. They learn about the different missions within the Department; our core financial functions; and the responsibilities of all financial management employees to support strong internal controls and to enforce compliance with fiscal law.

- Last fall, we published the Financial Management Policy Manual, an online repository that provides DHS guidance for program and budget formulation, budget execution, financial management, accounting and reporting. The Manual provides standard financial management policies to be used throughout the Department, with a focus on strong internal controls that help DHS accomplish our financial management goals by preventing and detecting potential waste, fraud, and abuse.
- We have issued three editions of the Internal Control Playbook. The Playbook outlines the DHS strategy to design and implement an effective internal control system to support our mission, eliminate internal control weaknesses, and build management assurances. In addition, we established an Internal Control Management Office to ensure the internal control improvements we put in place continue to work effectively.
- We are moving forward with our plans to consolidate our financial systems. This initiative will greatly improve the quality of and control over DHS financial data, make the financial accounting process more efficient throughout DHS, and serve as the foundation for standard business and financial management practices across DHS.

Financial Systems Consolidation

Mission support requires a real-time enterprise view of DHS resources. Currently, DHS has 13 separate financial management systems each reflecting many different business processes, numerous accounting lines, and varying levels of system integration—with many still relying on manual processes—resulting in inconsistent data across the Department. Likewise, maintaining multiple systems across the Department often leads to replication and high overhead when upgrades, support services and system changes are necessary.

As we work to address our financial management challenges and increase transparency in reporting, the Transformation and System Consolidation (TASC) initiative is critical. This initiative will result in the Department acquiring a proven, integrated financial, asset, and acquisition management system. This important

initiative will, among other things, enhance mission support and improve our ability to report financial data in a timely and accurate way.

We are in the midst of conducting the TASC acquisition and will select a vendor by the second quarter of FY 2010. Once awarded, the Department will integrate and standardize its financial, procurement, and asset management processes, including establishing one DHS accounting line. DHS also has a strong program management office to provide full-time, day-to-day oversight of the project to help ensure success.

The Path Forward

We have demonstrated our commitment both to develop and execute strong, actionable plans that improve our financial management with strong internal controls. Consolidating our financial, asset, and acquisition systems will accelerate Department-wide progress in our efforts for efficiency, effectiveness, transparency, and accountability. As DHS undertakes its transformation and system consolidation effort, the Department's financial management infrastructure will become more stable and will significantly contribute to achieving the intended goals of the DHS Financial Accountability Act.

Conclusion

Financial management has come a long way at DHS. I continue to be inspired by the extraordinary efforts of our dedicated staff at Headquarters and in the Components, and I am committed to pursuing financial management success. I appreciate the support we have received from our Office of Inspector General, the GAO, this Committee, and Congress. Thank you for your leadership and your continued support of the Department of Homeland Security.

Question#:	1
Topic:	statements
Hearing:	Oversight of Federal Financial Management (JUL 8 th , 2009)
Primary:	Diane E. Watson, Chairwoman
Committee:	HOUSE OVERSIGHT & GOV REFORM COMMITTEE – SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

Question: For some time, DHS auditor has been unable to offer an opinion on the Department's balance sheet and statement of custodial activity for multiple reasons, including material weaknesses related to financial reporting and financial systems (these are the two out of five financial statements that were audited in fiscal year 2008).

What do you see as the most critical financial management challenges facing DHS in obtaining an opinion on these two statements? When do you think that DHS will resolve these issues so that the agency will be able to receive an opinion on its balance sheet and statement of custodial activity?

Response: The two most critical financial management challenges in obtaining a DHS clean audit opinion are financial management at the U.S. Coast Guard and the reliance on outdated accounting systems lacking department-wide integration and financial management at the U.S. Coast Guard.

The Coast Guard organizational structure does not support accountability for internal controls over financial management and systems, to include oversight, roles and responsibilities, and accounting standards. In addition, the Coast Guard has not fully implemented an entity-wide risk assessment process and monitoring controls. For example, the Coast Guard lacks adequate levels of financial accounting expertise; roles and responsibilities are not clearly defined and promulgated; a prior reorganization eliminated the comptroller position; and a previous self-assessment model was ineffective.

In FY 2008, the Coast Guard was unable to provide sufficient evidential matter or make knowledgeable representations of facts or circumstances, that supported transactions and account balances of the Coast Guard as reported on the DHS financial statements. Additionally, the Coast Guard control deficiencies contributed to each of the six DHS Internal Control Deficiencies. While other DHS Components are in the process of effectively remediating their respective control deficiencies, the Coast Guard remediation is progressing at a slower pace.

To improve remediation, the Coast Guard recently created a Senior Executive Service comptroller position at Headquarters to increase financial management oversight. It has developed a plan to increase financial management controls over all balance sheet lines, such as funds balance with Treasury (\$5.8 billion), Property (\$8.8 billion), and Actuarial Pension Liability (\$26.6 billion) (amounts are as of 4/30/09). To further its progress, the Coast Guard is

Question#:	1
Topic:	statements
Hearing:	Oversight of Federal Financial Management (JUL 8 th , 2009)
Primary:	Diane E. Watson, Chairwoman
Committee:	HOUSE OVERSIGHT & GOV REFORM COMMITTEE - SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

refining its plan to address deficiencies and is in the early stages of executing that plan. By September 30, 2009, the U.S. Coast Guard plans to do the following:

- Establish the Coast Guard chief financial officer as the technical authority for all financial management.
- Establish an Accounting Oversight Board.
- Develop a consolidated communications strategy for financial transformation.
- Create a Financial Strategy for Transformation and Audit Readiness (FSTAR) technical support team to oversee Mission Action Plan execution and perform an entity-wide risk assessment.

The Department is in the process of selecting a new consolidated financial management system that will replace those currently servicing the DHS Components. The implementation will occur over the next three years, and as it progresses, several system improvements and efficiencies will occur. The result will be more timely and accurate financial information that will be critical for DHS to achieve a clean audit opinion.

DHS plans for the U.S. Coast Guard, FEMA, Immigration and Customs Enforcement (ICE), and U.S. Citizenship and Immigration Services (USCIS) to undergo complete standalone audits by FY 2013. The scheduling of the corresponding audit scope is based on each component's success in both remediating financial reporting internal control weaknesses as detailed in the DHS Internal Control Playbook and demonstrating the operating effectiveness of the newly implemented controls.

In FY 2009, two of the four referenced components (ICE and USCIS) are undergoing standalone audits of their respective balance sheet statements (is balance sheets appropriate terminology? Should they say assertion. No balance sheet audit). It is a widely held practice for standalone audits to begin with the balance sheet statement. Once this statement passes audit, the component is subject to the audits of the remaining financial statements, such as the statement of budgetary resources. We anticipate both ICE and USCIS will succeed in this year's balance sheet and statement of custodial activity audit.

Based on current progress in correcting its material weakness conditions, FEMA will undergo a balance sheet audit in FY 2011, followed by audits of all financial statements in FY 2012. The U.S. Coast Guard will undergo a balance sheet audit in FY 2012, and all financial statements will be audited in FY 2013.

Question#:	2
Topic:	IPIA
Hearing:	Oversight of Federal Financial Management (JUL 8 th , 2009)
Primary:	Diane E. Watson, Chairwoman
Committee:	HOUSE OVERSIGHT & GOV REFORM COMMITTEE – SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

Question: In FY 2008, auditors reported that DHS was again found to be out of compliance with the Improper Payments Information Act.

How does DHS plan to comply with the Improper Payments Information Act's requirements, and when do you expect that full compliance will be achieved?

Response: DHS has made significant progress complying with the Improper Payments Information Act. In the FY 2008 DHS Annual Financial Report the independent auditors reported the Department has made positive progress towards complying with the Act including: issuing strong guidance, improving training and oversight, identifying programs susceptible to improper payments, conducting Department-wide risk assessments, and completing payment sample testing for most high risk programs. FEMA is the only DHS component that still needs to make additional progress to comply with the Act. FEMA's payment sample testing of its grant programs in FY 2009 is an interim step toward full improper payment reporting in FY 2010. FEMA will complete payment sample testing on all programs this year except for the Homeland Security Grant Program, where testing will be limited to the program's largest state (California). FEMA expects to fully comply with the Improper Payments Information Act in FY 2010, when the Homeland Security Grant Program and FEMA's other high risk programs will measure and report improper payment rates.

Question#:	3
Topic:	error rate
Hearing:	Oversight of Federal Financial Management (JUL 8 th , 2009)
Primary:	Diane E. Watson, Chairwoman
Committee:	HOUSE OVERSIGHT & GOV REFORM COMMITTEE – SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

Question: To date, the error rate for DHS’s Disaster Relief Fund Vendor payments grew from 2.4 percent in FY 2007 to 7.5 percent in FY 2008, and improper payments increased by more than \$100 million as a consequence, from \$42 million to \$144 million.

Why has this program’s error rate skyrocketed, and what is DHS doing to tackle this problem?

Response: The error rate for DHS’s Disaster Relief Fund vendor payments grew in FY 2008, as compared to FY 2007, primarily due to a change in testing standards. In FY 2008 DHS completed stricter testing to verify that officials who signed for invoices and deliveries were appropriate and authorized. DHS noted additional internal control weaknesses when deliveries of goods and services did not always meet contract standards in disaster situations. To address these weaknesses, FEMA is reviewing and standardizing contract language, improving Contracting Officer Technical Representative training, and monitoring compliance and consistency.

In addition to these steps, FEMA continues to improve its improper payment testing procedures and has established the Internal Controls Board, which is proactive in making sure rules, regulations, and guidelines are strictly followed in order to reduce the contractual deficiencies identified in improper payment testing. Additionally, the Department’s Acting Chief Financial Officer provides oversight by conducting bi-weekly staff meetings to monitor FEMA’s progress in implementing improper payment corrective actions.

Question#:	4
Topic:	controls
Hearing:	Oversight of Federal Financial Management (JUL 8 th , 2009)
Primary:	Diane E. Watson, Chairwoman
Committee:	HOUSE OVERSIGHT & GOV REFORM COMMITTEE – SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

Question: The Coast Guard oversees almost 60 percent of DHS Property, Plant and Equipment, and in FY 2008, auditors found that the Coast Guard's Property, Plant and Equipment assets were not properly designed, consistently followed, or do not include sufficient controls to ensure compliance with policy.

What specific controls is DHS developing to correct this material weakness? What is DHS timetable for implementing these controls?

Response: The U.S. Coast Guard property, plant, and equipment assets are comprised of three main categories: construction-in-progress (CIP), personal property, and inventory and related property. DHS and the U.S. Coast Guard have developed the following specific controls to assert to the completeness, existence, or valuation of the assets.

1. CIP balance for all appropriations, including Acquisition Construction & Improvement (AC&I) and Operating Expenses (OE) accounts:
 - Implement policies and procedures for capitalization of assets to address the transfer of project costs to fixed assets as projects are substantially complete, and
 - Record (conceptual level: cost accounting system based) and accept property on a timely basis.
2. Personal property (vessels, aircraft, and small boats make up more than 98% of the net book value of this line item):
 - Implement policies and procedures for the valuation of personal property either through cost documentation or appraisals,
 - Improve physical inventories processes (FY 10–13 inventories), and
 - Record and accept property on a timely basis.
3. Inventory and related property, including Operating Materials & Supplies (OM&S) and Inventory Purchased for Resale:
 - Promulgate revised inventory and asset management policy and procedures, and
 - Execute annual inventory.

By September 30, 2009 we intend to:

- Implement manual processes to use alternate valuation methods and capitalize CIP items placed in service.
- Promulgate revised Capital Investment Planning & Budgeting process to ensure timely reclassification from CIP.
- Evaluate the CIP packages for project audit readiness.
- Promulgate AC&I CIP project policy and processes (all will be in final draft).

Question#:	4
Topic:	controls
Hearing:	Oversight of Federal Financial Management (JUL 8 th , 2009)
Primary:	Diane E. Watson, Chairwoman
Committee:	HOUSE OVERSIGHT & GOV REFORM COMMITTEE – SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

- Support 95% (\$3.2 billion) of net book value of personal property; we currently support 38% (\$1.3 billion).

By September 30, 2010 we intend to:

- Assert to completeness, existence, and valuation for AC&I CIP.
- Assert to completeness, existence, and valuation for personal property (vessels, aircraft, and boats).
- Create the CIP review board.
- Promulgate revised inventory and asset management policy and procedures and execute annual inventory.

Question#:	5
Topic:	property
Hearing:	Oversight of Federal Financial Management (JUL 8 th , 2009)
Primary:	Diane E. Watson, Chairwoman
Committee:	HOUSE OVERSIGHT & GOV REFORM COMMITTEE - SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

Question: DHS has traditionally managed a greater percentage of underused property than other large agencies. Are there particular authorities that could be given to DHS as a whole, or to some of the agency's or components, that would facilitate its ability to identify and discard underutilized properties?

Response: TSA and USCG hold the majority of the Department's underutilized property. These two components within the Department are focused on remediation plans and are currently developing and implementing controls over tracking and properly accounting for its property. Both components have teams dedicated to remediating these deficiencies. FEMA substantially corrected its control deficiencies over stockpile inventory in FY2008 and progress in FY2009 includes standing up a Property Management Division internal controls team and the development of Initial Response Resources (IRR) Standard Operating Procedures. During the FY2009 audit, FEMA anticipates the auditors will conclude their control deficiencies in this area are in fact remediated. We expect that the Department's execution of these corrective action plans will yield significant results in the next fiscal year as has occurred with FEMA in FY2008. DHS will consider pursuing possible legislative authorities if the current action plans do not produce anticipated results.

Ms. WATSON. Thank you. We will now proceed with Mr. Spoechel.

STATEMENT OF RONALD SPOEHEL

Mr. SPOEHEL. Thank you, Chairwoman Watson, Ranking Member Bilbray, and members of the subcommittee. I am pleased to be here this afternoon to discuss NASA's financial management and reporting and the seriousness with which NASA takes reporting its financial and operational performance to the President, to the Congress, and to the citizens of the United States.

On an annual basis, NASA prepares a full set of financial statements that are independently audited with three audit reports on financial statements, internal controls, and legal compliance. Since fiscal year 2003, though, NASA has received a disclaimer of opinion from its auditors. While the auditors' reports for fiscal year 2008 complimented NASA on its recent progress, as with prior years they also noted NASA's continued inability to provide sufficient evidential support for the amounts presented in some accounts in the financial statements. They cited two internal control material weaknesses as well as certain non-compliance with regulatory requirements for accounting and for financial systems.

In order to address the underlying problems preventing NASA from regularly obtaining unqualified audit opinions on its financial statements, the agency took an entirely new and holistic approach in fiscal year 2008 for resolving weaknesses, improving the fidelity of its financial data, as well as expanding the usefulness of reported financial information to drive enhanced financial and operational performance.

With respect to the preparation of its accounts and financial statements, this change in approach began with developing and implementing a new global financial management strategy, the Comprehensive Compliance Strategy or CCS, that focuses on assuring full compliance with generally accepted accounting principles [GAAP], and other financial reporting requirements across the agency.

This approach begins with identifying the requirements for meeting all applicable accounting and regulatory standards for each financial statement line item, including audit evidence for each such account, and the associated internal controls needed. It also addresses overarching financial reporting process and related IT system requirements.

To ensure CCS remains current, it is updated on a continuous basis with all applicable governing regulations and accounting standards.

To support effective CCS implementation and operation, NASA has also developed and implemented a Continuous Monitoring Program [CMP], which provides the overall management control framework and detailed processes designed to drive agency compliance with CCS. CMP performance certifications from the individuals responsible are also required on a monthly basis. These are backed by a rigorous quality control process documenting that each and every control activity has been performed at each of NASA's centers monthly.

Since NASA implemented CCS and CMP midway through last year, a significant decline in the number and dollar value of excep-

tion reports and a clear path forward to full compliance have been demonstrated. With these approaches providing validated performance for its financial statement processes and for adherence to GAAP, NASA should be able to demonstrate the effectiveness of management and internal controls, allowing the agency to eliminate the first of its two internal control weaknesses for financial systems analysis and oversight.

There are, however, key challenges remaining for obtaining an unqualified opinion. In particular, NASA's audit reports have for many years noted two critical issues with respect to the reporting of legacy property, plant, and equipment, PP&E. The first is with a sufficiency of evidential support for the PP&E balances reported and the second is with the internal controls for property accounting.

To remediate the property accounting, NASA has already implemented new property accounting policies and procedures and has incorporated a new integrated asset management module within its financial management system, taking care of those issues.

However, with respect to legacy PP&E assets, whose acquisition began before the CFO Act of 1990 and before the mandated use of GAAP accounting by the Government, NASA does not have the necessary supporting information available to provide auditable book values under current accounting standards. This includes, for example, NASA's legacy Shuttle and Space Station related assets that comprise the overwhelming portion of PP&E net asset value, about \$19 billion of the \$21.6 billion reported last year.

While the Space Station depreciation schedule brings the net asset value down to an immaterial level and naturally leads to resolution by 2016, NASA is presently developing a variety of alternatives in alignment with anticipated changes to PP&E Federal property accounting standards with a view to achieving a timelier, albeit still cost effective and efficient, solution for this issue.

The agency has made considerable progress in the last year as it established the foundation for financial management excellence with its Comprehensive Compliance Strategy, Continuous Monitoring Program, and expanded financial reporting capabilities along with improvements and consolidations to its financial management and operations. This year the agency is focused on and is committed to rigorous execution using this foundation, improving effective operation of its financial systems and processes, moving closer to achieving auditability of its financial statements, and driving even better financial performance across the agency's operations and projects.

Madam Chairwoman, thank you again. I would be pleased to respond to any questions you or the other members of the subcommittee may have.

[The prepared statement of Mr. Spoehel follows:]

HOLD FOR RELEASE
UNTIL PRESENTED
BY WITNESS
June 18, 2009

**Statement of
The Honorable Ronald R. Spoehel
Chief Financial Officer
National Aeronautics and Space Administration**

before the

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

Chairwoman Watson, Ranking Member Bilbray, and Members of the Subcommittee, I am pleased to be here this afternoon to discuss NASA's financial management and reporting. NASA takes seriously its responsibility for reporting its performance to the citizens of the United States, the President, and the Congress, as evidenced through the many public reports in which NASA details its programmatic and financial performance.

Financial Statement Audit "Disclaimed" Although Progress Complimented

On an annual basis, NASA prepares a full set of financial statements that are independently audited. There are three audit reports that cover the Agency's financial statements, internal controls, and legal compliance. Since FY 2003, NASA has received a "disclaimer" of opinion from the auditors on its financial statements. While the auditors' reports for FY 2008 complimented NASA on its recent progress, as with prior years, they also noted NASA's continued inability to provide sufficient evidential support for the amounts presented in some of the accounts in the financial statements. The reports also cited two internal control material weaknesses, as well as certain non-compliance with regulatory requirements for financial systems and an inability to meet certain requirements to ensure compliance with federal accounting standards.

New Approach Developed and Implemented in FY 2008 – Comprehensive Compliance Strategy

In order to address the underlying problems preventing NASA from regularly obtaining an unqualified audit opinion on its financial statements, the Agency took a new approach in FY 2008 toward resolving weaknesses and improving the fidelity of its financial data, as well as expanding the usefulness of reported financial information to drive enhanced financial and operational performance. With respect to the preparation of its accounts and financial statements, this change in approach began with developing and implementing a new global financial management strategy, a Comprehensive Compliance Strategy (CCS), that focuses on ensuring full compliance with Generally Accepted Accounting Principles (GAAP) and other financial reporting requirements. The CCS serves as the basis for implementing comprehensive proactive corrective actions as may be required and it provides the guiding principles for executing effective financial

management functions and activities with internal control and compliance solutions inherently embedded in the processes.

Comprehensive Compliance Strategy Identifies GAAP and other Regulatory Requirements by Financial Statement Line Item

The structure of the CCS begins with the identification of the baseline requirements by financial statement line item and account, including those on the Balance Sheet, Statement of Net Cost, Statement of Financing and Statement of Budgetary Resources. The requirements for meeting all applicable standards are identified for each of the financial statement line items and are identified in conjunction with required financial statement assertions which cover completeness, existence, accuracy, valuation, ownership, presentation, and disclosure. This serves as the foundation for identifying the evidence of auditability for each such account as required to ensure an adequate audit trail exists along with proper supporting documentation. Furthermore, the CCS addresses overarching financial reporting processes and related information technology systems. The CCS also delineates the generic control environment necessary to ensure functions and activities adhere to financial reporting requirements.

In addition, the CCS provides a solid platform for sound financial management practices and standards. Accordingly, the CCS is implemented through NASA Policy Directives (NPDs) on financial management, the associated NASA Procedural Requirements (NPRs), and the Continuous Monitoring Program (CMP). The CMP is designed to ensure that the CCS evidence of auditability flows naturally from the process, forming the Provide to Auditor (PTA) listing, and associated document generation, necessary to meet financial statement audit requirements. The alignment of CCS, the CMP, and financial management policy not only identifies actions necessary to close compliance gaps, but also provides uniform guidance that results in consistent processes, standard financial performance measurement capability, and GAAP compliance.

Continuously Updated

The components of the strategy are updated on a continuous basis to ensure that the CCS remains up to date with all governing requirements, including, but not limited to, current government regulations, accounting standards, communications from external auditors and other independent oversight bodies, reviews, and assessments. These updates also become the basis for developing issue-specific corrective actions or other remediation which may become necessary for continual full compliance with GAAP and other regulatory requirements.

CCS Facilitates Monitoring and Oversight to Ensure Operational Effectiveness

Monitoring and oversight of the effectiveness of the CCS is conducted through the Continuous Monitoring Program (CMP) as well as through ongoing Evaluation Monitoring and Testing (EMT) periodic compliance reviews. These monitoring tools are intended to provide another level of management assurance regarding compliance with the CCS. They also serve as a review program to periodically measure the effectiveness of the CMP, as well as ensure and validate the operation of a sound system of internal control over financial reporting.

Continuous Monitoring Program Provides Framework for Management Controls

While the CCS provides the roadmap for the ongoing achievement of financial management excellence, the CMP provides the overall framework of management controls that NASA uses to

assess and evaluate internal controls, compliance with GAAP, and evidence that balances and activity reported in its financial statements are auditable.

Further, the CMP ensures that errors and/or discrepancies are identified and corrected in a timely manner. It also ensures ongoing management reviews and validations of financial data and internal controls.

Continuous Monitoring Program Provides Control Activities for Each Business Process and Account

The details within each section of the CMP, referred to as Chapters, are designed to capture control activities for entire business processes for specific accounts. As a result, each Chapter may address multiple related line items in the financial statements. Each Chapter also includes the proprietary and budgetary accounts that relate to the business process. In each Chapter, control activities are defined for performing required reconciliations of each financial statement account.

Each Chapter of the CMP includes full details of the following: (i) reference to each of the financial statement line items that are supported by the section; (ii) references to each applicable general ledger account including both proprietary accounts and related budgetary accounts; (iii) management assertions to be made related to each financial statement line item and account listed; (iv) the control objectives to be met and how to detect misstatements in significant financial statement reporting assertions and Required Supplementary Stewardship Information (RSSI); (v) the GAAP financial reporting objectives that the control activities support; and, (vi) definition and applicable standards for all control activities that collectively support the management assertions, control objective, and financial reporting objective for the section.

Further, each of the control activities within each Chapter of the CMP is fully described and standards for each activity are covered as follows: (i) description of the purpose of reconciliation and any unique aspects of the activity; (ii) the frequency with which the reconciliation is to be performed (e.g., daily/weekly/monthly/quarterly); (iii) the designation of responsible reporting entity, generally either a Center or Agency Headquarters; (iv) information on the standard data sources that are to be used for the control activity; (v) information on applicable external data sources (e.g., Treasury reported confirmations); (vi) description of the transaction within the Agency's SAP financial system environment or other financial information database; (vii) the accounting periods to be analyzed, which generally are either year-to-date or inception-to-date periods; (viii) detailed explanation of the procedures and reviews to be performed; (ix) reference to valid and usual reconciling items and timing differences; and, (x) expected standards and thresholds for differences or exceptions (which may have different levels for month-end, quarter-end, or year-end financial statements).

These detailed processes and activities that comprise the CMP provide a comprehensive basis for effective monitoring and the assurance of compliance with all required and necessary control reconciliation processes at the account level.

Monthly Certification Process Ensures Timely Corrections and Provides Audit Documentation

Upon the closing of the financial books each month and the preparation of the financial statements, each NASA financial reporting entity provides a matrix of control activity results and

certifies that each control activity has been performed and completed. This ensures that either results were consistent with the standards set forth for each activity or that detailed exception reports and remediation plans were prepared and implemented. Then, each month the forms are analyzed and evaluated by both Headquarters and Center management.

NASA has also implemented a rigorous quality control process to validate that control and reconciliation processes are properly performed and the reported results are supportable and accurate. When all control activities have validated performance with results as targeted, NASA will be able to demonstrate that it has management and internal controls that ensure its financial statements are reliable and have been prepared in accordance with applicable federal GAAP. The reconciliations and other procedures performed as part of each control activity also provide the supporting documentation of balances and activities needed for audit purposes.

Key Challenges Remain to Attaining an Unqualified Opinion

Together the CCS and CMP provide the foundation and key compliance processes for addressing the data integrity, management oversight, and systems findings in the FY 2008 financial audit's first internal control material weakness, for financial systems, analyses, and oversight. By design, the CCS and CMP prompt the identification and elevation of any unresolved data integrity issues at NASA Centers, system configuration issues, and Agency-wide financial process issues. As these issues are identified and prioritized, corrective actions are designed to resolve them.

The data integrity issues identified through the CMP are, in many instances, related to anomalies at a specific Center, often due to past operating practices prior to the consolidation of all financial transactions into the Agency's SAP financial system. Once identified, the responsible Center takes the necessary actions to resolve the anomalies, with NASA Headquarters monitoring and assisting to ensure that prompt resolution occurs. The efficacy of the approach can be seen in the progress made as reported for the results of the CMP over time. From 210 exception reports totaling almost \$800 million (exclusive of the legacy PP&E account issues) across the Agency at the beginning of the CMP implementation in March 2008, last month showed substantial improvement with only 26 exceptions totaling approximately \$5 million.

With respect to remaining system configuration issues, NASA continues to identify and implement corrective measures for outstanding system issues. In FY 2007, a major SAP Version Upgrade was implemented, and at least twice during each year, including FY 2008 and 2009, system enhancements and upgrades were implemented. These upgrades collectively corrected a number of weaknesses identified by management and the auditors in the prior four years as well more recently identified issues. Nevertheless, fixes for many known issues remain to be implemented and the auditors continue to identify a variety of weaknesses as noted in their audit report on Internal Control. With the system corrections and enhancements which have been or are being implemented this year, NASA will significantly reduce, if not eliminate, incorrect transactions due to improper configuration or design within the Core Financial Module of its SAP financial management system.

NASA's other material weakness cited again in this past fiscal year's audit was on controls over reporting of legacy Property, Plant, and Equipment (PP&E) and materials contracts in the financial statements. For the more complex issues, like these related to NASA's PP&E reporting and systems configuration challenges, Agency-level solutions and intervention have been required. For example, early in FY 2008 NASA implemented a new policy and related procedures for identifying the cost of individual assets throughout such assets' acquisition

lifecycle. The policy change was based on guidance obtained from the Federal Accounting Standards Advisory Board (FASAB). The associated procedural changes support the verification and reconciliation of asset values for those assets created or developed under contracts awarded following the implementation of the revised policy, and also applied to certain large pre-existing contracts.

Additionally, during FY 2008, the Agency implemented a new Integrated Asset Management module within its financial management system that addresses a key part of the weakness and non-compliance with federal regulation noted in the audit report. This module is intended to provide the following benefits: (1) more accurate, timely recording and valuation of PP&E; (2) improved valuation, capitalization, and depreciation processes; (3) improved audit trail of capitalized PP&E; (4) standardization of NASA-held and NASA owned/contractor-held property management processes; (5) elimination of manual processes; and, (6) reduced operational costs.

With respect to legacy assets, however, like the International Space Station and Space Shuttles, whose acquisition began before the CFO Act of 1990 and the mandated use of GAAP accounting by the Government in FY 1998, NASA does not have the necessary supporting information available to provide *auditable* book values under current accounting standards. Together, Shuttle and Space Station related assets represent about \$19 billion of the total \$21.6 billion PP&E net asset value reported in NASA's September 30, 2008, year-end financial statements.

Although an issue for NASA at present, much of this issue may become moot with the passage of time, as the continuing depreciation of the Shuttle and Space Station assets brings the net asset balances on the balance sheet to levels that may become immaterial to the financial statements. The Shuttles are being depreciated through their expected useful life based on their current schedule for retirement in 2010 after completing the flight manifest, and the International Space Station is being depreciated based upon a 15-year specification life, through 2016. While the International Space Station depreciation schedule naturally leads to 2016 as an outside date for resolution of this PP&E issue, NASA is presently developing and evaluating a variety of alternatives with a view to achieving a timelier, albeit still cost efficient and effective, solution for this issue.

One of the alternatives the Agency has considered would involve a complete reconstruction of the original purchase invoice trail going back several decades since the inception of the Shuttle and the International Space Station programs. As NASA does not have the necessary records, it would need to rely on records which its contractors might be able to reconstruct. In addition to the considerable expense for reconstructing such an auditable invoice trail, the assurance of success is relatively low due to the low likelihood of contractors having maintained detailed and auditable records going back that far in time.

Another alternative is predicated on the Federal Accounting Standards Advisory Board amending applicable accounting standards, as it is currently considering in its exposure draft of a proposed Statement of Federal Financial Accounting Standards entitled, *Estimating the Historical Cost of General Property, Plant, and Equipment – Amending Statements of Federal Financial Accounting Standards 6 and 23*. This proposed standard, if it becomes effective, would amend existing accounting policies to clarify that reasonable methods of estimating original transaction data historical cost and accumulated depreciation may be used to value general property, plant, and equipment. As FASAB noted, use of estimates is a more cost effective means of implementing new accounting requirements than reconstructing actual historical amounts based on inadequate or non-existent accounting records. The Board further asserted that clarifying that

estimation based on adequate techniques is acceptable should promote cost effective implementation. NASA is preparing the foundational materials necessary for it to comply with the standard should it become effective and thereby allow the Agency to be in a position to provide auditable values for its Shuttle and Space Station PP&E accounts.

Nevertheless, until such time as (i) the reported net book value of these assets naturally depreciates to a level that is immaterial in comparison to NASA's other asset balances, or (ii) an auditable reconstruction of these assets' historical costs and revised depreciable values over more than a decade is performed, or (iii) applicable accounting standards change, or (iv) another of the alternatives under consideration is successfully implemented, NASA will not be able to attain an unqualified opinion.

Successful Implementation of Financial Management Initiatives and Continued Progress

As noted, the Agency successfully developed and introduced a new strategy and program to ensure that financial transactions are reported consistent with applicable accounting standards, laws and federal regulations and that financial data is accurate, reliable, and auditable. The strategy has contributed to a significant decline in the number and dollar value of exception reports and a clear path forward to full compliance has been demonstrated. A new PP&E policy, an upgraded Integrated Asset Management system, and revisions to accounting processes are resulting in more consistent and reliable tracking and reporting of the Agency's property, plant, and equipment capital costs. A successful transition of much of its transactional finance operations to the NASA Shared Services Center, a focus on improvements to its grants management processes, and continuing enhancements to its underlying core financial system capabilities, coupled with improvements in the Agency's financial and performance reporting, are already providing faster, more accurate, and more usable information to drive better decisions and resultant performance across the programs and projects at NASA.

In FY 2008, NASA established the foundation for financial management excellence through the newly developed and implemented Comprehensive Compliance Strategy, Continuous Monitoring Program, and expanded financial performance capabilities. In FY 2009, the Agency is focusing on rigorous execution using this foundation to improve effective operation of financial systems and processes and to drive even better financial performance across the Agency's operations and projects. Sound financial management remains vital to NASA's success in achieving its mission, requires the combined efforts of the entire Agency, and is a priority commitment for the Agency's management.

Madam Chairwoman, thank you for your support and that of this Subcommittee. I would be pleased to respond to questions you or the other Members of the Subcommittee may have.



National Aeronautics and Space Administration
Headquarters
Washington, DC 20546-0001

August 18, 2009

Reply to Attn of:

OLIA-2009:MC:ee1

The Honorable Diane E. Watson
Chairwoman
Subcommittee on Government Management,
Organization, and Procurement
Committee on Oversight and Government Reform
U.S. House of Representatives
Washington, DC 20515

Dear Chairwoman Watson:

Enclosed are responses to written questions resulting from the July 8, 2009, hearing entitled, "Oversight of Federal Financial Management," at which the Honorable Ronald R. Spoehel testified. This material completes the information requested during that hearing.

Sincerely,

A handwritten signature in black ink, appearing to read "Mary D. Kerwin".

Mary D. Kerwin
Assistant Administrator
for Legislative and Intergovernmental Affairs (Acting)

Enclosure

Responses to written questions submitted by Rep. Watson resulting from the July 8, 2009, hearing at which The Honorable Ronald R. Spoechel testified

QUESTION 1:

Since 2003, NASA has reported deficiencies related to its financial management processes and systems. Though NASA has shown improvement in its financial management and reporting, its auditors continue to disclaim an opinion on its financial statements.

- What challenges does NASA face in reforming its financial management systems?
- How does NASA plan to deal with these challenges?
- When do you estimate that NASA's issues with its financial management and systems be resolved?

ANSWER 1:

In order to address the underlying problems preventing NASA from regularly obtaining an unqualified audit opinion on its financial statements, the Agency took a new approach in FY 2008 toward resolving weaknesses and improving the fidelity of its financial data, as well as expanding the usefulness of reported financial information to drive enhanced financial and operational performance. With respect to the preparation of its accounts and financial statements, this change in approach began with developing and implementing a new global financial management strategy -- a Comprehensive Compliance Strategy (CCS) -- that focuses on ensuring full compliance with Generally Accepted Accounting Principles (GAAP) and other financial reporting requirements. The CCS serves as the basis for implementing comprehensive proactive corrective actions as may be required, and it provides the guiding principles for executing effective financial management functions and activities with internal control and compliance solutions inherently embedded in the processes.

Monitoring and oversight of the effectiveness of the CCS is conducted through the Continuous Monitoring Program (CMP) as well as through ongoing Evaluation Monitoring and Testing (EMT) periodic compliance reviews. These monitoring tools are intended to provide another level of management assurance regarding compliance with the CCS. They also serve as a review program to periodically measure the effectiveness of the CCS, as well as ensure and validate the operation of a sound system of internal control over financial reporting.

Together the CCS and CMP provide the foundation and key compliance processes for addressing the data integrity, management oversight, and systems findings in the FY 2008 financial audit. By design, the CCS and CMP prompt the identification and elevation of any unresolved data integrity issues at NASA Centers, system configuration issues, and Agency-wide financial process issues. As these issues are identified and prioritized, corrective actions are designed to resolve them.

Additionally, in FY 2008 the Agency implemented the Integrated Asset Management (IAM) Property, Plant, and Equipment (PP&E) module within its financial management system, which addresses a key part of the weakness and non-compliance with Federal regulation noted in the audit report. This module provides the following benefits: (1) more accurate, timely recording and valuation of PP&E; (2) improved valuation, capitalization, and depreciation processes; (3) improved audit trail of capitalized PP&E; (4) standardization of NASA-held and NASA owned/contractor-held property management processes; and, (5) elimination of manual processes. IAM provides a linkage between personal property equipment master records and the financial asset master record. Currently, plans are being developed to implement an IAM Real Property module in the financial management system.

As a result of the above actions, NASA has accelerated recent improvements to its financial management systems and data quality, remediating issues that had been pervasive since the implementation of the core financial system in 2003. With respect to legacy assets, however, such as the International Space Station (ISS) and Space Shuttles, whose acquisition began before the CFO Act of 1990 and the mandated use of GAAP accounting by the Government in FY 1998, NASA had not previously had the necessary supporting information available to provide *auditable* book values under current accounting standards. While an issue at present, as depreciation reduces the amounts carried on the balance sheet and as certain of the existing ISS and Space Shuttle assets are transitioned for use on other NASA programs, much of this issue may become moot with the passage of time. The Shuttle is planned to be retired in 2010 and the ISS is being depreciated based upon a 15-year specification life through 2016. While the ISS depreciation schedule naturally leads to 2016 as an outside date for resolution of this issue for NASA, the Agency is developing a variety of alternatives, in alignment with anticipated changes to PP&E Federal property accounting standards, to achieve a more timely, albeit still cost efficient and effective, solution for this issue.

QUESTION 2:

NASA also took part in OMB's pilot program to allow alternative approaches to performance and accountability reporting.

- How has NASA benefited (or not) from having a separate Agency Financial Report?
- What particular changes regarding statutory requirements for financial reporting would NASA support in order to make the report more accessible to the public?

ANSWER 2:

NASA elected to participate in the OMB Performance and Accountability Report (PAR) pilot program in FY 2007 primarily to mitigate a process and timeliness issue related to the review of the PAR. The independent auditors have access to any information deemed auditable in the traditional PAR document. While NASA agrees that all data should be able to meet the standards for verification and validation, the audit process for the PAR was lengthened considerably by auditor

attention to performance details in addition to the financial data. Since NASA's performance data has not impacted audit opinions, the pilot program offered a way to decouple the financial and performance information for more timely completion. NASA is currently evaluating its participation in the FY 2009 pilot program. NASA is also working with OMB and the Federal Accounting Standards Advisory Board to improve government financial reporting.

QUESTION 3:

NASA's FY 2008 Performance and Accountability Report states that 38 programs were excluded from the range of programs subject to risk assessment because their disbursements were not considered "material."

- What criteria does NASA use to eliminate programs from risk assessment procedures, and how was this threshold determined?

ANSWER 3:

NASA follows OMB requirements for implementation of the Improper Payments Information Act (IPIA) of 2002 to perform its risk assessment, including the identification of programs subject to assessment. OMB Circular A-123, Appendix C, *Requirements for Effective Measurement and Remediation of Improper Payments*, requires a review of programs and activities to identify those susceptible to significant improper payments. OMB defines significant improper payments as those in programs that exceed both 2.5 percent of program payments and \$10M annually. Therefore, to meet OMB's combined threshold, programs with disbursements of at least \$400M are subject to risk assessment.

However, NASA management elected to implement a more rigorous review and used a more conservative threshold of programs with disbursements of at least \$40M for selecting programs subject to risk assessment. While there are only six NASA Programs with disbursements over \$400M, use of the more rigorous threshold resulting in 42 additional programs being evaluated. Testing revealed that none of NASA's programs met the OMB definition of significant improper payments.

QUESTION 4:

NASA has a challenge in managing assets located at scattered sites across the nation, and NASA also has a policy of reusing excess or underutilized equipment as a way to reduce costs associated with purchasing new equipment. However, NASA has disagreed with GAO's recommendation that the agency's electronic property management system be modified to show the current use status of underused equipment for a given day or week.

- Isn't it the case that by failing to show an item's current use status online, NASA is thus forcing its employees to waste time in making phone calls to determine an item's availability?
- Wouldn't it be more efficient to just document an item's current use status in the electronic property management system?
- Does NASA believe its disposal of real property would be enhanced if the agency had the authority to keep proceeds from the sale of real property?

ANSWER 4:

With the new system which NASA has implemented, active equipment is visible Agency-wide for users to review equipment before it is declared excess. This visibility provides the opportunity for programmatic, technical, and scientific experts to consider and discuss possible reuse through loans or borrowing, coordinating through their property custodians or equipment managers, as noted in NASA Procedural Requirement 4200.1. Equipment issues can be made known to Property Disposal Officers and Property Custodians, so that when property is identified as excess, internal programmatic reuse opportunities are visible and maximized. Thus, NASA does not expect all NASA employees (or contactors) who are interested in using certain types of equipment to contact the end users on equipment availability. However, the option of stating a desire to a property custodian or equipment manager remains an alternative.

As the NASA Property, Plant & Equipment Module was designed and developed for a different purpose by evaluating the total business process for property management and equipment accountability, using this PP&E Module in its original configuration to document an item's current use status would not enhance the efficiency for property management. Two modules of the NASA PP&E System were designed to accurately manage property. All active records reside in the Equipment Master Record (EMR) Module. At no time should equipment in the EMR depict any status other than ACTIVE. Thus, there is no need to design a separate status category or use status for the EMR. Active equipment is visible Agency-wide. This visibility provides the opportunity for programmatic, technical, and scientific experts to discuss possible reuse through loans or borrowing, coordinating through their property custodians or equipment managers. After property is declared excess, it becomes eligible for reutilization. All excess property is processed through NASA's Disposition Module. Equipment no longer required for performance of a specific NASA requirement will be reported for reutilization screening throughout NASA. This is accomplished when an item is declared EXCESS. Declaration of excess can be made at any time or as the result of an annual walk-through.

The culmination of years of process reengineering and best practice assessments from both commercial and public sector entities resulted in a property system that achieved the goal of increasing property accountability of controlled property across the Agency. A resultant benefit is the heightened potential for property reutilization through Agency-wide visibility and accessibility to all NASA users. This capability was not previously available through the legacy system.

Retention of proceeds from the disposal of unneeded or underutilized real property assets could be an added incentive to NASA Centers if the sales proceeds could be deposited into a capital asset account and made available with or without further appropriation, for maintenance, capital revitalization, and improvements of the real property assets at the Center and remain available until expended.

QUESTION 5:

In your testimony, you state that NASA intends to retire its Space Shuttle by 2010, and the International Space Station in 2016. 5 You also refer to NASA's difficulty in tracking historical data to "provide auditable values for [the] Shuttle and Space Station Property, Plant & Equipment accounts."

- Given NASA's challenges in obtaining records for its legacy assets, do you anticipate that by 2016, the agency will have compiled accurate enough records of its legacy assets?
- Will NASA be on track to implement both its Integrated Asset Management system and its Comprehensive Compliance Strategy, Continuous Monitoring Program to improve its financial management systems by 2016, and to advance new space exploration projects, especially given the increasingly uncertain funding climate?

ANSWER 5:

The testimony states, "The Shuttles are being depreciated through their expected useful life based on their current schedule for retirement in 2010 after completing the flight manifest, and the International Space Station is being depreciated based upon a 15-year specification life, through 2016." The availability of records which provide the evidential support for an unqualified audit opinion is not expected to change between now and 2016. However, the Federal Accounting Standards Advisory Board (FASAB) has indicated that it will release additional guidance amending existing standards to support the use of "reasonable estimates of original transaction data historical cost." NASA believes that the guidance, Statement of Federal Financial Accounting Standard (SFFAS) #35, *Estimating the Historical Cost of General Property, Plant, and Equipment*, as drafted, will address auditor concerns related to auditable values for the Shuttle and International Space Station (ISS). Since the inception of the Shuttle and ISS programs, NASA has been using estimates to value these assets in line with the accounting standards in place at that time. As FASAB notes in the draft SFFAS #35, use of estimates is a more cost effective means of implementing new accounting requirements than reconstructing actual historical amounts based on inadequate or non-existent accounting records. The Board further asserted that estimation based on adequate techniques should promote cost effective implementation. NASA is preparing the foundational materials necessary for it to comply with the standard and thereby allow the Agency to be in a position to provide auditable values for its Shuttle and Space Station PP&E accounts.

In FY 2008, the Agency implemented the Integrated Asset Management (IAM) Property, Plant, and Equipment module within its financial management system. This module addresses a key part of the weakness and non-compliance with federal regulation noted in the audit report. Plans are currently being developed to implement an IAM Real Property module in the financial management system. Also in FY 2008, NASA implemented its Comprehensive Compliance Strategy and Continuous Monitoring Program, which are providing the foundation and key compliance processes for addressing the data integrity, management oversight, and

systems findings in the FY 2008 financial audit's internal control material weakness, for financial systems, analyses, and oversight. These foundational elements of the Agency's financial management systems and processes are operational now and will adequately support the Agency's new programs in science, exploration, and aeronautics well into the future.

Ms. WATSON. Thank you so much. Let us now proceed to you, Mr. Riedl.

STATEMENT OF BRIAN M. RIEDL

Mr. RIEDL. Chairwoman Watson and Ranking Member Bilbray, good afternoon. My name is Brian Riedl. I am the Grover Hermann fellow in Federal Budgetary Affairs at the Heritage Foundation. The views I express here are my own and should not be construed as representing any official position of the Heritage Foundation.

The most striking part of the 2008 Financial Report of the U.S. Government is not the balance sheets showing assets of \$2 trillion dwarfed by liabilities of \$12 trillion. Rather, it is the Statement of Social Insurance which shows \$43 trillion in excess future expenditures over future revenues for Social Security and Medicare. Indeed, the Statement of the Comptroller General notes the need for the Nation's leaders to "turn their attention to the long term challenges of addressing the Federal Government's large and growing structural deficits." He also warns that "the Federal Government is on an unsustainable long term fiscal path."

As a member of the bipartisan Fiscal Wake-Up Tour that consists of representatives of the Concord Coalition, the Heritage Foundation, the Brookings Institution, as well as former U.S. Comptroller General David Walker, I have spoken to thousands of Americans at public town hall meetings from coast to coast on the need to reform these entitlements. I would like to share with you what I have shared with these audiences.

First, in the short term, President Obama has offered a budget that would increase Federal spending to a peacetime record of 24.5 percent of GDP by 2019. That is not even counting the health care plan. Because tax revenues will not keep up with this spending growth, the President's budget would add \$9 trillion in new debt over the next decade. It would double the National debt to 82 percent of GDP.

By steeply increasing spending and digging the Nation deeper into debt, the Nation would have less financial flexibility and fewer resources to deal with that \$43 trillion shortfall that Social Security and Medicare face.

The basic entitlement challenge is as follows: The first of 77 million baby boomers have already begun retiring. Combined with longer life spans, these retirements drive down the ratio of workers supporting each retiree. In 1960, five workers paid the benefits of each retiree. Today, three workers pay the benefits of each retiree. By 2030, that ratio will be two to one.

Now, what does a two to one worker to retiree ratio really mean? Imagine a boy and a girl born today in 2009. In 2030, they get married and start their own family. This young couple just staring out will have to support themselves, their children, and the Social Security and Medicare benefits of their very own retiree. Every married couple will have that burden.

The costs will be enormous, especially given the steep rise in health care costs that plagues Medicare. Don't forget, the baby boomers' long term care expenses will raise Medicaid costs up as well. Overall, the combined cost of Social Security, Medicare, and Medicaid is projected to rise by 10 percent of GDP from 8.4 percent

of GDP to 18.4 percent of GDP by 2050. There are really not a lot of options here.

The first option is to raise taxes. But if you raise taxes to close that 10 percent of GDP gap, that would be the equivalent today of raising taxes by \$12,000 per household. That is what 10 percent of GDP would feel like. According to the Congressional Budget Office, the middle class would be pushed into a 63 percent income tax bracket and the wealthy into an 88 percent income tax bracket. That assumes that health care costs slow down. Even allowing the 2001 and 2003 tax cuts to expire, even including all of those for lower income individuals, would close just one tenth of the long term gap.

So a second option would be to finance these entitlements by cutting other programs. Surely there is a lot of waste in the Federal budget to eliminate. But in order to make room for the big three entitlements, every program but Defense would have to be eliminated by 2030. By 2049, Defense would have to be eliminated, too. At that point, 100 percent of the Federal budget would have to go to Social Security, Medicare, Medicaid, and net interest.

The third option, simply running budget deficits, is no better. Borrowing an additional 10 percent of GDP would be like today borrowing an additional \$1.4 trillion every year. That would drive the national debt to levels unseen in history and create a vicious circle of rising interest rates and debt resulting in economic collapse.

The only real option is to reform Social Security, Medicare, and Medicaid. An entitlement reform commission, such as the SAFE Commission proposed by Congressmen Jim Cooper and Frank Wolf, could design sustainable entitlement reforms and allow Congress to vote up or down on that package.

Now, some have asked why Congress should worry about the long term problems now. Well, the big three entitlements already consume 42 percent of all Federal spending. But more importantly, every year of delay raises the final reform cost by \$1 trillion. Additionally, some people have said that anyone over age 55 should be exempt from entitlement reforms. But every year, four million baby boomers cross that threshold. By 2019, all baby boomers will be 55. So at that point your only choice would be to pull the rug out from under those over age 55.

Nor does the Social Security Trust Fund reduce these long term obligations either. Yes, the Social Security Trust Fund likely guarantees that benefits will be paid through 2037. But without any actual economic assets in the Trust Fund, the painful tax increases and spending cuts I have described will need to begin in 2016 when the Social Security program falls into deficit. The Trust Fund does not reduce the future burden on taxpayers by a nickel.

In conclusion, the challenge of financing retirement benefits is perhaps the greatest economic challenge of our era. Unless lawmakers promptly reform Social Security, Medicare, and Medicaid, America faces a future of soaring taxes and Government spending that will cause poor economic performance and lower living standards. The longer lawmakers wait to enact these reforms, the more painful they will be.

Thank you.
[The prepared statement of Mr. Riedl follows:]



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CONGRESSIONAL TESTIMONY

**Facing America's Long-Term
Entitlement Challenges Laid Out in
the Financial Report of the United
States Government**

**Testimony before
The Subcommittee on Government Management,
Organization, and Procurement
House Committee on Oversight and Government
Reform**

July 8, 2009

**Brian Riedl
Grover M. Hermann Fellow in Federal Budgetary Affairs
Roe Institute for Economic Policy Studies
The Heritage Foundation**

My name is Brian Riedl. I am the Grover M. Hermann Fellow in Federal Budgetary Affairs at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The most striking part of the *2008 Financial Report of the United States Government* is not the balance sheets showing total assets of \$2 trillion dwarfed by total liabilities of \$12 trillion. Rather, it is the Statements of Social Insurance, which show \$43 trillion in excess future expenditures over future revenues for Social Security and Medicare. Indeed, the Statement of the Comptroller General notes the need for the nation's leaders to "turn their attention to the long-term challenges of addressing the federal governments large and growing structural deficits" and warns that "the federal government is on an unsustainable long-term fiscal path."¹

As a member of the bipartisan Fiscal Wake-Up Tour that consists of representatives of the Concord Coalition, Heritage Foundation, and Brookings Institution, and former United States Comptroller General David Walker, I have spoken to thousands of Americans at public town hall meetings from coast to coast on the need to reform these entitlements. I will share with you what I have shared with these audiences.

First, in the short term, President Obama has offered a budget that would increase federal spending to a peacetime-record 24.5 percent of GDP by 2019 – not even counting the health care plan. Because tax revenues cannot keep up with this spending growth, the President's budget would add \$9.1 trillion in new debt over the next decade. It would double the national debt to 82 percent of GDP by 2019.

¹ U.S. Department of the Treasury. *2008 Financial Report of the United States Government*, at <http://www.gao.gov/financial/fs/2008/08frusg.pdf> pp. 29, 39-41.

By steeply increasing spending, and digging the nation deeper in debt, the President would leave the nation with less financial flexibility and fewer resources to deal with the \$43 trillion shortfall that Social Security and Medicare face over the next 75 years.

The basic entitlement challenge is as follows: The first of 77 million baby boomers have already begun retiring. Combined with longer life spans, these retirements drive down the ratio of workers supporting each retiree. In 1960, five workers funded the benefits of each retiree. Today that ratio is 3:1, and by 2030 it will be just 2:1. To understand what a 2:1 worker-to-retiree ratio means, imagine a boy and a girl born today, in 2009. In 2030, they marry and start a family. This young couple will have to support themselves, their children – and the Social Security and Medicare benefits of their very own retiree. The costs will be enormous, especially given the steep rise in health care costs that plagues Medicare. The baby boomers' long-term care expenses will also drive Medicaid costs upward as well.

Overall, the combined cost of Social Security, Medicare, and Medicaid is projected to rise by 10 percent of GDP – from 8.4 percent to 18.4 percent of GDP – by 2050. In the absence of reform, these costs must be financed by raising taxes, slashing other government programs, or running ruinous budget deficits.

First, let's examine the tax increase option. Raising taxes to close that 10 percent of GDP gap would be economically devastating. In today's economy, a 10 percent of GDP tax increase would cost \$12,000 per household annually. According to the Congressional Budget Office, the middle class would be pushed into a 63 percent income tax bracket, the wealthy into an 88 percent bracket² – and even that assumes health care cost growth slows down. And allowing the

² Peter R. Orszag, Director, Congressional Budget Office, letter to Representative Paul Ryan (R-WI), May 19, 2008, at http://www.cbo.gov/ftpdocs/92xx/doc9216/05-19-LongtermBudget_Letter-to-Ryan.pdf

2001 and 2003 tax cuts to expire – including those that currently benefit low-income families – would close just one-tenth of the long-term gap.

A second option would finance these entitlements by cutting other programs. Surely, there are candidates for spending cuts. But in order to make room for the “big 3” entitlements, every remaining program except defense would have to be eliminated by 2030. And by 2049, defense would have to be eliminated as well. At that point, 100 percent of the federal budget would have to go towards Social Security, Medicare, Medicaid, and net interest.

The third option, simply running budget deficits, is no better. Borrowing an additional 10 percent of GDP annually – the equivalent today of \$1.4 trillion – would drive the national debt to levels unseen in history, and create a vicious circle of rising interest rates and debt, resulting in economic collapse.

The only real option is to reform Social Security, Medicare, and Medicaid. An entitlement reform commission, such as the SAFE Commission³ proposed by Congressmen Jim Cooper (D–TN) and Frank Wolf (R–VA), could design sustainable entitlement reforms and allow Congress to vote up or down on the package.⁴ The Breaux–Thomas Bipartisan Medicare Commission of 1997 is another example, but unfortunately, their strong reforms were not adopted.

Some have asked why Congress should worry now about long-term costs. These “big 3” entitlements already consume 42 percent of regular federal spending. More importantly, every year of delay raises the final reform cost by about \$1 trillion, as higher Social Security benefit levels and Medicare costs become locked in. Furthermore, many believe that anyone over age 55

³ H.R. 1557.

⁴ Alison Acosta Fraser, “The SAFE Commission Act (H.R. 3654) and the Long-Term Fiscal Challenge” Heritage Foundation Testimony before Committee on the Budget, United States House of Representatives, June 25, 2008 at <http://www.heritage.org/Research/Budget/tst062508b.cfm>

should be exempt from entitlement reforms. Yet every year, 4 million more baby boomers cross that threshold. By 2019, all 77 million baby boomers will have turned 55. So if we don't want to pull the rug out from underneath baby boomers over age 55, lawmakers must begin reforming these programs as soon as possible. Tackling reforms immediately will reduce their ultimate costs, spread the burden across more people, and give baby boomers more time to adjust their retirement strategies.

Nor does the Social Security Trust Fund reduce these long-term obligations. Yes, the Social Security Trust Fund likely guarantees that full benefits will be paid through 2037. But without any actual economic assets in the trust fund, the painful tax increases or spending cuts will need to begin in 2016 when the Social Security program falls into deficit. The trust fund does not reduce the burden on future taxpayers at all.

The challenge of financing retirement benefits is perhaps the greatest economic challenge of our era. Unless lawmakers promptly reform Social Security, Medicare, and Medicaid, America faces a future of soaring taxes and government spending that will cause poor economic performance. Americans will pay onerous taxes, and future generations will have lower living standards than Americans enjoy today. The longer lawmakers wait to enact the necessary reforms, the more painful those reforms will be. Thank you.

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Backgrounder

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A Guide to Fixing Social Security, Medicare, and Medicaid

Brian M. Riedl

The coming challenge of paying Social Security, Medicare, and Medicaid benefits to 77 million retiring baby boomers will be one of the greatest economic challenges of the 21st century. What Federal Reserve Chairman Ben Bernanke called the “calm before the storm” ended on January 1, 2008, when the first baby boomers became eligible for early Social Security benefits.¹ In three years, they will also become eligible for Medicare.

In the coming decades, the cost of these programs will leap from 8.4 percent of gross domestic product (GDP) to 18.6 percent of GDP—an increase of 10.2 percent of GDP. Without reform, this increased cost would require raising taxes by the current equivalent of \$12,072 per household or eliminating every other government program. Funding all of the promised benefits with income taxes would require raising the 35 percent income tax bracket to at least 77 percent and raising the 25 percent tax bracket to at least 55 percent.

Although aware of this coming crisis, Members of Congress have largely ignored it because all of the possible reforms are considered politically risky. Yet delays only increase the pain of the ultimate reforms, which are becoming about \$1 trillion more expensive annually. Furthermore, many believe that Americans ages 55 and over should be exempt from any reforms. One-third of all baby boomers have already crossed that threshold, and at 4 million per year, all of them will have crossed it by 2019.

Entitlement reform is more than just an economic issue. Americans need to decide whether they want a

Talking Points

- The first of 77 million baby boomers have begun to collect Social Security and will soon start receiving Medicare and Medicaid benefits.
- The total cost of these entitlement programs will increase from 8.4 percent of GDP to 18.6 percent of GDP by 2050. In comparison, the entire federal budget is 20 percent of GDP.
- To cover these additional costs, Congress would need to raise taxes permanently by the equivalent of \$12,072 per household or eliminate every other federal program.
- A first step in reforming the entitlement programs is addressing whether or not entitlement programs should always have the first claim on tax dollars, leaving discretionary programs (e.g., defense, education, and veterans health) to fight over the remaining scraps of the federal budget.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Budget/bg2114.cfm

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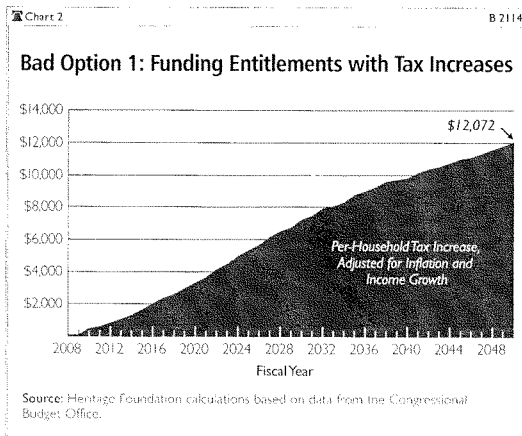
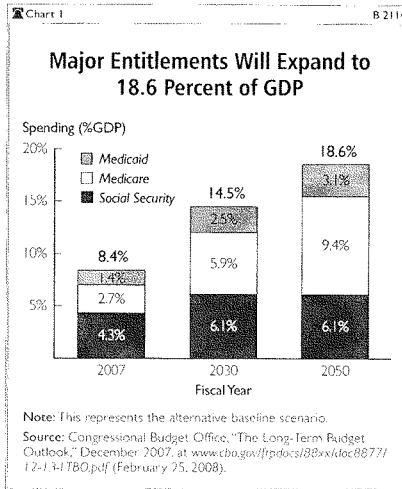
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future in which older Americans have an automatic claim on one-fifth of the future income of their grandchildren—who will be raising their own children and paying off their home mortgages. Under the current system, retirees will spend one-third of their adult lives in taxpayer-funded retirement while national security, education, health research, and antipoverty programs fight for the few remaining tax dollars.

This paper provides an introduction to the coming crisis in Social Security, Medicare, and Medicaid and sets up a framework for the consideration of various reforms.

No Easy Solutions

The Congressional Budget Office (CBO) projects that federal spending on Social Security, Medicare, and Medicaid will leap from 8.4 percent of GDP today to 18.6 percent by 2050.² (See Chart 1.) For comparison, the entire federal budget is 20 percent of GDP (18 percent spent on programs and 2 percent on net interest). This massive cost increase will



be fueled by the 77 million retiring baby boomers, combined with steep inflation in health care costs and automatic scheduled benefit hikes.

These costs far exceed what taxpayers will be able to afford. Increasing taxes by 10.2 percent of GDP today would come to \$1.394 trillion, or \$12,072 per household. (See Chart 2.) It could mean raising income tax rates by at least 120 percent—and probably more because tax increases slow economic growth and dampen new revenues—with additional raises thereafter.³ Funding all of the promised benefits would require raising the 35 percent income tax bracket to at least 77 percent and the 25 percent tax bracket to at least 55 percent.³

1. Ben Bernanke, "Long-Term Fiscal Challenges Facing the United States," testimony before the Committee on the Budget, U.S. Senate, January 18, 2007, at www.federalreserve.gov/boarddocs/testimony/2007/20070118/default.htm (February 25, 2008).
2. Congressional Budget Office "The Long-Term Budget Outlook," December 2007, p. 5, at www.cbo.gov/ftpdocs/08xx/doc0877/12-13-TBO.pdf (February 25, 2008). This represents the alternative fiscal scenario.



Regrettably, five common myths undermine the cause for immediate action.

MYTH 1: There is no hurry.

Social Security, Medicare, and Medicaid already absorb 42 percent of the federal budget and are growing by 7 percent annually, making them the largest impediment to balancing the budget. Furthermore, many believe that anyone over age 55 should be exempt from entitlement reforms.

Yet every year, 4 million more baby boomers turn 55, effectively locking in their future benefits (and taxpayer costs) by this standard. By 2019, all 77 million baby boomers will have turned 55,⁴ leaving future lawmakers with the unpalatable options of massive, economy-stagnating tax increases, unprecedented program terminations, or the paring back of benefits for those over 55. Tackling reforms immediately will reduce their ultimate costs, spread the burden across more people, and give baby boomers more time to adjust their retirement strategies.

MYTH 2: These budget projections are unreliable.

Projecting economic variables such as growth and inflation rates is difficult, but the impending retirement of 77 million baby boomers is not a vague theoretical projection. The Social Security costs for these future retirees are determined by a set benefit formula. Medicare faces the same demographic realities, and its steep spending projections even assume a sharp slowdown in per capita growth. These same baby boomers will also push up Medicaid spending on long-term care.

MYTH 3: Economic growth will solve the problem.

Revenues associated with higher economic growth would help only marginally. As Federal

Reserve Chairman Ben Bernanke has testified:

Economic growth leads to higher wages and profits and thus increases tax receipts, but higher wages also imply increased Social Security benefits, as those benefits are tied to wages. Higher incomes also tend to increase the demand for medical services so that, indirectly, higher incomes may also increase federal health expenditures.⁵

In short, the same factors that could increase tax revenues would also increase spending.

MYTH 4: Cutting waste and pork is enough.

Although Washington wastes billions of dollars, cuts in federal spending cannot absorb a cost increase of 10.2 percent of GDP. In fact, offsetting this spending hike would require eliminating every other federal program by 2049 except interest payments on the federal debt. Non-defense programs would be eliminated by 2030, and defense spending would be eliminated by 2049. (See Chart 3.)

MYTH 5: Letting the 2001 and 2003 tax cuts expire is enough.

The CBO projects that tax revenues will increase from 18.8 percent of GDP to a record 22.8 percent by 2050, but letting the 2001 and 2003 tax cuts expire in 2011 would only nudge revenues up to 23.4 percent by 2050.⁶ Thus, losing the tax cuts would close less than 1 percentage point of the 10.2 percent gap.

Even that projection unrealistically assumes that such a large tax increase on families, investors, and businesses would have no negative economic consequences and that Congress would not spend the new revenues elsewhere. Massive new spending, not low tax revenues, is the problem.

All five of these myths distract America and its lawmakers from confronting the difficult but nec-

3. Individual income tax revenues are currently 8.5 percent of GDP. Adding 10.2 percent of GDP represents a 120 percent increase over that original level.

4. Baby boomers are defined as those born between 1946 and 1964.

5. Bernanke, "Long-Term Fiscal Challenges Facing the United States."

6. Calculated using Congressional Budget Office "The Long-Term Budget Outlook," pp. 44-46, at www.cbo.gov/ftpdocs/88xx/doc8877/12-13-11BO.pdf (February 25, 2008), and supplemental data, Figure 1.1 and Figure 5.3, at www.cbo.gov/ftpdocs/88xx/doc8877/SupplementalData.xls (February 25, 2008). The 23.4 percent figure assumes that Congress does not adjust the alternative minimum tax threshold. If the Bush tax cuts are made permanent and the AMT is adjusted annually, the CBO's 2050 revenue projections are 19.4 percent of GDP, which is still well above the historical average.

essary entitlement reforms. The continued refusal to modernize Social Security, Medicare, and Medicaid leaves only three options:

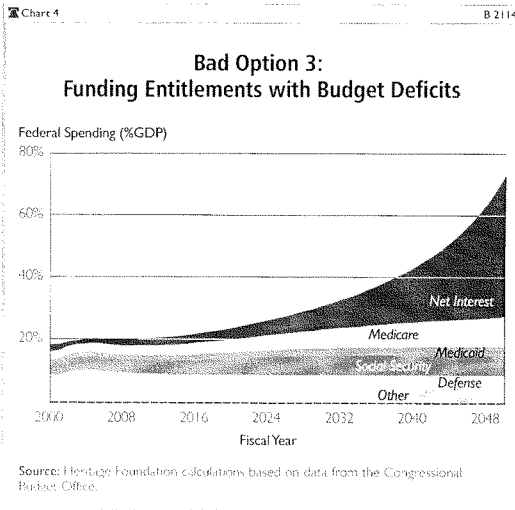
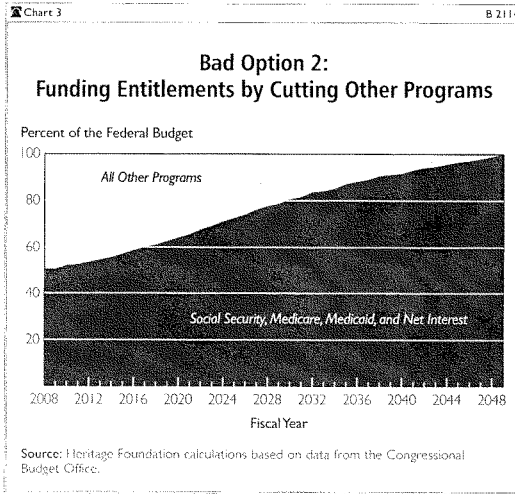
1. Massive and economically debilitating tax increases. (See Chart 2.)
2. Elimination of other federal programs. (See Chart 3.)
3. Unprecedented budget deficits. (See Chart 4.)

How Entitlements Hijack the Budget Process

Biased budget rules are a major obstacle to fixing Social Security, Medicare, and Medicaid. Federal spending should be allocated based on national priorities, yet programs classified as entitlements are given a nearly untouchable status above discretionary programs.

Entitlement programs—including Social Security, Medicare, Medicaid, most antipoverty programs, farm subsidies, and refundable tax credits—are effectively on autopilot. Their budgets grow automatically each year without going through the regular budget process, being examined, or being forced to justify their growth. Smaller entitlement programs are examined only once or twice per decade when they are reauthorized. Large entitlement programs are not required to be reauthorized or re-examined.

Each year, when Congress begins writing the annual budget, it accepts the 53 percent of the budget (and growing) spent on entitlements as a given, sets aside an additional 9 percent for net interest, and then spends the rest of the year deciding how to allocate the remaining scraps to defense, homeland security, education, health research, transportation, justice, foreign aid, and the environment.



This practice conflicts with America's budget priorities. It effectively gives Medicare drug subsidies for well-off Americans priority over body armor for American troops serving in Iraq and Afghanistan. It guarantees farm subsidies to corporate agribusinesses, leaving homeland security, education, and health research to fight over whatever tax dollars are left over.

These trade-offs are not theoretical. As Social Security, Medicare, and Medicaid costs surge over the next few decades, the funds available for other programs—such as defense, education, poverty relief, and veterans aid—will continue to shrink toward zero.

Approaches for a Solution. Entitlements were originally placed on autopilot to provide predictability in eligibility standards and benefit formulas. While overhauling these standards and formulas each year would be unwise, Congress could convert major entitlements into 30-year budgeted programs that must be reviewed and reauthorized every five years to keep spending within long-term allowable levels.

Additionally, Congress could create triggers that would automatically adjust the program if current and future spending trends exceed the allowable amount. (This is similar to a law that triggers reform proposals when outside sources are needed to fund at least 45 percent of Medicare spending.⁷) As long as the 30-year budget and five-year targets are written realistically, any annual adjustments would be small.

The Coming Costs

Over next few decades, the cost of providing promised Social Security, Medicare, and Medicaid benefits will exceed projected revenues by trillions of dollars.

Social Security. Social Security was created in 1935 to provide pensions to Americans age 65 and over.⁸ Old Age and Survivors Insurance is funded by a 10.6 percent payroll tax, split equally between employer and employee, on the first \$102,000 earned—a level that is adjusted annually for inflation.⁹

Initial Social Security benefits are calculated based on the worker's average monthly income, called the Average Indexed Monthly Earnings (AIME), during the worker's 35 years of highest earnings. (Each year's earnings are indexed for subsequent average wage growth in the economy).¹⁰ Monthly benefits equal a percentage of the AIME, ranging from 90 percent for very low earners down to 15 percent for the highest earners.¹¹ After the initial benefit is determined, it is indexed annually for price inflation.

Currently, the average annual benefit is approximately \$15,000. Those who live long can receive benefits well in excess of what they paid into the system. Those who die young can pass only minimal benefits on to their survivors. For the most part, they can leave little to nothing of their contributions for their heirs.

The Problem. Social Security spending is projected to increase from 4.3 percent of GDP today to 6.1 percent by 2050—an increase of 1.8 percent of GDP. Today, a spending increase of 1.8 percent would equal \$246 billion, or \$2,130 per household. Of this spending hike, 55 percent would result from demographic changes, and 45 percent would result from higher benefit levels.

The demographic side is simple. The 77 million retiring baby boomers born between 1946 and 1964 will overwhelm a Social Security system that

7. Public Law 108-173.

8. A retiree may choose to begin receiving Social Security benefits at age 62, albeit at permanently reduced levels.

9. Social Security Disability Insurance accounts for an additional 1.8 percent payroll tax, making the entire Social Security payroll tax 12.4 percent.

10. All income earned before age 60 is adjusted upward for average wage growth in the economy; earnings after the worker's 60th birthday are adjusted for price inflation.

11. For an individual who first becomes eligible for old-age insurance benefits in 2008, the benefits formula is 90 percent of the first \$711 of the AIME, plus 32 percent of the income between \$711 and \$4,288, plus 15 percent of the income over \$4,288. The thresholds are adjusted annually. See Social Security Administration, Office of the Chief Actuary, "Primary Insurance Amount," updated October 17, 2007, at www.ssa.gov/OACT/COA/PIAformula.html (February 25, 2008).

currently pays benefits to only 42 million seniors.¹² Not only will more Americans retire, but they will live longer and collect benefits longer. In 1940, a 65-year-old senior could expect to live 13 more years. Today, that figure is 18 years and is projected to increase to 22 years in coming decades. The combination of 77 million retiring baby boomers and longer life spans will double the number of Social Security beneficiaries by 2030, while the number of taxpaying workers will increase by just 17 percent.¹³

This will endanger the program because today's benefits are paid by today's payroll taxes. Social Security's sustainability depends on having enough workers to support all of the retirees. In 1960, five workers supported each retiree. This ratio has fallen to 3:1 and will drop to 2:1 by 2030. A 2:1 ratio means that each married couple in 2030 will be supporting the Social Security and Medicare benefits of one retiree.

Higher benefit levels will drive the rest of the cost increase. As stated, initial Social Security benefits are calculated by adjusting lifetime incomes upward for the economy's average wage growth over a person's working life, which is historically higher than price inflation. This pushes people's AIMEs well above their inflation-adjusted lifetime earnings. Because of this more generous formula, the CBO estimates that the average retiree's inflation-adjusted benefits will nearly double by 2075.¹⁴

What About the Trust Fund? The Social Security Trust Fund is the most misunderstood aspect of this program. In 1983, with Social Security's finances in dire straits and baby boomers approaching retirement, lawmakers raised the payroll tax so that Social Security could build a \$5 trillion "surplus." Beginning in 2017, when the payroll tax can no longer cover the rising annual program costs, this "trust fund" would be large enough to

cover all program shortfalls until 2040. At least, that was the idea.

In practice, Congress has already spent this money. Each year, the Social Security program lends its surplus to Congress to spend on regular government programs in return for special-issue Treasury bonds, which are backed only by the federal government's promise to repay them. In 2017, when Social Security begins to redeem these bonds, Congress—and the taxpayers—will start to repay the entire \$5 trillion from scratch.

This means the trust fund does not save taxpayers a dime. Future taxpayers are still on the hook for the entire \$5 trillion Social Security deficit between 2017 and 2040. The "assets" of the trust fund are only an IOU, a tally of how much the American people will have to repay the system. Congress taxed workers to build the trust fund, spent the money, and will have to tax them a second time to repay the trust fund.

Critics respond that the federal government has never defaulted on its debt, so the Social Security program will definitely be repaid the \$5 trillion, allowing it to pay full benefits until 2040. While this may be true, the key question is how lawmakers will find the extra \$5 trillion. These critics must be counting on big tax increases or spending cuts elsewhere in the budget beginning in 2017.

Thus, 2040 is not a very important date. The program currently runs an \$85 billion annual surplus that Congress uses to fund other federal programs, thereby reducing the budget deficit by that amount.¹⁵ The surplus will begin decreasing by 2012, and Congress will be less able to use these funds to reduce the budget deficit artificially. By 2017, Social Security will begin running a deficit, and Congress will need to begin transferring outside taxes into the system to pay full benefits. After

12. This figure includes recipients of survivors benefits. Approximately 8.8 million more receive Social Security disability payments. See Social Security Administration, Office of Policy, "Monthly Statistical Snapshot," December 2007, at www.ssa.gov/policy/docs/statbullet/stat_snapshot (February 25, 2008).

13. Congressional Budget Office, "The Looming Budgetary Impact of Society's Aging," *Long-Range Fiscal Policy Brief*, July 3, 2002, at www.cbo.gov/ftpdocs/35xx/doc3581/July3.pdf (February 25, 2008).

14. Congressional Budget Office, "The Future Growth of Social Security: It's Not Just Society's Aging," *Long-Range Fiscal Policy Brief*, July 1, 2003, at www.cbo.gov/ftpdocs/43xx/doc4380/07-01-SocSecAging.pdf (February 25, 2008).

2017, the amount of outside taxes needed to pay all promised benefits will grow every year.

Approaches for a Solution. The options for preserving Social Security's solvency are relatively straightforward. Rather than dumping large debt or tax increases on the next generation, several feasible options exist to restrain program costs. One option is to raise the retirement age (currently set to rise to 67 by 2030) by two months each year until it reaches 70, which would allow future seniors an average retirement of 17 years.

A second option would income-adjust benefits to target needy seniors more effectively. This could be accomplished through "progressive indexing," which would index initial benefit levels for middle-income and upper-income families to price inflation rather than wage growth, eliminating much of the increased Social Security costs driven by higher benefits. This would also target more benefit growth to lower-income retirees. If accompanied by an increase in the retirement age, progressive indexing could eliminate the entire Social Security shortfall.¹⁵

Finally, many economists believe that the consumer price index overstates inflation. Aligning Social Security's inflation adjustment with the actual (and lower) inflation rate would save money while still providing benefit growth.

In the long run, a more generationally equitable system would add a Social Security option in which individuals set aside money for their own retirement that they own themselves. The challenge is funding the transition period when one generation will need to fund current senior citizens' benefits while prefunding its own retirement.

Personal accounts by themselves do not reduce the taxpayer liabilities to current seniors. However,

if Congress slightly pared back the growth rates of benefits for upcoming retirees and allowed workers to direct a portion of their payroll tax savings into personal retirement accounts, workers could harness enough long-term investment growth to do much better than they can under today's system. This is the most realistic way to fund two generations of retirement on one generation's payroll tax. Millions of Americans with 401(k) plans and IRAs already understand how even safe investments can grow significantly over several decades.¹⁷

Medicare. Medicare was created in 1965 to provide medical care to Americans age 65 and older. An average of just under \$10,000 is spent annually on each of Medicare's 43 million enrollees.¹⁸ Medicare has three main components:

- **Medicare Part A** covers hospital and skilled nursing care. It is funded by a 2.7 percent payroll tax (split equally between employer and employee) on all income. For most enrollees, Medicare operates as a fee-for-service system, meaning that once the enrollee satisfies a modest deductible, Washington reimburses participating health care providers for services based on a set payment schedule.
- **Medicare Part B** covers physical and outpatient care. This optional program, in which most Medicare recipients participate, requires recipients to pay a monthly premium set at approximately 25 percent of total program costs, leaving the taxpayers to fund the remaining 75 percent.
- **Medicare Part D** is the new prescription drug benefit enacted in 2003. This optional program is funded mostly from general tax revenues, although enrollees pay a small deductible and monthly premium. Enrollees choose from com-

15. Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2009* (Washington, D.C.: U.S. Government Printing Office, 2008), pp. 289–301, Table 13.1, at www.whitehouse.gov/omb/budget/fy2009/pdf/list.pdf (February 11, 2007). Intragovernmental interest revenues are excluded from the Social Security surpluses because they are transfers from other taxes into the Social Security program and therefore not true program revenues.

16. Robert C. Pozen, "PIN Money," *The Wall Street Journal*, January 9, 2007.

17. For a blueprint for reforms, see David C. John, "How to Fix Social Security," Heritage Foundation *Background*er No. 1811, November 17, 2004, at www.heritage.org/Research/SocialSecurity/bg1811.cfm.

18. Steve Teske, "2006 Medicare Spending Rose 18.7 Percent Due to RX Drug Benefit, Researchers Say," Bureau of National Affairs *Daily Report for Executives*, January 8, 2008. In 2006, an average of \$9,538 was spent on each fee-for-service beneficiary, and \$10,133 was spent per managed care enrollee.

peting private health plans, which are reimbursed by Washington.

Only Medicare Part A is a social insurance program in which retirees “earn” their benefits with lifelong payroll taxes. Benefits for Medicare Parts B and D are not earned with payroll taxes. They are financed by general revenue (75 percent) and premiums (25 percent) paid by the senior enrollee.

The Problem. Medicare costs are projected to more than triple from 2.7 percent of GDP today to 9.4 percent by 2050. In current terms, a cost increase of 6.7 percent of GDP would equal \$916 billion, or \$7,930 per household annually.

Even this projection assumes that per capita Medicare costs will grow only about 1 percentage point faster than GDP, even though Medicare costs have grown an annual average of 2.4 percentage points faster than GDP since the 1970s.¹⁹ If this trend continues, actual Medicare costs through 2050 could be double the current projection.

Medicare faces the same demographic challenges as Social Security, and the projected increase in seniors over age 85 will add additional strains.²⁰ It also faces steep inflation in health care costs that will increase its long-term debt well beyond Social Security’s debt. Overall, health spending has been increasing 7 percent to 10 percent annually. Health spending averaged \$7,026 per person in 2006, or 16 percent of GDP.²¹ Furthermore, creation of the Medicare prescription drug entitlement added approximately \$8 trillion to Medicare’s 75-year unfunded obligations.²²

What About the Trust Fund? Medicare Part A is funded by payroll taxes that are theoretically “saved” in a trust fund for future retirees. Parts B and D are not funded by payroll taxes. As with Social Security, Congress has already spent all past surpluses for Part A, leaving taxpayers to fund all future shortfalls from scratch. The program is projected to begin running a deficit in 2010 (2007 if interest income is excluded) and then remain in deficit indefinitely.²³ Because at least 75 percent of Parts B and D is funded by taxpayers, these programs also face enormous long-term deficits.

Approaches for a Solution. Medicare reform is very complex. While Social Security transfers income from one group to another and therefore can be fixed with formula changes, fixing Medicare is more difficult because it is a major part of the health care economy. Thus far, reforms have centered on reducing payment rates to doctors and hospitals, but payment rates are already well below market prices. This amounts to rationing health care, which may reduce costs but will not advance better care or encourage more rational decisions.

Some reforms, which could be made quickly, would significantly rein in Medicare costs. One new approach would be to reduce the massive Part B and Part D subsidies for upper-income families. These programs are not social insurance: Enrollees did not earn their benefits with payroll taxes. Rather, they are large subsidies from taxpayers. Part B recently began modest income-relating. President Bush has proposed larger means-testing of Parts B and D.

19. *Ibid.*, p. 23.

20. The percentage of Americans ages 85 and older is projected to increase from 1.5 percent in 2000 to 5 percent in 2040. See Douglas Holtz-Eakin, “Implications of Demographic Changes for the Budget and the Economy,” statement before the Committee on Ways and Means, U.S. House of Representatives, May 19, 2005, p. 2, at www.cbo.gov/ftpdocs/63xx/doc6365/05-19-Long-Term.pdf (February 25, 2008).

21. Aaron Catlin, Cathy Cowan, Micah Hartman, and Stephen Hefler, “National Health Spending in 2006: A Year of Change for Prescription Drugs,” *Health Affairs*, Vol. 27, No. 1 (2008) pp. 14–29, at <http://content.healthaffairs.org/cgi/content/abstract/27/1/14> (February 25, 2008).

22. U.S. Government Accountability Office, *Fiscal Year 2007 Financial Report of the United States Government*, December 2007, p. 46, at www.gao.gov/financial/fy2007/financialreport.html (February 25, 2008).

23. Boards of Trustees, Federal Hospital Insurance and Federal Supplemental Medical Insurance Trust Funds, *2007 Annual Report*, April 23, 2007, p. 48, Table III.B4, at www.cms.hhs.gov/ReportsTrustFunds/downloads/tr2007.pdf (February 25, 2008). Interest income is often excluded because it is not true revenue from the program, but rather outside funding from general revenues.

Long-term fundamental reform will likely involve bringing more choice and competition into health care, such as moving Medicare from a defined-benefit system to a defined-contribution system. The Federal Employees Health Benefits Program (FEHBP) has held down costs by creating a voucher-type system for federal employees to purchase coverage from competing health plans that offer differing coverage and costs.²⁴ By creating more choice and competition, the FEHBP has held down cost increases and may serve as a model for Medicare reform.

Medicaid. Medicaid is a federal-state partnership, created in 1965, that provides medical care to 46 million low-income individuals. States run their own Medicaid programs, while Washington sets minimum eligibility and benefit standards and reimburses states for an average of 57 percent of all program costs. Approximately one-third of Medicaid spending is on senior citizens, partly because Medicare does not cover most long-term care such as nursing homes. Overall, Medicaid finances 40 percent of all long-term care costs.²⁵

The Problem. Federal Medicaid spending is projected to jump from 1.4 percent of GDP to 3.1 percent by 2050. Today, a 1.7 percent of GDP spending hike would equal \$232 billion, or \$2,012 per household. Most of this spending growth will come from senior citizens, whose long-term care costs are not covered by Medicare.

Two other factors will also drive up Medicaid costs: inflation of health care costs and the funding structure, which encourages states to overspend on Medicaid. Because Washington reimburses states for 57 percent of all costs, every dollar that a state spends on Medicaid guarantees an additional \$1.33 grant from Washington. Consequently, states have

a stronger incentive to allocate their budgets to expand Medicaid benefits and eligibility levels rather than to provide tax relief or education, regardless of the state's actual needs.

Not surprisingly, approximately 60 percent of the average state's Medicaid budget is now spent on optional services and populations beyond the federal minimum.²⁶ These optional services, such as weight-loss help and substance-abuse treatment, have played a large role in increasing the program's spending by an inflation-adjusted 227 percent since 1990.²⁷

Approaches for a Solution. Converting Medicaid into a block grant to states would eliminate state incentives to overspend on Medicaid. Additionally, giving states more flexibility to craft different Medicaid packages for different individuals based on their unique personal circumstances could save money while improving service delivery.²⁸ State incentives to help individuals purchase long-term care insurance could also substantially reduce Medicaid's burden insofar as these expenses are concerned.

Conclusion

Unless lawmakers promptly reform Social Security, Medicare, and Medicaid, America faces a future of soaring taxes and government spending that will cause poor economic performance. Americans will pay onerous taxes, and future generations will have lower living standards than Americans enjoy today. The longer lawmakers wait to enact the necessary reforms, the more painful those reforms will be.

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24. Robert E. Moffit, "Lessons of Success: What Congress Can Learn from the Federal Employees Program," Heritage Foundation WebMemo No. 565, September 14, 2004, at www.heritage.org/Research/HealthCare/wm565.cfm.
25. Kaiser Family Foundation, "Medicaid's Role in Long-Term Care: Q & A," at www.kff.org/medicaid/upload/Medicaid-s-Role-in-Long-Term-Care-Q-A-Fact-Sheet.pdf (February 25, 2008).
26. Raymond C. Schepbach, "Unfunded Mandates: A Five-Year Review and Recommendations for Change," testimony before the Subcommittee on Energy Policy, Natural Resources, and Regulatory Affairs, Committee on Government Reform, and the Subcommittee on Technology and the House, Committee on Rules, U.S. House of Representative, May 24, 2001, at www.rules.house.gov/archives/rules_sch12.htm (February 25, 2008).
27. See Office of Management and Budget, *Historical Tables*, pp. 144–149, Table 8.6.
28. See John S. O'Shea, "More Medicaid Means Less Quality Health Care," Heritage Foundation WebMemo No. 1402, March 21, 2007, at www.heritage.org/Research/HealthCare/wm1402.cfm.

Ms. WATSON. I want to thank all of the witnesses.

Mr. Riedl, when we propose our questions to you, I would like not only responses to those questions but recommendations. If we have to reform the entitlement programs, the top three, where does that leave the safety net for society? So I would like you to let us know from your investigation research what you would recommend.

Mr. RIEDL. That is a great question. I will be happy to answer it.

Ms. WATSON. OK. I would like to call on Mr. Bilbray, our ranking member.

Mr. BILBRAY. Let me just say as a former mayor and county chairman, let us also not forget about the fact that the Federal Government thinks of itself in isolation. But then you have the other segments of the front line service—the counties, the cities, and the States—and the impact there.

You are looking at just the resources of 40 percent of the Federal Government. But when we get into this crisis, it is a very real possibility that we will want to make a priority decision and basically say that the Federal Government needs to absorb all of the government funds that are generated in this country and supersede local and community funding.

Do the American people want to see now all funding and power centralized in the Federal system and to literally bleed the local and community systems dry of any money? Because there is only so much capital in there. We totally ignore the fact of the eventual impact on the local communities. We might have to decide, is Medicare more important than having sewer service? Is Social Security more important than having a firefighter? Those are legitimate arguments.

We forget that the great separations of power in this country are not between the three branches of the Federal Government but actually between the city, county, State, and Federal Governments. Those other segments are going to be impacted somewhere down the line as a revenue source that we could tap into but at what cost.

Thank you very much. I yield back.

Ms. WATSON. Thank you so much. I thank the audience for being here with us and for your patience. I will now declare the meeting adjourned. Thank you.

[Whereupon, at 4:10 p.m., the subcommittee was adjourned.]

