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FINANCIAL MANAGEMENT

First Financial Audits of IRS and Customs Revealed Serious Problems

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the results of our recently completed financial statement audits at the Internal Revenue Service (IRS) and the Customs Service and the need to accelerate governmentwide financial management reform through the full and effective implementation of the Chief Financial Officers (CFO) Act of 1990.

Our financial audits at IRS and Customs show that serious financial management problems exist at the Department of the Treasury. The results of these audits and our work at the Department of Defense, on which I testified before you on July 1, 1993,[1] demonstrate the necessity of preparing and auditing annual financial statements.

The CFO Act's pilot program of agency-level audited financial statements has proven that this process pinpoints problems and provides the road map needed to establish financial accountability and control. The audits are demonstrating that there are specific flaws in budget execution needing correction, that particular steps should be taken to improve the efficiency and effectiveness of government, and that better accountability measures will protect against unnecessary losses. It is my hope that the requirement for audited financial statements will be expanded to all major agencies and departments and implementation of the CFO Act will be strengthened. We also believe that the time has come to arrange for audited governmentwide financial reports that will tell the American public where its government stands financially.

Through the CFO Act's pilot financial statement audits, IRS and Customs management have begun the process of improving their financial reporting and the quality of the underlying financial and program performance data. Also, they have gained a greater insight into the areas needing improvement and are now better able to focus on solutions to fundamental problems for which a number of corrective actions are already underway. Further, the Congress has a better idea of how these organizations are actually functioning. Among the results of these financial audits are the following.

-- The Congress now has reliable estimates of IRS' receivables and the related collectible amount, which are tens of billions of dollars less than what had been reported by the agency in the past. Also, management efforts of the IRS to address the collection function can now be better focused.

-- Revenue information at IRS and Customs, covering over 99 percent of the government's total revenues, has undergone an audit for

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[1] Financial Management: DOD Has Not Responded Effectively to Serious, Long-standing Problems (GAO/T-AIMD-93-1).

the first time, highlighting for management's attention a wide range of problems with the quality of the information and with fundamental internal controls over billions of dollars. For instance, IRS will need to overcome a problem whereby its systems cannot provide details as to amounts of specific excise taxes collected. As a result, general tax revenues inappropriately subsidized excise tax trust funds, perhaps by billions of dollars. This condition has important management implications and may have some effect on excise tax policy.

-- IRS is presently focusing on fixes to problems involving unauthorized access to taxpayer information and serious weaknesses regarding the use of its appropriated operating funds that have led to (1) unreconciled differences between its records and Treasury's cash records, (2) unresolved discrepancies and transactions in suspense accounts, and (3) duplicate and other inappropriate payments to contractors.

-- At Customs we noted many opportunities for seized drugs, weapons, and currency to be stolen or misappropriated without detection. The audit has provided additional impetus to address serious control weaknesses evident throughout the seized property process, from the time property is seized until disposed of, that could result in financial loss to the government or danger to the general public.

-- Information has been provided to Customs management and the Congress about the great reliance Customs places on importers and brokers to voluntarily assess and honestly report the amount of duties, taxes, and fees owed on imported merchandise. Customs and the Congress can now better address the potential for additional revenue through an increase in the level of inspection and monitoring.

Other civilian agencies, including those participating in the CFO Act's pilot program, likewise have received important benefits from the audited financial statement process. For the Committee's benefit, I have attached to my testimony a summary of the results of financial statement audits of (1) the student loan program at the Department of Education and (2) the Social Security Administration (SSA). (See attachment I.) Some examples follow:

-- Insights into the costs and operating problems of Education's guaranteed student loan program were disclosed by our recently completed financial audit and are being considered in pending legislation. The Department's use of overly optimistic projections of loan defaults has contributed to a nearly $3 billion shortfall in Education's budgetary estimates of program costs for fiscal years 1992 and 1993. There is now additional emphasis to address misplaced incentives and conflicts of interest that are built into the present student loan program.

-- Six years ago, SSA, much like IRS and Customs this year, began the challenge of preparing financial statements that could withstand audit scrutiny. Through a sustained effort, this year the audited financial statements were available in February 1993--in time to be useful for appropriation hearings and budget deliberations--and included extensive performance information tied to many of SSA's strategic goals and objectives.

In my July 1 testimony, I spoke to you about the need for leadership at the Secretary of Defense level to address long-standing financial management weaknesses. The problems we identified at IRS and Customs, coupled with our findings at Defense, demonstrate not only the need for agency leadership but also for strong leadership at the Presidential, Office of Management and Budget (OMB), and Treasury levels. Governmentwide implementation of the CFO Act must be greatly accelerated and made a top priority of the administration. While important progress has been made in the 2-1/2 years since the passage of the act to set a foundation for change and to better identify problems, a greater sense of urgency is needed to solve a range of problems that pervade government.

Decisive action is needed now to reform federal financial management by

-- selecting an OMB Controller with proper credentials as a financial management leader and a team of highly qualified agency CFOs who can work together to solve difficult common problems;

-- drastically overhauling existing processes, controls, and systems and, in the interim while new systems are being developed, increasing discipline over basic accounting functions such as transaction processing and reconciliations;

-- attracting and retaining qualified financial management personnel;

-- expeditiously developing generally accepted accounting, financial reporting, cost, and systems standards to guide the agencies' improvement efforts; and

-- fostering a strong program of financial statement preparation and auditing.

Our financial audits at IRS and Customs represent the first such audits of these organizations, requiring a major effort by these agencies. Before discussing our specific audit findings, I would like to recognize both agencies for their cooperation and strong efforts to implement the CFO Act. In contrast to the concerns I raised to the Committee on July 1 regarding the Department of Defense's response to its serious financial management weaknesses, both IRS and Customs management have been very responsive to our audit findings and have made progress toward developing reliable information and establishing financial control.

Nevertheless, we were unable to express an opinion on the reliability of IRS' and Customs' fiscal year 1992 financial statements because critical supporting information for billions of dollars was either not available or was unreliable. Preparation of financial statements presented a substantial challenge to IRS and Customs. This undertaking was made especially difficult because their existing systems were not designed to provide meaningful and reliable financial information needed to effectively manage and report on their operations. Compounding this problem, internal controls were not designed and implemented to effectively safeguard assets, provide a reasonable basis for determining material compliance with certain laws and regulations, and assure that there were no material misstatements in the financial statements.

IRS and Customs have begun the process of rebuilding their financial management processes and systems. Continued strong implementation of the CFO Act by these agencies can result in a tremendous payoff through an improved ability to safeguard assets, manage operations, and collect revenues. But the job will not be easy. Using audited financial statements as an important foundation to improve financial management, IRS and Customs will have to overcome the broad range of very serious problems that our financial audits have identified. This will require sustained, high priority management attention and congressional support.

I will now highlight the results of our IRS and Customs audits.

SERIOUS WEAKNESSES EXIST IN IRS' FINANCIAL MANAGEMENT OPERATIONS AND CONTROLS, AND MANAGEMENT IS ACTING TO ADDRESS THESE PROBLEMS

First, I would like to discuss some of the more severe problems we identified in our audit of IRS' financial statements.[2]

IRS Significantly Overstated Its Accounts Receivable

After performing a detailed analysis of IRS' receivables as of June 30, 1991, we estimated that only $65 billion of about $105 billion in gross reported receivables that we reviewed were valid and that only $19 billion of the valid receivables were collectible. At the time, IRS had reported that $66 billion of the $105 billion was collectible.

Historically, IRS reports have significantly overstated its receivables primarily because IRS included duplicate and

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[2] Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993).

insufficiently supported assessments that it had recorded as part of efforts to identify and collect taxes due. While IRS may have a need to maintain such records for enforcement purposes, these and many erroneous assessments were not valid receivables for financial reporting purposes and should not have been included in the reported balances. In addition, IRS' estimates of the collectibility of its receivables have been unreliable because, in addition to including invalid receivables, IRS relied solely on collection experience and did not group assessments according to their collection risk or consider the taxpayer's current ability to pay. This unreliable information on IRS' accounts receivable has affected decisions about the (1) impact of increased collections on the deficit, (2) evaluation of enforcement and collection performance, (3) determination of staffing levels, and (4) allocation of resources.

Based upon the methods that we recommended in our May 1993 report,[3] IRS developed and reported an estimate of $22 billion for collectible receivables as of September 30, 1992. Ultimately, though, systems must be developed to keep an accurate running record of IRS' receivables.

Important Revenue Information Is Unavailable or Unreliable

We were able to determine that IRS' total reported revenues of about $1.1 trillion were actually collected and deposited into Treasury accounts.[4] Although we were able to audit total revenue collections, we were not able to audit the components of revenue because IRS' systems could not provide the detailed transactions supporting the revenue balance, which is a serious limitation. IRS' systems also did not maintain and, thus, could not report the amounts of specific excise and social security taxes collected.

As a result, IRS could not provide Treasury the information needed to distribute excise taxes among the general revenue fund and the various excise tax trust funds based on collections, as required by law. Instead, IRS reported to Treasury the amounts of excise taxes assessed, and Treasury distributed revenue based on these amounts. Since total assessments exceed total collections, this practice, in effect, results in subsidies to the excise tax trust funds from general tax revenues. Over the past several years, such subsidies may have totaled several billion dollars. Also, the reported

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[3]Financial Audit: IRS Significantly Overstated Its Accounts Receivable Balance (GAO/AFMD-93-42, May 6, 1993).

[4]Our financial audit for fiscal year 1992 was not designed to address IRS' information on (1) the impact of tax policies on revenue, often referred to as "tax expenditures," and the process used by IRS to determine this information or (2) potential tax revenues, often referred to as the "tax gap."

information gives the impression to decisionmakers that the excise taxes are generating more revenue than they actually do.

Similarly, IRS cannot determine the general revenue fund's subsidy to the social security trust fund. This subsidy occurs because, amounts distributed, which are by law to be based on wages earned, generally exceed social security taxes collected. However, IRS cannot precisely determine the subsidy amount because it does not account for the specific amounts of social security taxes collected. As a result, IRS cannot provide information on the subsidy to congressional committees and others who may be interested in monitoring the financial condition of the social security program.[5]

We identified additional fundamental deficiencies in IRS' analysis and summarization of its revenue-related records and in controls over the reliability of this information. Some examples follow.

-- IRS' reports did not include transactions that were in process at the end of reporting periods because IRS did not analyze such transactions to determine which needed to be reported. As of September 30, 1992, in-process transactions, which could have affected IRS' reported accounts receivable, refunds payable, and other noncash accounts, exceeded $150 billion.

-- IRS' current paper-based Federal Tax Deposit System for collecting payment data from businesses allowed numerous errors, primarily because the payment data and the related tax data were collected separately. Resolving such errors was both time-consuming and costly to IRS and taxpayers.[6]

To address problems in revenue accounting, IRS is expanding the role of the CFO and is either studying, planning, or implementing various improvements to its systems and processes. Many of these improvement efforts, however, have not yet been defined or are not expected to be complete until well past the year 2000 because they are part of IRS' long-term Tax Systems Modernization effort.

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[5]In our report entitled Social Security: Reconciliation Improved SSA Earnings Records, But Efforts Were Incomplete (GAO/HRD-92-81, September 1, 1992), we suggested that the Congress consider amending the Social Security Act to require that revenues credited to the social security trust funds be based on social security taxes collected.

[6]Federal Tax Deposit System: IRS Can Improve the Federal Tax Deposit System (GAO/AFMD-93-40, April 28, 1993).

Unreliable Records for Automated Data Processing Property

Inventory records for IRS' automated data processing (ADP) property were unreliable for managing and reporting on computer hardware and software. IRS had not instituted basic procedures to ensure that this information was current and accurate. Specifically, IRS (1) had not developed procedures to record acquisitions and disposals accurately and promptly, (2) did not effectively perform physical inventories, and (3) did not properly value computer resources. For example, a video display terminal costing $752 was valued in the ADP inventory records at $5.6 million, and telecommunications and electronic filing equipment, which IRS valued at a total of $84.2 million, was omitted altogether.

As a result of unreliable and incomplete records, IRS did not readily have the information it needed to (1) make computer support staffing decisions, (2) support development of budget requests, procurement decisions, and performance measurement information related to the use of computer assets, or (3) effectively manage maintenance contracts. For example, we found that IRS paid $36,000 for a maintenance contract for a minicomputer that had not been used for 3 years, because maintenance contract officers could not readily determine what equipment was still in use. Further, IRS did not maintain records of the costs of in-house software development which, when combined with ADP inventory information, would provide more complete accountability for ADP costs and assist in planning decisions.

For the last 3 fiscal years, IRS had budgeted acquisitions of property and equipment totaling $453 million. Planned future expenditures for ADP assets, approaching $9 billion under IRS' Tax Systems Modernization effort, increase the importance of accurate ADP asset records to IRS.

Inadequate Controls Over Computerized Taxpayer Data

Though heavily dependent on automated systems to process and safeguard taxpayer data, IRS did not adequately control access authority given to computer support personnel or adequately monitor employee access to this information. Further, controls did not provide reasonable assurance that only approved versions of computer programs were implemented.

Such weaknesses increase the risk of unintentional errors and fraud and may compromise the confidentiality of taxpayer information. For example, IRS' internal reviews found that some employees had used their access to monitor their own fraudulent returns, to issue fraudulent refunds, and to inappropriately browse taxpayer accounts. IRS is in the process of implementing new systems to monitor employee activities relating to computerized taxpayer information.

Inadequate Management of Operating Funds

For years, IRS' systems used to process and account for spending of operating funds could not provide accurate and timely information needed to manage these funds. We were unable to audit approximately $4.3 billion, or 64 percent, of the reported spending of $6.7 billion from IRS' operating appropriations because IRS could not reconcile the total of detailed spending information in its outdated systems with summary amounts reported in such systems. The remaining $2.4 billion of reported spending in fiscal year 1992, which we audited, was processed by a new system installed in fiscal year 1992 in IRS' National Office and one region. This new system was implemented throughout IRS on October 1, 1992.

For the spending we were able to audit, IRS' systems and controls did not provide (1) a reasonable basis for determining compliance with laws governing the use of budget authority and (2) reasonable assurance that its disbursements were appropriate.

We found, for instance, that IRS had several billion dollars in unresolved cumulative gross differences between its records and Treasury's cash records at the end of the fiscal year. Also, as of September 30, 1992, IRS had not resolved $53 million in unmatched expenditures which were in a suspense account. To clear the account, IRS arbitrarily charged the $53 million to three of its appropriations (each appropriation was allocated one-third of the amount), causing IRS' reports to show that it had exceeded the budget authority for one of its appropriations. However, to eliminate the appearance that it exceeded such authority for this appropriation, IRS recorded an unsupported receivable from another appropriation.

Further, some disbursements were inappropriately processed because supporting documents were not adequately reviewed, related processing guidance was insufficient, and procurement and payment systems were not designed to automatically exchange information. In a random sample of 280 payments, for example, we found (1) 32 duplicate and overpayments totaling $0.5 million, 4 of which were part of our sample and 28 that were discovered in related documentation and (2) 112 payments totaling $17.2 million, for which complete supporting documentation could not be provided. As a result of these problems, IRS made improper payments, and reports used by its managers, Treasury, OMB, and the Congress to manage and oversee IRS' operations were unreliable.

IRS expects that its new system will provide up-to-date information that would enable it to better monitor available appropriations and determine whether funds are available before they are obligated--two problems identified during our financial audit. But even if the new system is successful, additional changes are needed to solve a number of the weaknesses we identified which were not intended to be addressed by the new system.

IRS' FMFIA Reporting

IRS did not disclose the overall severity of its internal control and accounting system weaknesses in its fiscal year 1992 report to Treasury under the Federal Managers' Financial Integrity Act (FMFIA) of 1982. Without adequate disclosure, the Congress and other users of the FMFIA report will not be aware of the extent of IRS' weaknesses and the efforts needed to correct them. We identified material weaknesses that IRS either did not include or, in our view, did not adequately disclose. For example, the serious problems we noted in the revenue area were largely undisclosed as were the problems in the management of operating funds.

In addition, some previously identified material weaknesses that were reported as corrected still exist because IRS did not address the fundamental causes of those weaknesses or ensure that corrective actions were effective. IRS' FMFIA process for identifying, disclosing, and correcting material weaknesses must be improved if IRS is to produce reliable information that top management can use to control costs and improve operations.

Actions by IRS to Improve Financial Management

Prior to fiscal year 1989, IRS had put neither substantial effort nor resources into rectifying the poor state of its financial management operations and no one at IRS was responsible for ensuring the integrity and efficiency of financial management and accounting systems agencywide. Responding to a recommendation in our 1988 report[7] on our general management review of IRS, which was a joint effort with the agency, and the mandate of the CFO Act, IRS established financial leadership through the appointment of a CFO and an Assistant Commissioner (Finance)/Controller. These individuals and the support of IRS' top management have been key to the progress to date.

Among the actions IRS has taken are to (1) significantly increase its CFO staff, (2) implement agencywide, in fiscal year 1993, a new integrated accounting and budget system, and (3) begin development of a cost management system to enable better performance measurement and reporting on operating performance. Also, IRS is studying, planning, or implementing various additional improvements to its systems and processes.

IRS will continue to face major challenges in developing meaningful and reliable financial management information and in providing effective internal control as envisioned by the CFO Act. It will take a significant and sustained commitment by IRS management,

[7]Managing IRS: Actions Needed to Assure Quality Service in the Future (GAO/GGD-89-1, October 14, 1988).

particularly by the CFO and CFO staff, to successfully implement the improvement initiatives now under way.

We believe IRS is making progress because it has had a sustained commitment to improving the management of its operations. The past several IRS Commissioners adopted a consistent management improvement agenda that we helped IRS initially frame as part of our 1988 general management review. Management's response to the findings of the general management review, similar to IRS' work to address the findings of our financial audit, has been most encouraging and signifies an organization willing to recognize its problems and attempt to do something about them. My hope is that we will see this type of management involvement and commitment across government. In my view, only in this way will agencies achieve the level of improvement that is needed to successfully implement the CFO Act and to improve overall management of agency programs and operations.

SERIOUS WEAKNESSES EXIST IN CUSTOMS' FINANCIAL MANAGEMENT OPERATIONS AND CONTROLS, AND MANAGEMENT IS ACTING TO ADDRESS THESE PROBLEMS

I will now discuss some of the more serious problems we identified through our financial audit of the Customs Service.[8]

Weak Accountability for Seized Property and Special Operations Documents

Customs reported $542 million in seizures during fiscal year 1992 and an ending balance of $489 million in seized property in its financial statements. The policies and procedures the agency established to control seized property, though, were not consistently and effectively implemented. We identified weaknesses in internal controls throughout Customs' seizure process, from the time property was seized to the time of its disposal. Seized property was vulnerable to theft or loss, which could result in financial loss to the government or danger to the public.

The following are examples of control breakdowns.

-- The transfer of seized property from seizing officers to seizure custodians for safeguarding was often delayed. Over 50 percent of the 118 items we tested were not transferred within Customs' prescribed 2-day maximum--the average was 35 days. In one instance, about one-half pound of heroin was held by a seizing officer from August 11, 1992, the date of the seizure, until March 16, 1993, when we visited the Customs' district involved. No one could explain the reason for the delay.

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[8]Financial Audit: Examination of Customs' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-3, June 30, 1993).

-- Seized drugs were not properly weighed and tested, creating an environment where drugs could be stolen without detection. For instance, although Customs had established procedures to weigh drug seizures, we found a case where a shortage of 1,850 pounds of seized marijuana could not be accounted for. Customs was unable to explain the discrepancy other than to state that the initial weight assigned to the marijuana was probably an estimate and that the seizure had not been weighed as required at the time of receipt.

-- Storage facilities were not properly protected. At 14 of the 20 Customs' seized property storage facilities we visited, we observed that unaccompanied seizure custodians had access to vaults. None of the 20 Customs districts we visited had security cameras in their vaults, and 2 sites containing large bulk quantities of drugs had open physical access in full public view.

Further, Customs did not adequately control millions of dollars in funds advanced to its agents for special operations, such as undercover work and payments to informants, or the sensitive documents related to these advances. For advances, Customs' accounting records had to be adjusted from $37 million to $19 million to show the correct balance at year-end. More serious though, sensitive documents supporting special operations transactions were not adequately safeguarded. At Customs' National Finance Center, sensitive documents were routinely stored in an open filing cabinet in an unlocked room or were left unattended on a desk. Failure to adequately protect these documents could threaten the safety of informants and Customs' agents, compromise important relationships with informants, and undermine Customs' credibility.

<u>Inadequate Accounting for and Controlling of Accounts Receivable</u>

The $828 million Customs reported as accounts receivable as of September 30, 1992, was inaccurate and incomplete. Customs' internal controls over accounts receivable were so poor that we could not gain assurance that all valid receivables were included in its reported amounts. Further, Customs' reported amount did not include certain valid receivables, included some receivables at a net amount instead of gross, and included some receivables which could not be supported. For example, the reported accounts receivable included only $26 million for fines and penalties cases. In a relatively small sample, we found fines and penalties cases with an assessed value of $78.7 million which should have been included but were not.

Also, Customs had not developed a reliable methodology for estimating the amount of its receivables that is likely to be collected. Customs' methodology was flawed because it considered primarily historical collection experience but did not consider the debtor's current ability to pay. Our review of $403 million of valid receivables as of June 30, 1992, showed that Customs' estimate of the uncollectible amount of these accounts receivable was understated by about $41 million.

In addition, efforts to collect delinquent debt were hampered by missing documents. In our sample of 966 cases, Customs could not locate 144 key documents, involving 127 cases, needed to support its claims against the importer or surety. In addition, Customs did not effectively monitor bond coverage which gave rise to delinquent and, in some cases, uncollectible accounts receivable. In one instance, a petroleum importer, with 15 outstanding bills totaling about $3.1 million, had a continuous surety bond of only $400,000. Customs pursued collection from the surety and collected the bond amount. However, the remaining $2.7 million was not covered by the bond and is most likely uncollectible as the importer is more than 4 years delinquent in paying this debt.

Finally, large differences existed between the amounts of fines and penalties assessed, mitigated, and collected. Overall, Customs collected pennies on a dollar of assessed fines and penalties. Violators, who are aware of these differences and Customs' practice of mitigating most assessments, may routinely petition for mitigation, requiring Customs to devote large amounts of resources to the mitigation process. While Customs does not routinely report data that correlate individual assessments to collections, we found that only a small fraction is being collected. As a measure of the potential difference, during the past 2 fiscal years, Customs assessed fines and penalties totaling approximately $7.9 billion and collected only about $87 million for various fines and penalties cases, including cases opened in earlier years.

According to Customs' officials, such differences result primarily from (1) the statutory requirements that Customs assess fines and penalties in large amounts and (2) Customs' practice of mitigating most accounts to nominal amounts. We found that some assessments are mitigated because Customs did not have sufficient documentation at the time of assessment and later mitigated the assessment to reflect documentation provided by the importer. For example, Customs assessed a penalty amount of about $4.4 million to an importer for allegedly fraudulently undervaluing merchandise being imported. The importer filed a petition with Customs and provided additional information, and the penalty was reduced to $150,000.

<u>Weaknesses Over Import and Drawback Verification Create Opportunities for Lost Revenue and Fraud</u>

Customs relies to a great extent on importers and brokers to voluntarily report and assess the amount of duties, taxes, and fees owed on imported merchandise. We found no significant internal controls to ensure that merchandise entering the United States was identified and the proper duty assessed. Based on certain audit tests, we were able to conclude that Customs' reported revenues of $20.2 billion for fiscal year 1992 approximate revenues collected from importers who voluntarily reported and paid amounts owed. However, because of the potential for goods to enter and not be identified, we cannot give any assurance that the $20.2 billion represents all revenues which Customs should have collected for fiscal year 1992. Customs recognizes this problem and has established a project to improve importer compliance and target inspections for trade enforcement purposes. It will, though, take a significant effort to adequately address the broad scope of problems in this area.

Furthermore, our review of Customs' duty refund (drawback) policies and procedures showed that serious control weaknesses existed throughout the process. Customs makes refunds to claimants for 99 percent of duties paid when the related imported merchandise is subsequently exported or destroyed. Customs reported that it made almost half a billion dollars in drawback payments during fiscal year 1992. However, we found that procedures were inadequate to prevent excessive or duplicate payments or detect fraudulent claims. Specifically, Customs did not (1) adequately assess the validity of a drawback claim and track the amount of drawback paid against an import entry, (2) establish sufficient review procedures to ensure that a claim was accurate, (3) ensure that required bonds were adequate, and (4) ensure that only authorized claimants received accelerated[9] drawback payments.

In the absence of appropriate controls, Customs' extensive reliance on voluntary compliance of the trade community to accurately report duties owed and drawbacks claimed creates an environment where the federal government could lose substantial amounts of revenue.

Customs Lacked Adequate Accountability for Property

Customs lacked adequate accountability for property which it valued at $710 million at September 30, 1992. About 85 percent of this amount consisted of equipment such as aircraft, vehicles, and vessels. For years, Customs was unable to reconcile its accounting records with the related detailed subsidiary property records. In fiscal year 1992, Customs made a substantive effort to reconcile these records, which resulted in net adjustments that totaled $115 million. Some of these adjustments, though, were not supported by identifiable transactions and were made to force these records to agree. Customs did not know whether the adjustments

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[9]Accelerated drawback payments were made to authorized claimants prior to Customs reviewing and verifying the validity and accuracy of the claim. Nonaccelerated claims are paid after Customs reviews them. Therefore, accelerated payments represent a greater risk than nonaccelerated payments.

represented property that was simply incorrectly accounted for or, was lost, misappropriated, or stolen.

Also, Customs' fiscal year 1992 physical inventory of equipment was ineffective. We found, for example, $6.2 million of computer equipment on hand which was not included in the property records. Further, Customs was unable to support the values assigned to over 50 percent of the 650 property items we sampled and tested. The value assigned to many items appeared to be estimates. In the cases where Customs was able to provide documentation, 12 percent of the property items were improperly valued, resulting in an estimated net understatement of at least $4.7 million.

Customs' FMFIA Reporting

Similar to IRS, Customs did not report the overall severity of its internal control and accounting system weaknesses in its fiscal year 1992 FMFIA report. Its report did not include or did not adequately disclose the seriousness of the problems identified in our audit. Customs' FMFIA process for identifying, disclosing, and correcting material weaknesses must be improved if the agency is to produce reliable information that top management can use to control costs and improve operations.

Actions by Customs to Improve Financial Management

Customs has made strides in addressing long-standing financial management problems. For years, until the passage of the CFO Act, Customs, like IRS, lacked financial management leadership with sufficient expertise, responsibility, and authority to ensure that its financial systems, processes, and internal controls fully supported its financial information needs. Over the last 2 years, through the strong support of the Commissioner and Customs' top management, the agency has put in place a CFO structure and given the CFO the authority and responsibility necessary to begin to correct many of the problems identified in our audit. During 1992, for instance, the agency installed a new core general ledger system which became effective October 1, 1992.

Customs is either studying, planning, or implementing various improvements to its systems and processes. It is in the process of redesigning its Automated Commercial System, which was developed to automate information on Customs' program operations and is used to account for revenue collected, and it has begun development of a new cost accounting system. Customs has also begun to modify its methodology for estimating the collectibility of its accounts receivable and has made positive strides towards addressing its debt collection problems. Further, Customs has taken steps to resolve long-standing problems in its property records and is planning additional efforts.

The success of Customs' ongoing ADP modernization efforts and planned procedural improvements will be critical to improving its financial management systems and internal control structure. Many of these efforts, though, are not expected to be complete for several more years. As a result, it will take a significant and sustained commitment by Customs' management, particularly by the CFO and the CFO staff, to build on efforts now under way to develop new systems and put proper controls in place.

REACHING FOR FINANCIAL MANAGEMENT REFORM: SUCCESSFUL IMPLEMENTATION OF THE CFO ACT MUST BE A HIGH PRIORITY

This leads me to the broader issue of ensuring successful governmentwide implementation of the CFO Act. As discussed in our December 1992 transition series report on Financial Management Issues (GAO/OCG-93-4TR), widespread financial management weaknesses are crippling the ability of our leaders to effectively run the federal government. Reducing the federal deficit requires monumentally difficult decisions. If our government is to make these decisions in an informed manner, it must have better financial information. Also, our citizens should be provided meaningful information that allows them to judge the performance of their government and controls that help guarantee fundamental accountability. Because credible financial data are not available today, public confidence in the federal government as a financial steward has been severely undermined.

There is no magical formula to solve the federal government's financial management problems. The issues are very complex, deeply rooted, and involve the largest entities in the world, which have no counterparts in the private sector--the federal government is clearly different. Nevertheless, successful financial management reform can and must be achieved.

The CFO Act, enacted under the leadership of this Committee and the House Committee on Government Operations, provided the needed foundation. This landmark legislation is the most comprehensive financial management reform package in 40 years--but it must be fully and effectively implemented. The CFO Act is now 2-1/2 years old. Many important initiatives are under way and planned, and I am most pleased that the basic concepts are taking root. But a much greater sense of urgency is essential to successfully implement needed reforms and to ensure that the huge potential savings to the taxpayer from the resulting improvements in the efficiency and effectiveness of government are realized as promptly as possible. I would now like to highlight these critical actions.

Ensuring Sustained High-Level Priority Attention to Resolve Problems

Only through consistent and continuous attention from the highest levels of government and the Congress, including agency CFOs with requisite skills and experience and the needed powers and authority to get the job done, will we see the results that are possible. Without decisive action by the new administration and strong oversight and support by the Congress, efforts to reform financial management will falter. There must be a sense of urgency. Changing a government culture that has not always seen financial management as important is difficult, especially if there is not a continuity of effort or if this change is not perceived as important.

Essential to success will be the President making financial management reform a high priority in the administration, and I am hopeful this will emerge as one of the top action items of the National Performance Review. The President must hold agency heads accountable for successfully implementing the CFO Act. There has to be an increased emphasis on professional management. In my view, the success of financial management reform is critical to any effort to reinvent government.

Agencies must give high-level attention to financial management improvements. For example, the recent announcement by the Department of Defense that it had established a senior management steering committee, chaired by the Deputy Secretary, to bring together financial, program, and information management, was encouraging. Agency leadership has to provide an appropriate framework for integrating accounting, program, and budget systems and data in order to develop more useful and relevant information for decision-making and to break down traditional barriers between program and financial management. Further, the central financial management agencies--OMB, Treasury, and GAO--must expedite sorely needed accounting, financial reporting, cost, and systems standards.

The CFO Act established a Controller in OMB to provide overall leadership and CFOs to direct and control financial management activities in major departments and agencies. A highly qualified Controller is needed to steer this effort, with the authority to lead the CFOs in the major departments and agencies and the resources to do the job. The administration must also appoint agency CFOs who are highly qualified financial management professionals, with the right mix of properly defined duties and full authority for traditional financial management functions, including budgeting. At most agencies, the CFO has not yet been appointed.

Expanding Audited Financial Statements to the Entire Federal Government

As I have stated on many occasions, I am firmly convinced of the value of audited financial statements. As I discussed earlier, the results of the pilot financial audits at Defense and the civilian agencies further reinforce this belief.

On June 25, 1993, OMB Bulletin 93-18 extended the pilot program for audited financial statements at 10 agencies for 3 years and established March 1 as the new due date for the issuance of all audited financial statements. In issuing this new bulletin, the Director of OMB stated:

> "The preparation and audit of financial statements has provided significant financial and related information, identified and stimulated correction of deficiencies in the agencies' financial systems, and improved understanding of the agencies' financial condition and results. Accordingly, it is beneficial to continue and expand the audited financial reporting process."

I fully support the OMB Director's extension of the pilots and establishment of a March 1 reporting date to tie in with the budget cycle. OMB's continuing strong support of audited financial statements and the leadership of its Office of Federal Financial Management have been very important to the success of this program.

To further build on this success, it is now time to expand the requirements for agency level audited financial statements beyond the 10 pilots to cover all the agencies identified in the CFO Act. This could be phased in over the next 3 years and would ultimately enable preparation of financial statements for the government as a whole, which GAO would audit. For the first time, the American public would be given an accountability report from its government.

We believe it would be best for this requirement to be anchored in legislation. The legislative mandate in the CFO Act for audited financial statements has been a catalyst for the important results we have seen to date in moving agencies to a higher level of financial accountability. While administrative requirements to prepare financial reports date back to the 1950s, the legal force of the CFO Act, together with the interest and involvement of this Committee and the House Committee on Government Operations, is what finally moved this effort ahead.

Also, the preparation of audited financial statements, including required performance information on the results of operations, would support the implementation of the Government Performance and Results Act of 1993. In my view, implementation of this important new legislation can be greatly aided with good cost and operating performance information that audited financial statements under the CFO Act are intended to provide.

Making Wise Investments in Systems and Personnel to Rebuild Financial Management Infrastructures

Today, it is well acknowledged that current financial systems across government are in extremely poor condition, despite spending billions of dollars over the years on improvement efforts. IRS and

Customs, for example, struggled in preparing reliable financial statements primarily because of severely weak systems. This has to be overcome through wise investments in modern systems that enable streamlined operations and have a dollar pay-off in terms of better information and better efficiency. While investment in new systems is essential, billions of dollars are already being spent on systems every year--the money just has to be better invested in carefully developed systems that will meet government information needs.

The CFO Act calls for integrated systems, meaning financial and operating systems that are interconnected to support both agency business plans and management information needs. There must be increased emphasis on using information resource management to facilitate agency reengineering projects. Reform cannot be viewed merely as further automating existing processes. Rather, those processes must be simplified, redirected, and reengineered.

An equally important step is breaking down traditional barriers between program and financial management so that financial management supports programs, missions, and business lines. For example, the serious problems IRS faced in accounting for its receivables stemmed in large part from a system that was designed to capture information for enforcement and collection activities and was not properly tied to financial reporting. Further, efficiencies could be gained through more standard systems and more "cross servicing" in which one agency provides accounting services (such as payroll and disbursing) to another agency. The development and use of governmentwide systems development standards to better guide system design and implementation efforts would be a vital component in such efforts.

The federal government must address immediately the serious problem of attracting and retaining well-qualified financial management personnel. Agencies reported a significant need to upgrade their financial management staff capabilities. In our financial audits, we have found that bad systems are made even worse because people do not properly process transactions. We have identified tens of billions of dollars of accounting errors that could have been avoided if there had been more discipline in following existing policies and procedures. Financial managers must upgrade their training efforts to increase professional skills.

Implementation of new systems that eliminate the duplicative and manual processes that agency systems require today should enable agencies to decrease the size of their financial management staffs. But, they may need more skilled professionals such as financial analysts and cost and systems accountants. Further, to ensure a cadre of professional financial managers for a government that is the largest financial entity in the world, we support mandatory continuing professional education for all financial managers similar to the requirement now in place for auditors.

Fostering Reforms Through Strong Congressional Oversight and Support

I have spoken many times about the importance I place on annual congressional oversight hearings of agency management. Managers must be held accountable for results. The annual agency CFO report, which includes the audited financial statements, together with the reporting required under FMFIA, can provide a baseline for such hearings.

In the case of FMFIA, these reports have to be meaningful and must be used or else they will not be taken seriously. As I testified on July 1, we had major problems with the Department of Defense's most recent FMFIA report, and earlier I cited the problems we identified with IRS' and Customs' FMFIA reporting. Greater accountability can be established through reporting that combines the agency CFO and FMFIA reports and focuses on outcomes and results which are scrutinized by annual congressional oversight hearings.

Finally, in difficult budget times, and where the pay-off may not be immediate, funding for financial management improvements will need to be viewed as investments. For the CFO Act to succeed, the Congress will have to provide the necessary funding support through investments in modern systems, personnel staffing and development, and expanded financial reporting and auditing.

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In closing, I want to emphasize that the CFO Act has had an important impact in changing perceptions about the need for good financial management, and agencies have made improvements and are working in response to the act to significantly strengthen their financial processes and systems. But it will take a great deal of commitment and hard work to achieve the full potential and objectives of the act and turn around long-standing neglect of financial management. Our financial audits at IRS and Customs, for example, have identified major problems that will need management's continuing top-level attention and their support of the CFO. Top management's recognition that they have serious problems and efforts to establish a viable CFO structure in their agencies are an important beginning to a difficult challenge.

Shifting now to a governmentwide perspective, an intensified sense of urgency will be needed. We are at a critical juncture in implementation of the CFO Act. Financial management reform must be a high priority of the President and the Congress. Changing a government culture that has not always seen financial management as important is difficult, especially if there is not a continuity of effort or if this change is not perceived as critical. We stand ready to work with the Committee in any way we can. Attached to my statement is a summary of the needed actions which were included in our Financial Management Issues transition series report. (See attachment II.) I view implementation of the CFO Act as essential to establishing accountability in the federal government, which has been one of my fundamental goals as Comptroller General.

Mr. Chairman, this concludes my statement. I will be glad to answer any questions that you or the other Members of the Committee may have at this time.

FINANCIAL AUDITS AT OTHER CIVILIAN AGENCIES DEMONSTRATE THE BENEFITS OF PREPARING AGENCY FINANCIAL STATEMENTS

In addition to IRS and Customs, other civilian agencies, including those participating in the CFO Act pilots, have realized important results from audited financial statements. The following highlights two examples: (1) the Department of Education, where GAO has just issued its audit report on the student loan program and (2) the Social Security Administration (SSA), which has issued audited financial statements since 1988.

Education's Student Loan Program Has Serious Financial Management Problems

With a reported $63 billion in outstanding loan guarantees at September 30, 1992, the Department of Education's Federal Family Education Loan Program (FFELP), referred to as the guaranteed student loan program, is the largest postsecondary education loan program of the federal government. Due to a history of program mismanagement and the significant increase in loan defaults since the program's inception--gross loan defaults were about $3 billion in fiscal year 1992--the FFELP has been on our list of high-risk programs since we began this designation in 1990. We have been especially concerned with the program's structural flaws and the lack of adequate incentives that some participants have to prevent defaults and to operate more efficiently.

Education has put forth a substantial effort in implementing the CFO Act and in preparing the first comprehensive financial statement for the FFELP. As with IRS and Customs, this effort was hampered because Education's systems were not designed to provide the financial management information needed to effectively manage and report on the FFELP's operations.

Education fully cooperated with us and began significant efforts towards developing such information. However, because critical supporting information for almost $14 billion of recorded liabilities for loan guarantees and related accounts was unreliable, we were unable to express an opinion on the reliability of the FFELP's fiscal year 1992 financial statements taken as a whole.[10] Compounding this problem, internal controls were not designed and implemented to effectively safeguard assets and assure

[10]Financial Audit: Federal Family Education Loan Program's Financial Statements for Fiscal Year 1992 (GAO/AIMD-93-4, June 30, 1993).

that there were no material misstatements in the financial statements. For example,

-- Education is not able to ensure that billions of dollars in program payments to lenders and guaranty agencies are accurate;

-- FFELP participants, including banks and other financial middlemen, operate under misplaced incentives and conflicts of interest that result in waste and abuse;

-- optimistic projections of loan defaults have contributed to a nearly $3 billion shortfall in Education's budgetary estimates of program costs in fiscal years 1992 and 1993; and

-- Education did not have adequate financial reporting processes and procedures.

Under the leadership of the CFO's office, Education has made progress in addressing some of these long-standing deficiencies. Efforts include intensifying its reviews of lenders and guaranty agencies and developing and reconciling subsidiary ledgers for the FFELP which, if successful, will increase program accountability. A strong CFO and a continuing firm commitment from top management is necessary if Education is to sustain this progress.

The Social Security Administration Has Made Improvements in Financial Management and Reporting

SSA has issued audited financial statements for the past 6 years. Over this period, SSA has improved the usefulness, timeliness, and accuracy of its financial management information. We believe that the progress to date at SSA is a result of the strong leadership and commitment from the SSA CFO.

For the past 3 years, SSA's financial statements have included performance information which shows actual performance for the last 4 years for many of the key goals and objectives outlined in the Social Security Strategic Plan. The Strategic Plan identifies SSA's strategic priorities and service delivery goals and objectives for the year 2005, including the consequences of not achieving these objectives. The performance section of the financial statements thus can serve as a "report card" on how SSA is progressing towards its strategic goals and objectives.

Another factor that has increased the usefulness of SSA's fiscal year 1992 statements is that SSA issued them in February 1993, in time for use in congressional appropriation hearings. The timely release of these financial statements serves as a model for other large agencies.

Except for unresolved differences in wage certification and the accuracy of SSA's accounts receivable (benefit overpayments), the Department of Health and Human Services' Inspector General (IG) reported that the 1992 SSA financial statements were fairly stated. During fiscal year 1992, SSA made improvements that allowed the IG to remove prior years' opinion qualification on property management.

Although wage certification, accounts receivable, and other issues remain unresolved, significant progress has been made in SSA's financial management and reporting. We believe that through continued strong leadership from the CFO, SSA can effectively address these concerns in the future.

TAKING FURTHER ACTIONS TO EFFECTIVELY IMPLEMENT THE CFO ACT

The framework of the CFO Act offers great hope for achieving better government management. But while important progress has been made, the government is a long way from achieving the act's objectives. A sense of urgency is needed to solve the problems.

The following actions, which are discussed in GAO's transition series report on Financial Management Issues (GAO/OCG-93-4TR), are essential to successfully implementing needed reforms.

The President should

-- make financial management reform a high priority in the administration;

-- hold agency heads accountable for successfully implementing the CFO Act and for attaining good financial management, effective internal controls, and sound financial reporting that ties together financial and program information;

-- sustain a high level of financial management leadership in OMB and provide adequate resources to the Office of Federal Financial Management; and

-- appoint to agencies' CFO positions only highly qualified individuals who (1) have extensive practical experience and demonstrated ability in financial management, as mandated by the CFO Act, and (2) meet the qualification requirements established by OMB.

The Director of the Office of Management and Budget should

-- closely monitor agencies' adherence to existing accounting policies and procedures in order to improve data accuracy and promptly take necessary remedial action when agencies are not doing the job;

-- expand OMB's ability to oversee and, where needed, direct agencies' actions to correct long-standing internal control weaknesses and high-risk problems, especially in cases in which results have not been forthcoming;

-- foster a strong program of financial statement auditing by supporting (1) needed funding for the Inspectors General and (2) audit requirements that meet the broad objectives of the CFO Act;

-- promote and closely oversee agencies' efforts to build first-class financial management infrastructures--both personnel and systems;

-- provide an appropriate framework for integrating accounting, program, and budget systems and data to (1) develop more useful and relevant information for decision-making and oversight and (2) break down traditional barriers between program and financial management;

-- continue to work with GAO and the Department of the Treasury to develop accounting standards and concepts to meet the unique needs of the federal government;

-- expand financial reporting to encompass the full range of accountability, which includes operating results, program performance measurement, and cost information; and

-- establish minimum levels of continuing professional education requirements for financial management personnel and work with the CFO Council to develop and expand training programs.

The Congress should

-- amend the CFO Act to require audited financial statements on an annual basis for all major agencies and for the government overall;

-- focus closely on CFO appointments to ensure the qualifications of these individuals;

-- conduct annual oversight hearings using the CFOs' annual reports and audited financial statements; and

-- provide necessary funding support for financial reform efforts through investments in modern systems, personnel development, expanded financial reporting and auditing, and a strengthened Office of Federal Financial Management.

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