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Financial Management Issues



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**Comptroller General
of the United States**

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The President of the Senate
The Speaker of the House of Representatives
The Secretary-designate of the Treasury
The Director-designate, Office of Management and
Budget

Over the past several years, GAO has done a considerable amount of work related to improving the government's financial management. This report, which is one of a series that addresses major policy, management, or program issues facing the new administration and the Congress, summarizes our position on key elements of financial management reform which have emerged from this work. These issues are discussed in detail in the reports listed at the end of this report.

While there are many facets to be considered in rebuilding the government's financial management structure, these are the four components which we believe deserve the highest priority of the new administration and the Congress.

- Restructure the budget to include capital and operating subtotals for general, trust, and enterprise activities, and reformulate deficit reduction targets to correspond with the revised budget structure.
- Develop politically binding agreements on multiyear macro budget targets between the White House and the Congress in a fashion similar to those set during the legislative-executive budget summit of 1987.
- Establish a chief financial officer structure for the government, which would provide leadership and direction for financial systems, reporting, and internal control improvements.
- Retain the President's Council on Integrity and Efficiency and continue its activities to coordinate

inspector general efforts to prevent and detect fraud, waste, and abuse.

Financial management reform of this nature is urgently needed to better manage the government's financial affairs, potentially save billions of dollars, and help restore the accountability of managers and the credibility of government in the eyes of the public.

Charles A. Bowsher

Charles A. Bowsher

Contents

Letter	1
Reaching for Financial Management Reform	6
The Federal Budget: A Process in Need of Change	10
Sound Financial Systems and Reporting: A Major Need	18
Effective Internal Controls: An Ongoing Commitment	26
Inspectors General: A Strong Corps Made Stronger	29
Related GAO Products	33

Transition Series		34
Tables		
	Table 1: Restructured Federal Budget for Fiscal Year 1987	12
	Table 2: Activities Reported by Major Agencies as Having Material Internal Control Weaknesses	27

Reaching for Financial Management Reform

Major financial management reform is needed to restore integrity to government programs and credibility to their operation—thereby contributing to renewed accountability in the federal government. A broad restructuring and rebuilding of our overall financial management structure is essential and deserves a top priority of the new administration and the Congress.

Dealing with the overwhelming federal deficit is one of the most pressing issues our government faces. Reducing that deficit requires monumentally difficult decisions to be made in selecting programs and activities for reduced funding and in generating enough revenue to pay for services the public wants and needs.

If our government is to make these decisions in an informed manner, it must have better financial data. Good financial information will not make the deficit go away, nor will it make budget decisions easy. But that information can help our government better understand the issues it faces and the implications of the decisions it makes, as well as better manage scarce resources once those decisions are made.

Aside from affecting wise budget reduction decisions, poor financial systems and

weak internal controls have resulted in wasteful spending, sloppy management, and losses involving billions of dollars. Agency and program managers must have reliable financial information and controls to effectively and efficiently manage their operations.

Contributing to this fiscally unhealthy condition is a federal government which faces very serious financial management problems. The budget's structure masks the severity of the deficit, its review and approval process is cumbersome, and its numbers are misleading. Information generated by the government's vast network of financial systems is unreliable. The routine audit of financial information and systems is lacking. Controls over program operations are not adequate to ensure that they are effectively run and that assets are safeguarded.

Improvements are possible. It will be difficult, but it can be done. The government is already on a path leading to better financial information and systems. But all parties involved need to work diligently to ensure continued progress and to make the improvements permanent.

To be most effective, reform must be governmentwide, serving the needs of both

the Congress and the executive branch. As described more fully in other sections of this report, modernizing the federal financial management structure encompasses a number of interrelated actions.

1. Improved budget practices. Key features of budget reform are (1) restructuring the budget to include capital and operating subtotals for general, trust, and enterprise activities, (2) reformulating Gramm-Rudman-Hollings deficit reduction targets to correspond with the revised budget structure, and (3) streamlining the budget process by developing politically binding agreement on multiyear macro budget targets by the White House and the Congress.

2. Sound financial accounting and reporting. The cornerstone of improved financial systems and information requires an independent chief financial officer to provide central direction and leadership for the effort and a corresponding leadership structure in each agency.

3. Effective internal controls. A sustained commitment must be made by the administration and the Congress to the ongoing process of identifying and correcting internal control problems across the spectrum of government programs and operations.

4. Strong auditing of financial information and program operations. Greater attention and priority must be given to auditing accounting systems, financial data, and internal controls. To effectively carry out this aspect of financial reform, as well as audits and investigations of other program operations, continuity in inspector general leadership is vital.

These elements of reform would bring a fresh perspective from which to manage and control the cost of government. Budgets would be formulated and approved more efficiently. The focus of deficit reduction goals would be expanded. Agency managers and the Congress would have reliable, timely, consistent financial data as a basis for identifying problems, reaching decisions, and judging whether or not policy decisions have been properly implemented. Finally, sorely needed funds would be saved and assets protected through better internal controls and more effective auditing. These remedies to a presently ill-cast financial management structure would help in regaining the American public's confidence that its government is being effectively managed.

The Federal Budget: A Process in Need of Change

The number one fiscal problem facing the nation today is the federal budget deficit and how to reduce it.¹ Overcoming the towering hurdles of sorting out these issues is compounded by budgeting practices which impede sound management of taxpayer dollars. This section explores (1) a budget structure and process that does not provide the Congress and federal managers with the information they need to make decisions among competing demands and (2) how budget reform can be brought to the federal government.

A Restructured Budget

The current budget focuses exclusively on a single surplus or deficit number. This structure is misleading for several reasons.

First, there is no distinction between capital investments and operating expenses. This perpetuates false economies and leads to unsound deficit reduction strategies. For example, buildings and equipment are leased in cases where purchase could be more economical solely because leasing produces smaller budget numbers in the current year. Distinguishing current operations from capital investments, which is being done by a vast majority of state governments, would allow the relative needs

¹Budget deficit reduction policy issues are discussed in another GAO transition series report, The Budget Deficit (GAO/OCG-89-1TR).

of each to be considered when setting deficit targets.

Second, the reported deficit of \$150 billion for 1987 would have been \$222 billion if not offset by a \$72 billion surplus in accounts classified by GAO as trust funds. The reported fiscal year 1988 deficit of \$155 billion was similarly masked by billions of dollars of trust fund surpluses. The nontrust fund deficit is continuing to grow, heading toward \$300 billion in the early 1990s, but it is masked by the rapidly growing Social Security reserves.

Third, the budget's bottom line does not set apart figures for enterprise operations. Unlike most programs for which funding decisions must be made, these are business-type activities, such as the Postal Service with its \$30 billion-a-year program, which are generally funded through receipts from selling products or services to the public. Including the financial results expected from these operations as part of an overall budget calculation further masks the total dollars needed to fund current operations and capital investments for activities that are not intended to be self-sustaining.

Restructuring the budget produces a much clearer picture of its different components

and activities. Table 1 shows GAO's recasting of the fiscal year 1987 budget,² which shifts the focus away from a single deficit figure of \$150 billion for that year.

Table 1: Restructured Federal Budget for Fiscal Year 1987

Billions of dollars

Components	Activities			Total
	General	Trusts	Enterprises	
Operating revenues	\$573	\$326	\$59	\$958
Operating expenses (net)	736	258	60	1,054
Operating surplus or deficit	\$-163	\$68	\$-1	\$-96
Net capital financing requirements	-58	4	0	-54
Unified total financing requirements	\$-221	\$72	\$-1	\$-150

With the budget structured in this way, deficit reduction targets could then reflect the appropriate balance between short-term consumption needs (operating expenses) and long-term infrastructure and productivity enhancing needs (capital investments). Separate consideration could then also be given to establishing targets for capital financing, the operating deficit, and total financing requirements.

Streamlining the Budget Process

The budget process has been an annual race that was seldom won. Regular appropriations bills for fiscal year 1989 passed the Congress with only minutes to spare

²Comparable information was not readily available to recast fiscal year 1988's deficit of \$155 billion in a similar manner.

before the fiscal year began. This is the sole exception to a 12-year streak of late appropriations. The Congress reached its goal of delivering that budget on time by scrambling to bridge the many pitfalls accentuating today's budget process.

The budget process has been punctuated by activities which crowd out other legislative business. The percentage of budget-related rollcalls in the Senate increased from an average of 43 percent in the 1955 to 1975 period to an average of 60 percent over the 1980 to 1985 period. Even with all of this time devoted to budgeting, deadlines were still missed, funding gaps sometimes occurred between fiscal years, and omnibus continuing resolutions were passed (with little debate) in place of regular appropriations bills.

This situation is caused partly by the layering of congressional functions. Programs are revisited several times during a session by authorization, appropriation, and budget committees. Absent the discipline of a binding budget resolution and related enforcement procedures, a constantly changing budget and process is produced that, at times, seems out of control.

To eliminate unnecessary repetition, detail, and obstacles to action, the budget

process should be simplified by promoting better integration among congressional leadership and the committees involved in budget matters. Another streamlining technique would be to use a biennial budgeting approach on macro budget levels, with legislative and executive branch agreement on the levels early in the budget process.

The November 1987 legislative-executive budget summit demonstrated the success possible from macro-level biennial budgeting. This summit produced an agreement, forged in the heat of the concerns raised by the stock market events of October 1987, which provided politically binding macro budget levels for 2 years and significantly streamlined the budget process for the second year of the agreement. This became a driving force behind the fiscal year 1989 appropriations legislation being enacted without need for continuing legislation—an accomplishment that had not occurred since October 1976.

**Improving the
Budget's Numbers
and Cost
Information**

Putting the budget structure and process aside, we must do a considerably better job of pulling the budget numbers together and restoring the credibility of the budget. The Congress and the administration must reestablish mutual trust which has diminished in recent years.

There is a continuing problem with inadequate agency budget systems and misleading budget numbers. Frankly, the Congress does not believe the numbers it gets from the executive branch and thus develops its own numbers. Faulty figures creep into the budget in the following ways.

- Agency financial management systems do not produce reliable data from which the budget can be formulated.
- Economic assumptions and deficit projections tend to be overly optimistic.
- Numbers that appear in the budget are understated, distorted, and able to be manipulated by billions of dollars. For example, civilian employee retirement costs are not fully included, payroll payment dates are intentionally shifted from one year to another, and loan guarantees do not show up until loans go bad. Further, critical situations, such as the billions of dollars that will be needed for bailout of savings and loan institutions through the Federal Savings and Loan Insurance Corporation, do not appear in the budget as a problem until years after meaningful action can be taken to reduce the cost.

As discussed more fully later in this report, improvements are needed in

agency financial management systems which will make the quality of the budget's numbers better. Also, economic assumptions should be based on more stable economic and financial trends and less upon optimistic policy and goals. The budget's cost information must also be improved by requiring that the costs for loan programs, federal civilian employee retirement, payroll, and other activities be fully and accurately reported in the budget each year.

**Proposed
Solutions**

The budget's structure and process shortcomings only add to the already difficult task of making the tough decisions necessary to reduce the budget deficit. The budget needs to be made a more useful tool for allocating resources and a better vehicle for providing the Congress more effective ways to make budget decisions. We believe the following ideas should be considered.

- Reshape the budget to include capital and operating subtotals for general, trust, and enterprise activities.
- Form Gramm-Rudman-Hollings deficit reduction targets along the same lines as the restructured budget.

- Break the perennial budget process logjam by reaching politically binding agreement on multiyear macro budget targets between the White House and the Congress.
- Give the Congress solid budget figures to guide it in considering the hard choices demanded when legislating spending and revenue levels to lower the deficit.

Sound Financial Systems and Reporting: A Major Need

The federal government is the world's largest financial operation. Its annual outlays amount to almost a quarter of the country's Gross National Product. It employs 5 million people and runs hundreds of programs, many of them individually larger than our largest corporations and state governments and affecting the lives of virtually all Americans.

Yet, the financial management concepts and practices followed by the federal government are weak, outdated, and inefficient. The government's inability to effectively manage its financial operations contributes to the popular belief that government cannot be counted on to get anything right.

We think improvements are possible. In fact, the government is already on the road to making some of them. But it is clear that all the parties involved will need to work diligently to ensure that this progress continues and to make permanent the improvements that are already in place.

Two elements are critical to sound financial systems and reporting:

- centralized leadership responsible for developing and implementing a governmentwide plan for improving financial

management systems and financial reporting and

- corresponding financial management leadership in executive branch agencies.

Financial Systems Are Weak and Outdated

The government's financial systems are in poor condition. They are incompatible and costly to operate and maintain. Systems fail to produce the complete, timely, reliable financial data needed for policy-making and day-to-day operations. This situation is further compounded by weak internal controls, which are discussed later in this report.

Today's financial reports provide a flood of information but little of the reliable operational and cost data that is essential to monitoring programs, anticipating overruns, and providing a basis for program and budget planning. Desperately needed, for example, is basic information to control and collect the billions of dollars of accounts and loans receivable owed to the government. Acting on uncollected debts is hard when simple questions about them are unanswerable, questions such as: How many receivables are really current, and how many are delinquent but being worked on or are in a restructuring phase? Administrators need reliable data, data that is consistent from one agency to the

next and that is produced in a disciplined way. Too often, they must do without it.

The lack of financial data is just as crippling at the overall program management level. For example, the Veterans Administration, which runs 172 hospitals around the country, lacks information on the cost of each one or the cost of a given medical procedure at one hospital versus another. If someone were to inquire about the potential financial impact of closing a veterans hospital—or for that matter, a State Department embassy or consulate or one of the Forest Service's hundreds of offices—enough information could be brought together to form a rough estimate of the savings. That might be sufficient for onetime decision-making. But it is certainly insufficient for the program manager who must try to run a whole network of operations every day—who needs to know where things are working well, where costs are going up, where costs are going down, and where procedures are cost-effective and where they are not.

There is a lack of reliable information on weapons systems and other major projects for which multimillion or even multibillion dollar funding decisions must be made; the B-1 bomber is a classic case. Current project-reporting systems are not tied to

accounting, budgeting, or project-management systems. All too often, reports are incomplete, inconsistent, or unreliable.

Many of the government's financial systems are old, with their basic structure being laid out during World War II. Hundreds of millions of dollars are spent each year on uncoordinated efforts to upgrade these systems. Despite improvement efforts over many years, the systems are second rate. As the President's fiscal year 1989 report on Management of the United States Government states, "Once a leader in the early days of automation, the Government's financial systems and operations have eroded to the point that they do not meet generally accepted standards."

Where Is
Financial
Management
Reform Headed?

Conventional efforts to put the government's financial house in order have lacked the long-term, governmentwide approach that is necessary to ensure that consistent data are available across agency and department lines. In 1985, we issued a report entitled, Managing the Cost of Government (GAO/AFMD-85-35 and 35A), which was the culmination of a major study of the government's financial management practices. The report identified significant problems affecting the federal financial management

structure, proposed a conceptual framework to guide improvement efforts, and provided an implementation strategy. Since then we have seen a growing consensus as to the need to reform the government's financial management systems and as to what needs to be done across government to accomplish meaningful and lasting improvement.

Providing Central
Leadership and
Continuing Direction

One positive development would be the establishment of an Under Secretary of the Treasury for Federal Financial Management who would be the government's chief financial officer. This person would provide central focus to the long-range planning of improvements and oversight of agency financial management activities. Executive branch departments and agencies would be required to establish corresponding financial management leadership positions to provide the continuity needed for improved agency financial management and support for the chief financial officer.

In July 1987, the Director of the Office of Management and Budget (OMB) administratively appointed a chief financial officer for the federal government who was given responsibility to provide leadership, policy direction, and oversight for

federal financial management. Subsequently, in November 1987, OMB recommended that chief financial officers be established in the major departments and agencies. Initially, the Reagan administration did not support the need for legislatively establishing the chief financial officer position, but that view changed. The President's 1989 management report called for "legislation that will define and provide statutory underpinning for a permanent Chief Financial Officer structure throughout Government."

Equally important, the chief financial officer should develop a long-range, governmentwide financial management improvement plan. Trying to institute improvements without such a plan is like trying to build a house without a set of architect's drawings. An overall plan would generate greater confidence that the financial management system improvements would result in integrated systems for the government as well as provide information and financial reporting needed by individual agencies. Finally, an overall plan would provide direction and continuity when leadership changes occur, centrally as well as at the agency level.

Supporting
Financial
Management
Reform Through
Legislation

Financial management reform legislation is needed because experience has shown that management reforms are more likely to succeed if they have a legislative mandate. GAO studied centrally directed, governmentwide management improvements conducted in the 1970s and found that few initiatives had lasting impact. In our view, many of these initiatives would not have been so short-lived if there had been a legislative mandate to ensure that they would continue across successive administrations.

It is not surprising that administrative actions to improve operations are not fully successful, particularly when agency personnel perceive that there will be new directions from succeeding managers. A legislative mandate would provide the needed assurance that the direction and existence of financial management reform would be stable by giving it a sense of structure, force of law, permanence, and prominence.

For problems as complex and long-standing as those of federal financial management, there are no magical solutions. The situation can be righted only through painstaking, long-term efforts. These efforts cannot be haphazard; they must be made part of the government's standard operating procedure. To build in that

approach so that it endures from one administration to the next will require legislation. Legislation may not solve every facet of the problem, but it will, without doubt, enable the federal government to better manage its financial affairs, save billions of dollars, and help restore the accountability of managers and the credibility of government in the eyes of the public. OMB recognized the need for financial management reform legislation in its 1989 report, Management of the Federal Government, which called for legislation that will provide a structure for implementing and sustaining financial management initiatives.

Effective Internal Controls: An Ongoing Commitment

The government does not have the internal controls necessary to effectively operate its programs and to safeguard its assets. Americans are deeply skeptical of their government's integrity. They expect an effective and efficient government, which is, at all times, fully accountable for how public moneys are spent. Seemingly never ending reports of fraud, waste, abuse, and mismanagement, however, only serve to reinforce a perception that the federal government is poorly managed, with little or no control.

Weaknesses in internal controls impede agencies' ability to carry out their responsibilities, and, in some cases, crucial programs have been hampered. This results in losses totaling millions of dollars, wasteful spending, and poor management.

Material weaknesses in controlling government operations are not limited to certain programs or areas and are not isolated instances affecting a few agencies, but span major activities across government. The following table shows the breadth of internal control problems reported by 18 major agencies in 1987.

Table 2: Activities Reported by Major Agencies as Having Material Internal Control Weaknesses

Activities	Number of agencies
Procurement	11
Grant, loan, and debt collection management	8
Eligibility and entitlement determinations	5
Cash management	6
Automated data processing	13
Property management	9
Financial management and accounting systems	14
Personnel and organizational management	12

These weaknesses in internal controls are at the very core of the government's management processes. They are serious and long-standing. To identify and correct problems such as these, the Congress enacted the Federal Managers' Financial Integrity Act of 1982. The requirements of this law are concise and straightforward: Agency managers are to evaluate and report annually to the President and the Congress on the adequacy of their internal controls and accounting systems and what is being done to correct the problems. Since the act's passage, we have seen some good results in correcting weak internal controls. However, because of constant changes in systems, people, and procedures, evaluating internal controls is an ongoing process, with identification and correction of internal control problems

being a continuous objective of well-managed programs.

The administration and the Congress, therefore, need to clearly articulate priority and support for internal control improvement initiatives. In addition, the administration must take the following actions.

- Priority must be given to correcting known, long-standing internal control problems.
- At those agencies which experience internal control problems, leadership must be held accountable for improving internal controls.
- Emphasis must be given by agencies' inspectors general to the review of internal control systems and to making managers fully aware of the internal control implications of audit findings.

Inspectors General: A Strong Corps Made Stronger

While the government's budget, accounting, and internal control systems must be well-designed and operated, their effectiveness and reliability must be assessed through periodic audits and evaluations. The government's audit and evaluation process also provides critical feedback to agency managers on the effectiveness of government-financed policies, programs, organizations, projects, and activities, and on how well they are achieving their intended objectives.

Many of these functions have been carried out by presidentially-appointed inspectors general (IGs) in 19 departments and agencies, as authorized by the Inspector General Act of 1978 and similar legislation. IGs are a proven means for preventing and detecting fraud, waste, and mismanagement in federal programs and have been a key factor in strengthening federal internal audit and investigative activities and improving operations within the federal government.

The Congress, the executive branch, and the public look to IG auditors and investigators to help hold agencies accountable for the proper and efficient use of taxpayer dollars, to ensure that federal programs are meeting their intended objectives, and to foster improved internal

controls and fraud prevention. In the past 10 years, IGs have produced numerous management improvements and have been credited with major savings and cost avoidance measures in federal agencies.

**Maintaining
Continuity of IG
Leadership**

High turnover among IGs at the outset of the new administration could rob the government of important expertise and insight into the most pressing problems facing agencies and how to remedy them. Government agencies and the Congress would benefit greatly from maintaining continuity of IG leadership by drawing upon the resources available through the current roster of incumbent inspectors general.

The IGs have provided independent and objective views of program operations to both agency management and the Congress. Their views can be particularly valuable in a new administration because the value of many programs and operations will likely be reassessed.

The President has the authority to appoint new inspectors general. However, consideration should be given to retaining IGs based on their individual capabilities and performance records. This would be consistent with the IG act, which provides that IGs be appointed without regard for

political affiliation and solely on the basis of integrity and demonstrated ability.

**Work of the
President's
Council on
Integrity and
Efficiency**

Another means of maintaining continuity of leadership in the audit community is afforded through the President's Council on Integrity and Efficiency. This group, which is made up of IGs, has coordinated implementation of governmentwide activities to combat fraud and waste. The council has worked effectively to share ideas and foster innovative and effective approaches to improve government programs and operations and to identify suitable candidates for IG positions. We suggest that the activities of the President's Council on Integrity and Efficiency be continued.

**Newly Authorized
IGs**

In October 1988, the Congress enacted legislation to establish new presidentially-appointed IGs in the Departments of the Treasury and Justice, the Nuclear Regulatory Commission, the Office of Personnel Management, and the Federal Emergency Management Agency. This legislation also provides for IGs to be appointed by the heads of 33 other agencies.

Agency heads will need to ensure that these new IG organizations become operational in accordance with the recent legislation which established them, and that they carry out their responsibilities independently and objectively. In addition, the President's Council on Integrity and Efficiency should assist the new IGs by suggesting policies and quality controls that have been effective in the 19 established IG organizations.

Related GAO Products

Managing the Cost of Government: Building an Effective Financial Management Structure (GAO/AFMD-85-35 and 35A, Feb. 1985).

Financial Integrity Act: Continuing Efforts Needed to Improve Internal Control and Accounting Systems (GAO/AFMD-88-10, Dec. 30, 1987).

Budget Reform for the Federal Government (GAO/T-AFMD-88-13, June 7, 1988).

Ten-Year Perspective on Federal Inspectors General (GAO/T-AFMD-88-16, Aug. 4, 1988).

Financial Management: Progress of OMB's Chief Financial Officer (GAO/AFMD-88-52, June 6, 1988).

Budget Issues: Trust Funds and Their Relationship to the Federal Budget (GAO/AFMD-88-55, Sept. 30, 1988).

Budget Issues: Capital Budgeting for the Federal Government (Exposure Draft—
GAO/AFMD 88-44, July 1988).

Budget Issues: Current Status and Recent Trends of State Biennial and Annual Budgeting (GAO/AFMD-87-53FS, July 15, 1987).

Transition Series

The Budget Deficit (GAO/OCG-89-1TR)

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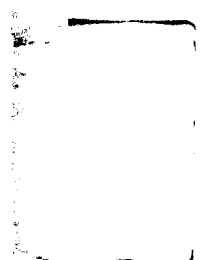
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