United States General Accounting Office

GAO

Report to the Chairman, Senate Budget Committee

January 1993

FEDERAL CREDIT PROGRAMS

Agencies Had Serious Problems Meeting Credit Reform Accounting Requirements

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GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

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January 6, 1993

The Honorable Jim Sasser
Chairman, Budget Committee
United States Senate

Dear Mr. Chairman:

The Federal Credit Reform Act of 1990 (Public Law 101-508) was enacted to better control and manage the government's direct and guaranteed loan programs, which agencies reported as amounting to $855 billion as of September 30, 1991. Because of the importance of achieving this objective through consistent and proper implementation, you asked us to examine agencies' progress and problems in carrying out the act. This report addresses the issues you raised involving the Office of Management and Budget's (OMB) requirements for implementing the act and agencies' capabilities to account for domestic lending programs under credit reform and to calculate the federal government's cost (subsidy) for these programs. We will report later on the other areas you requested us to examine, including implementation of credit reform for international credit programs.

Results in Brief

OMB's approach to accounting for the cost of loans and loan guarantees specifically covered by the Credit Reform Act and to preparing related subsidy cost estimates for the budget is consistent with the act's provisions. Nevertheless, the act's full potential for improved credit program budget information is yet to be realized. Agencies' initial efforts to comply with OMB's credit reform requirements were seriously hampered by severe and long-standing financial systems and control problems which would have required correction regardless of changes necessary to implement the act. OMB expected agencies to initially have difficulty developing the detailed data needed and, on a case-by-case basis, permitted temporary exceptions to the requirements. Also, OMB helped agencies prepare credit program subsidy cost estimates. But the potential for inaccuracies was great because of economic uncertainties and because agencies had to rely on information that has historically been incomplete and unreliable. Further, since the act and OMB's requirements apply only to direct and guaranteed loans beginning with fiscal year 1992, most agencies are accounting for and reporting on pre- and post-credit reform loans and loan guarantees inconsistently.

Agencies projected that implementing credit reform will take several years and will require extensive financial systems modifications and additional staff to meet the new requirements. Even though OMB is considering alternatives, such as the use of sampling techniques, to its prescribed credit reform accounting requirements that may facilitate short term agency compliance, substantially upgraded systems are necessary to overcome the lack of reliable credit program information. Also, improved accounting, such as required by credit reform, and consistent financial statement reporting would provide more accurate and relevant information to alert decisionmakers to future funding needs of pre-credit reform programs, facilitate more accurate post-credit reform estimates, and improve important trend analysis information. While these problems will be difficult for agencies to deal with, the Chief Financial Officers (CFO) Act of 1990 (Public Law 101-576) provides additional impetus to improve credit program financial systems and information and to focus top management's attention to resolving credit reform implementation issues.

Background

Federal credit programs provide interest subsidies and sustain losses caused by defaults totaling billions of dollars annually. The Credit Reform Act's passage was a major milestone toward presenting these costs in the budget. The act, which legislated changes we have long supported,[1] holds great potential for the Congress and agencies to make credit program budget decisions based on meaningful financial information. It is crucial, therefore, that the Congress have full and accurate information on actual and expected credit program costs, information which was lacking in the past.

Before the Credit Reform Act's passage, the cost of loans and loan guarantees was reflected in the budget when cash was disbursed. For direct loans, the full amounts originally disbursed were treated as budget cash outlays in the year the loans were to be made. In the case of federally guaranteed loans, no outlays were budgeted for until borrowers defaulted. This cash basis budgetary treatment overstated the cost of direct loans and delayed recognition of guaranteed loan costs. This led to inaccurate representations and hindered comparisons of the cost of direct loans and loan guarantees with each other and with non-credit programs in the budget.

[1] Budget Reform for the Federal Government (GAO/T-AFMD-88-13, June 7, 1988); Budget Issues: Budgetary Treatment of Federal Credit Programs (GAO/AFMD-89-42, April 10, 1989); and Managing the Cost of Government: Proposals for Reforming Federal Budgeting Practices (GAO/AFMD-90-1, October 1989).

The Federal Credit Reform Act changed the budgetary treatment of loans and loan guarantees made after fiscal year 1991 by requiring agencies to estimate their full long-term cost to the government. The act is intended to ensure that the full cost of credit programs over their entire lives is considered by the Congress as it deliberates the amount of direct loans and loan guarantees to authorize and fund each year. In effect, the act now requires that the cost of federal credit programs be measured more accurately and presented on an accrual basis in the budget. The act's concepts are intended to encourage the delivery of benefits in the form most appropriate to beneficiary needs and to improve the information available to those making decisions on the allocation of resources among credit programs and between credit and other spending programs.

As defined by the act, a direct or guaranteed loan's cost (subsidy) is its estimated long-term cost to the federal government calculated on a net present value basis, excluding administrative costs. A direct or guaranteed loan's subsidy cost would be calculated by projecting the related cash flow over its life and then discounting the cash flow using the average interest rate of marketable Treasury securities with a similar maturity. For a direct loan, cash flow would include, for example, loan disbursements, principal repayments, interest, and other payments by or to the government over the life of the loan. For guaranteed loans, the cash flow would include, for example, estimated default payments and payments to the government from loan origination fees.

To implement the act, OMB revised Circular A-11, Preparation and Submission of Budget Estimates, and Circular A-34, Part VI, Instructions on Budget Execution: Credit Apportionment and Budget Execution. These circulars provide requirements for credit program accounting under the act and for preparing and monitoring subsidy cost estimates using the information maintained in accordance with the requirements.

In implementing credit reform, agencies must also consider the CFO Act's provisions, which require improved financial information and financial systems that comply with applicable accounting standards. In addition to making budgetary estimates and accounting for budget execution, the agencies must also properly account for and include in their financial statements the costs of credit programs. Accounting standards will be published by the Director of OMB and the Comptroller General based on recommendations by the Federal Accounting Standards Advisory Board which was established cooperatively by the Comptroller General, the Director of OMB, and the Secretary of the Treasury. In September 1992, the

Board issued an exposure draft for public comment on its proposed accounting requirements for direct loans and loan guarantees.[2] This exposure draft addressed both pre- and post-credit reform accounting.

Objectives, Scope, and Methodology

The objectives of our work were to assess (1) whether OMB's cost requirements are consistent with the Credit Reform Act's provisions, (2) agencies' overall efforts to implement OMB's requirements for accounting and calculating subsidy cost estimates under the act, (3) whether the usefulness of financial reporting for pre-credit reform loans and loan guarantees can be improved, and (4) the CFO Act's potential effect on credit reform. Our work was done at the five major domestic lending agencies, which included the Departments of Housing and Urban Development (HUD) (Federal Housing Administration (FHA)), Veterans Affairs (VA), Education, and Agriculture (Farmers Home Administration (FmHA)), and the Small Business Administration (SBA). These agencies are responsible for 82 percent of the government's direct and guaranteed loans. Appendix I further discusses our objectives, scope, and methodology.

Our review was conducted between April and August 1992 in accordance with generally accepted government auditing standards. As you requested, we did not obtain official comments from agencies on the information in this report.

OMB's Cost Requirements Are Consistent With the Act

With regard to estimating the costs of loans and loan guarantees, the act directs OMB to establish requirements that are consistent with the act's definition of cost. OMB's requirements are consistent with the definition of cost. Under OMB's requirements, direct and guaranteed loans are subdivided into three levels. First, they are to be grouped into cohorts, consisting of direct loans obligated or loan guarantees committed by a program in the same fiscal year, regardless of when funds are disbursed. Next, within cohorts, direct and guaranteed loans are to be grouped by risk categories, which are to consist of loans or loan guarantees with relatively homogeneous risk characteristics. Finally, within each cohort and risk category, tranches are to be established, which are to consist of direct or guaranteed loans within a cohort and risk category that are disbursed in the same quarter and have the same maturity date. Each loan and loan guarantee is to be identified with a cohort, risk category, and

[2]Federal Accounting Standards Advisory Board's Statement of Recommended Accounting Standards, Accounting for Direct Loans and Loan Guarantees, Exposure Draft, September 15, 1992.

tranche. Appendix II illustrates the credit reform cohort, risk category, and tranche relationship.

Sections 502(5)(B) and (C) of the act define cost as including, for example, the risk associated with estimated defaults to be included in calculations of direct and guaranteed loan costs. Also, in section 505 the act authorizes agencies to finance through borrowings from Treasury the portion of credit programs which are expected to be repaid by credit program beneficiaries (that is, the unsubsidized portion of credit programs). OMB requires agencies to maintain separate identification for loans and guaranteed loans disbursed in a particular quarter (tranche) in order to compute the interest expense on Treasury borrowings related to these disbursements in accordance with quarterly changes in Treasury interest rates.[3] OMB's requirements in implementing the act's provisions and their successful implementation would result in the availability of highly accurate and relevant information.

Agencies Had Significant Problems Implementing OMB's Requirements

OMB's instructions for implementing the act created an explosion of new and complex accounting and reporting requirements which agencies attempted to satisfy using financial systems that were already seriously deficient. Overall, the major domestic lending agencies could not fully implement OMB's credit reform requirements because agencies' (1) financial systems and controls have long been flawed so that basic data was unavailable or incorrect, (2) existing financial systems were not designed to handle the information OMB prescribed, and (3) staff resources were insufficient to meet the added requirements. Difficulties were compounded by the fact that agencies' subsidy cost estimates involved forecasting uncertain and volatile economic conditions.

Before addressing the problems presented by credit reform implementation, it is important to emphasize that, across the board, agencies had widespread and long-standing problems with credit program financial systems and controls. Predating the Credit Reform Act, information on government lending programs was all too often lacking or unreliable, contributing to billions of dollars in losses. Agencies' credit program financial systems and control problems, which appendix III discusses in detail, are so serious and pervasive that we and OMB have identified several of these programs as high risk.

[3] Under OMB's requirements, an agency would, for direct loans, borrow from Treasury the amount of the loan disbursement, less the subsidy; and for guaranteed loans, borrow on occasion, such as to meet default claims in excess of its cash balances.

Agencies Could Not Meet OMB's Basic Accounting Requirements and Alternatives Were Permitted

Working with fundamentally flawed systems and controls from the outset, the major domestic lending agencies experienced significant problems meeting virtually every one of the basic aspects of OMB's credit reform accounting requirements. Especially troublesome were the requirements to maintain information on a loan-by-loan basis and to group loans and loan guarantees by risk categories and tranches. OMB temporarily granted agencies exceptions to its credit reform requirements on a case-by-case basis. Examples of the types of problems that permeated agencies' implementation efforts follow.

- VA had not implemented OMB's loan-by-loan accounting requirement because its financial systems were not designed to provide certain fundamental data elements, such as the date a loan is guaranteed, that are necessary to achieve credit reform accounting on an individual loan basis.
- FHA lacked information needed to identify loans by risk categories. Thus, FHA used overall historical default data to develop subsidy costs, which did not provide for changes in risk factors for the loan portfolio as OMB required.
- Education and FmHA were unable to provide tranche-level information. OMB permitted Education to use statistical sampling to determine costs and FmHA to report subsidy cost by cohorts in lieu of tranches.
- SBA's initial credit reform implementation has been confined to implementing a system to maintain cohort-level information.

Each of the major domestic lending agencies found that its financial systems required substantial changes under credit reform. For instance, FHA plans to develop a new system and modify 22 program systems to capture and maintain credit reform data. Also, although unspecific as to the numbers of staff involved, each of the agencies we reviewed also found that additional staff, such as professional accountants, financial analysts, and systems experts, have been necessary, or will be required in the future, to implement credit reform.

OMB was aware that agencies would experience severe implementation problems. It is monitoring agencies' progress to implement the act, and if necessary, plans to clarify or revise its requirements. OMB told us that its credit reform requirements were intended to represent the ultimate accounting and reporting for credit programs to which agencies were to aspire and that, as agencies' systems moved toward meeting these requirements, credit program financial information would improve governmentwide. OMB recognized that agencies' financial systems were already hampered by serious problems and stated that an immediate shift to accommodate fully the complex credit reform requirements was unlikely. Thus, OMB acknowledged that credit reform implementation would evolve over a potentially long time.

To facilitate the act's implementation, Treasury developed case studies to illustrate accounting under OMB's requirements. Also, OMB and Treasury provided credit reform training in cooperation with the Association of Government Accountants. Based on the questions and concerns raised during this training, OMB gained a greater appreciation for the extent of agencies' problems involving credit reform accounting requirements.

With OMB's encouragement, agencies that could not satisfy the specific requirements developed options for maintaining credit reform information and developing subsidy cost estimates. Some of these alternatives have merit. For instance, for a program involving high volume, low dollar loan guarantees, such as Education's guaranteed student loans, it may well be more practical, less costly, and sufficiently reliable to use sampling to develop credit reform information than to maintain information classified as to cohorts, risk categories, and tranches on an individual loan-by-loan basis. We have successfully used statistical sampling techniques during our financial audits to evaluate large volumes of information and draw relevant conclusions. We believe such techniques are well suited for agencies' use, especially on an interim basis, in developing and maintaining loan portfolio information under the Credit Reform Act.

Before any of these alternatives are adopted on a permanent basis, other factors would have to be considered, such as whether they would eliminate or reduce the effectiveness of an important aspect of the act. For example, using quarterly interest rates is only possible if tranche information is available, and using other than quarterly rates might significantly over- or understate credit program cost information because the data would not as precisely link a loan's cost with the interest rate prevailing at the time an agency either issued direct loans or authorized guaranteed loans. Inaccurate credit reform subsidy cost information adversely affects the Congress' ability to fund and oversee credit programs. The relevant question is how much accuracy is lost by not using quarterly interest rates. Subsequent to our review, OMB representatives advised us that OMB and Treasury plan to replace tranche accounting and are working on an alternative procedure that they believe will achieve the same accounting objective without requiring agencies to maintain the detailed tranche-level data now required.

Potential for Inaccurate Subsidy Estimates Was Great

Several factors, together with the problems in meeting OMB's basic credit reform accounting requirements, provided great potential for inaccurate subsidy cost estimates. Accurately estimating subsidy costs was difficult for three principal reasons.

1. Future economic conditions are uncertain. We reported in April 1990, for example, that housing loans at HUD and VA were particularly subject to risk due to economic conditions, such as recessions and unemployment, and risks were especially high in economically stressed regions.[4]

2. In many credit programs, the government plays the role of a lender of last resort, making it difficult to judge the risk. The loans and loan guarantees in these programs are inherently more risky than those in the private sector. In April 1990, we reported, for example, that Education's loans were risky because they were not secured or approved based on creditworthiness criteria.[4]

3. Agencies' historical data on past trends is unreliable. Apart from the new systems requirements of credit reform, existing financial systems and controls do not ensure an accurate data flow. Appendix III discusses numerous problems that contributed to unreliable credit program information.

By their nature, the effect of the first two factors on the accuracy of agencies' subsidy cost estimates is unavoidable. The potential for inaccurate subsidy cost estimates caused by unreliable historical data or by manipulation, which was a concern of the Budget Committee, could, however, be minimized through reliable pre- and post-credit reform information reported on a consistent basis.

Although these conditions continue to affect the accuracy of estimates, agencies have at least applied a standard approach to calculating the post-credit reform subsidies. In general, subsidies were calculated as follows. Using assumptions and estimates pertinent to particular loan programs, such as perceived future economic conditions and default and delinquency rate histories, agencies developed automated worksheets which projected the likely future cash flow for their credit programs. Next, agencies entered the cash flow worksheet information into a computerized model that OMB developed which calculated the subsidies. To minimize the

[4] Credit Management: Deteriorating Credit Picture Emphasizes Importance of OMB's Nine-Point Program (GAO/AFMD-90-12, April 16, 1990).

degree of error, OMB's budget examiners worked closely with agencies as they made subsidy cost estimate decisions.

Inconsistent Pre- and Post-Credit Reform Financial Reporting Can Hinder Effective Program Management

While credit reform focuses on post-credit reform loans and loan guarantees it has not been extended to loans and loan guarantees prior to fiscal year 1992. The Credit Reform Act specifies that pre-1992 loans and loan guarantees are to be shown in the budget on a cash basis.

At the end of fiscal year 1991, the government's direct loan and loan guarantee portfolio approximated $855 billion, of which $202 billion was in direct loans and $653 billion was in guaranteed loans. During fiscal year 1991, direct loan write-offs amounted to $10 billion and loan guarantee terminations due to defaults amounted to $14 billion. Further, loan guarantee terminations for default have steadily risen over the past several years.

There will, of course, be defaults on outstanding pre-credit reform loans and loan guarantees that could be enormous and will stretch out over many years. The government, however, lacks accurate financial information on this credit, which could make it difficult to minimize losses and to predict the budgetary effect of pre-credit reform loans and guarantees. This also means that the government does not have a complete historical data base that it might use to judge whether subsidy cost estimates for post-credit reform activity are reasonably accurate. Application of credit reform principles to the accounting and financial reporting of this outstanding credit and the implementation of systems improvements necessary for credit reform would provide information on the $855 billion loan and guarantee portfolio which would have the following results.

- Improve the ability to forecast the future budgetary impact of loan collections and loan guarantee payments. Credit reform principles, which require loans and loan guarantees to be classified by time periods to determine their present value, would provide accurate cash flow information with which to make budgetary decisions, such as the amount of funds needed to pay claims on future defaulted loan guarantees.
- Minimize losses through improved credit program management. Accurate historical information by fiscal year and risk category would facilitate trend analysis over time of various types of loans. It would pinpoint, for example, upward trends in costs of certain types of loans that could indicate the need to shift resources so as to intensify collection efforts,

monitor certain lenders or guarantors more closely, and/or scrutinize particular types of borrowers' eligibility more carefully.

- Provide the basis for judging the reasonable accuracy of subsidy estimates for post-1991 credit. An accurate information base does not now exist of relevant historical information derived from improved systems and credit reform principles. It will take years to establish an information base from post-1991 loans and guarantees that would be useful for assessing the reasonableness of future credit subsidy estimates. To fill the void, it is essential to develop accurate and relevant information about the $855 billion of pre-credit reform loans and loan guarantees.

While the Credit Reform Act did not require that pre-credit reform loans and loan guarantees be budgeted or accounted for on a present value basis, the act recognizes the importance of historical accounting information on credit programs in providing that OMB shall

> "review, to the extent possible, historical data and develop the best possible estimates of adjustments that would convert aggregate historical budget data to credit reform accounting."

OMB's October 22, 1992, requirements[5] for preparing agency financial statements allow pre- and post-credit reform loans and loan guarantees to be treated differently. It provides that, for pre-fiscal year 1992 credit activity, accounting for total direct loans and defaulted guaranteed loans should reflect estimated uncollectible amounts, but does not impose credit reform standards for determining such amounts and does not require that the net amounts of loans and loan guarantees be reported on a present value basis. On the other hand, post-fiscal year 1991 credit activity is to be reported as amounts due net of subsidy allowances, which would be computed under the stringent standards mentioned earlier and presented on the basis of the present value of these activities' cash flows. In its September 1992 exposure draft, the Federal Accounting Standards Advisory Board has proposed using OMB's credit reform requirements as a framework for federal agency accounting and financial statement reporting standards, meaning that accounting and financial reporting for pre- and post-credit reform loans and loan guarantees would be done differently.

Essentially, as we understand it, the position of OMB and others is that, because of the large volume of loans and loan guarantees outstanding, the

[5]Office of Management and Budget Bulletin 93-02, Form and Content of Agency Financial Statements, October 22, 1992.

poor quality of the underlying information and systems, and the limited resources available, restating pre-credit reform loans and loan guarantees in financial statements using OMB's credit reform concepts would require efforts that outweigh benefits. In our view, however, it is because of the large volume and the $855 billion involved and the costs of poor information about these amounts, that developing this information becomes more essential. The government faces tens of billions of dollars of losses on this credit which need to be closely managed and the costs and cash flows accurately measured.

We recognize that, similar to the problems now being experienced in accounting for post-credit reform loans, inaccurate data stemming from systems and control breakdowns hinders developing information necessary to restate pre-credit reform loans accurately and on a comparable basis and that agencies do have resource constraints. Also, this is not a fundamental issue of whether or not agencies can implement a process of discounting pre-credit reform information to calculate its present value as required under credit reform, which would be relatively simple if accurate and relevant information were available. Rather the issue is that by not requiring the same level of accounting for pre- and post-credit reform loans and loan guarantees, poor information on this exposure is perpetuated, which, as highlighted earlier, can affect the ability to (1) forecast the future budgetary impact of pre-credit reform credit activity, (2) minimize losses, and (3) judge the reasonable accuracy of subsidy estimates for post-1991 credit.

Recognizing that some additional resources may be required to attain consistent credit program accounting and reporting, this resource requirement can be reduced and reasonable information developed on pre-credit reform loans and loan guarantees by using the alternatives, such as statistical sampling, that OMB allowed on an interim basis for post-credit reform loans and loan guarantees. We would not anticipate that using the alternatives would require applying all of the stringent credit reform principles to the $855 billion of outstanding pre-credit reform loans and loan guarantees.

For example, to improve its knowledge of its exposure to liabilities, Education applied statistical sampling techniques to pre-credit reform guarantees. In preparing the guaranteed student loan program's fiscal year 1991 financial statements, which we are now auditing and will separately report on, Education used a sample of pre-credit reform loan and loan guarantees to project the net present value of the program's cash flows, which is similar to the subsidy cost estimate required under credit reform. Formerly, Education's financial statements for the program had not recognized any liability for future defaults on guaranteed loans. Across government, the difference between reporting in financial statements pre-credit reform loans and loan guarantees on a net present value basis and the basis presently used by agencies could be substantial, perhaps amounting to billions of dollars.

CFO Act Requirements Complement Credit Reform Requirements

The CFO Act provides additional impetus to improve credit program financial systems and information. Accurate and reliable financial information, such as the CFO Act envisions, is a necessary underpinning for credit program decisionmaking and oversight. More detailed cost and performance information on direct loans and loan guarantees can highlight types of loans whose costs are deviating from budget estimates because of such factors as increased risk. Based on such information, program managers can take prompt action to reduce costs, control risks where possible, and improve credit program performance.

Financial statement audits, such as the CFO Act requires, often surface accounting problems that could impede successful credit reform implementation. For instance, during our audit of Education's student loan insurance program fiscal year 1990 financial statements, we identified significant internal control and accounting weaknesses, including lack of proper accounting for billions of dollars in estimated loan losses.[6]

Likewise, the Agriculture Inspector General's examination of FmHA's internal controls as part of a fiscal year 1991 financial audit under the CFO Act disclosed weaknesses which caused inaccurate loss estimates for the farm loan portfolio. The weaknesses resulted in adjustments of $745 million to FmHA's allowance for losses for that year. Our audit of FmHA's fiscal year 1988 financial statements disclosed similar problems.[7]

Further, an audit of FHA's fiscal year 1991 financial statements revealed the agency was unable to (1) classify loans according to risk and identify problem loans for its general insurance fund or (2) provide loan delinquency information for its single family home loan insurance fund. Previously, the first financial audit of FHA, covering fiscal year 1988, disclosed that FHA had suffered a loss much greater than the $858 million

[6]Letter to the Secretary of Education (GAO/AFMD-91-53ML, April 12, 1991).

[7]Financial Audit: Department of Agriculture's Financial Statements for Fiscal Year 1988 (GAO/AFMD-91-65, August 13, 1991).

loss reported for the year. The auditors determined that the loss was actually $4.2 billion, or 5 times the amount managers believed had occurred.[8]

Also, under the act, agency CFOs are given important new responsibilities, such as to better plan systems improvements, which is essential to correct long-standing credit program financial systems and control problems, and to maintain effective asset management systems, which include those used to account for credit programs. Further, the act envisions that agencies' budget, program, and financial managers will work closely together to improve financial management, which will be important to implement the Credit Reform Act.

The CFO Act's impetus notwithstanding, fully achieving the Credit Reform Act's objectives will require the major domestic lending agencies' sustained attention and commitment to enhance implementation efforts. In the past, these agencies have not always responded promptly to new legislative requirements intended to improve the management of their loan and guaranteed loan programs. For instance, 10 years after its enactment, these agencies are not yet fully using the authorities of the Debt Collection Act of 1982 to carry out their credit programs, as we reported in 1990 and again in 1992.[9]

Conclusions

The Credit Reform Act's potential has not yet been realized, and it is unlikely to be fully achieved soon, considering the generally poor state of financial systems and controls. The problems agencies will have to address include (1) serious and long-standing weaknesses in credit program financial systems and controls and resulting unreliable historical credit information, which stymied the major domestic lending agencies in meeting OMB's implementing requirements under the act; (2) inadequate staff resources to develop and implement the systems necessary to carry out the new requirements of the act; and (3) inappropriate accounting and inconsistent reporting for pre-credit reform loans and loan guarantees, a condition which will both prevent that information from being used to appraise the reasonableness of post-credit reform data and diminish the value of financial reports in measuring agency performance, future funding needs, and other credit program analyses.

[8] Financial Audit: Federal Housing Administration Fund's 1988 Financial Statements (GAO/AFMD-90-36, February 9, 1990).

[9] Letter to the Chairman, Committee on Governmental Affairs, U.S. Senate (GAO/AFMD-92-25R, January 21, 1992). See also footnote 4.

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parties. We will make copies available to others upon request. This report was completed under the direction of Jeffrey C. Steinhoff, Director, Civil Audits, who can be contacted at (202) 275-9454 if you or your staff have any questions concerning this report.

Sincerely yours,

Donald H. Chapin
Assistant Comptroller General

Contents

Abbreviations

CFO	Chief Financial Officers
FHA	Federal Housing Administration
FmHA	Farmers Home Administration
HUD	Department of Housing and Urban Development
OMB	Office of Management and Budget
SBA	Small Business Administration
VA	Veterans Affairs

Objectives, Scope, and Methodology

The objectives of our work were to assess (1) whether OMB's cost requirements are consistent with the Credit Reform Act's provisions, (2) agencies' overall efforts to implement OMB's requirements for accounting and calculating subsidy cost estimates under the act, (3) whether the usefulness of financial reporting for pre-credit reform loans and loan guarantees can be improved, and (4) the CFO Act's potential effect on credit reform.

To assess whether OMB's cost requirements are consistent with the Credit Reform Act's provisions, we identified and compared their pertinent sections. We analyzed these sections to determine whether OMB's requirements are consistent with the act's definition of cost.

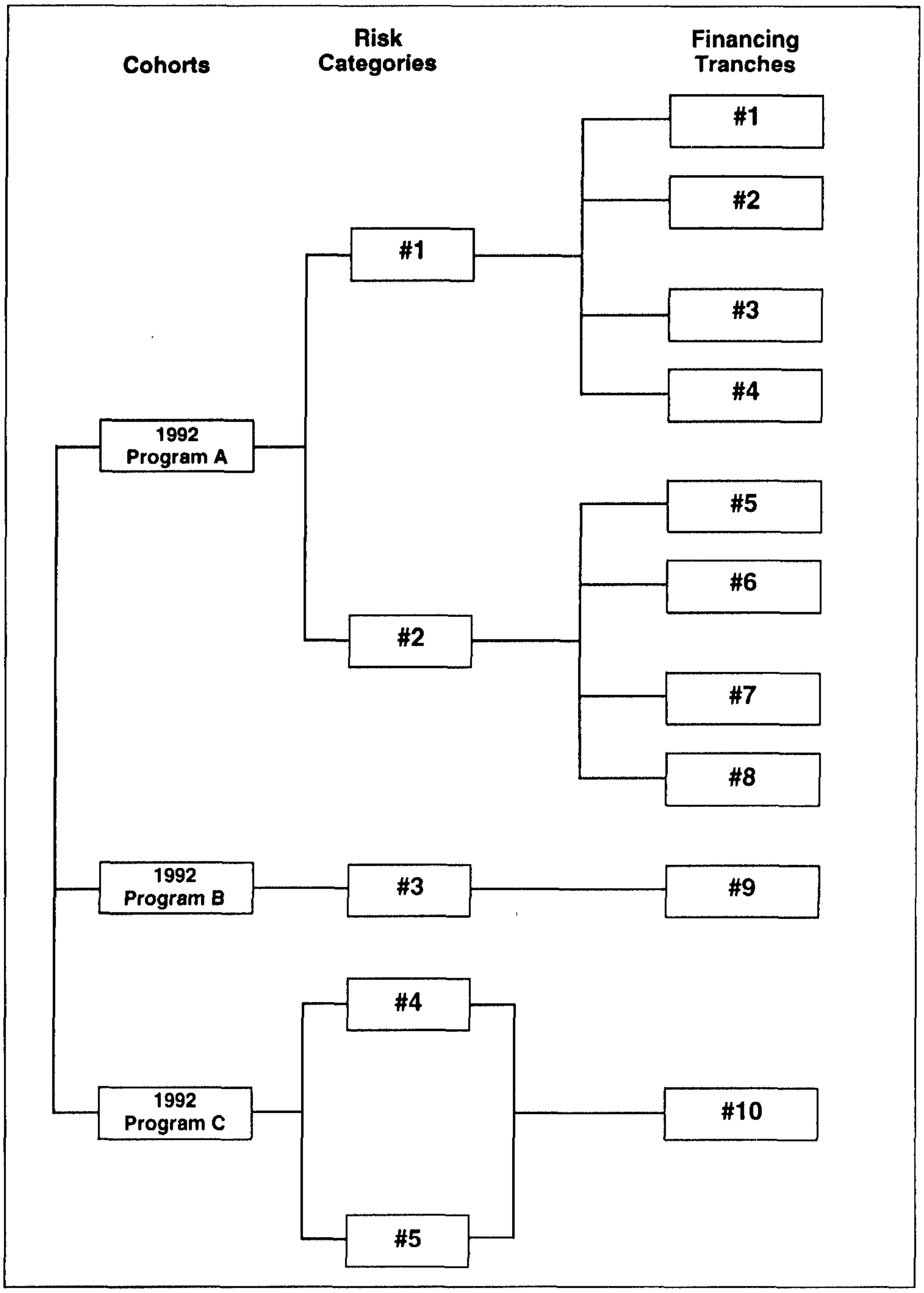
To assess agencies' overall efforts to implement OMB's requirements for accounting and calculating subsidy cost estimates under the act, we visited the five major domestic lending agencies, which included Education, FHA, FmHA, SBA, and VA. These agencies are responsible for 82 percent of the government's direct and guaranteed loans. We met with officials from these agencies to discuss their efforts and any alternatives to OMB's credit reform requirements that were being used. Much of the information was gathered during our ongoing work to audit, or to consult with agencies as they prepared and audited, agency financial statements under the CFO Act. We did not verify the accuracy of agencies' specific direct and guaranteed loan subsidy cost estimate calculations.

To assess whether the usefulness of financial reporting for pre-credit reform loans and loan guarantees can be improved, we examined the Federal Accounting Standards Advisory Board's September 1992 exposure draft on federal agency accounting for direct and guaranteed loans. Through our discussions with agencies, we identified how they account for and report pre- and post-credit reform direct and guaranteed loans. We analyzed the effect of differences between pre- and post-credit reform financial reporting and discussed with agencies whether consistent reporting was feasible.

To assess the CFO Act's potential effect on credit reform, we examined pertinent provisions of the act and determined their applicability to agency credit programs. Also, we identified and examined our previous reports of credit program financial audits, which are now required by the act. Further, we drew on information from our prior reports on problems with lending agencies' financial systems, which would require improvement under the CFO Act.

We also discussed credit reform requirements and agencies' implementation efforts with representatives of OMB and Treasury. To obtain their overall views on credit reform, we met with the House and the Senate Budget Committees' staffs and Congressional Budget Office officials who played major roles in the act's passage.

Credit Reform Cohort, Risk Category, and Tranche Relationship



[a]As the preceding letter discusses, OMB and Treasury plan to replace tranche accounting with an alternate procedure.

Information on Credit Program Financial Systems Problems

Agencies had major credit program financial systems and accounting deficiencies which preceded the Credit Reform Act and OMB's requirements under the act. These systems were not always designed to handle fundamental loan receivable and guaranteed loan liability data well and resulted in historical credit program data being unreliable.

We have previously reported on serious and long-standing weaknesses in agencies' credit program financial systems. For example, in May 1986, we reported that the major domestic lending agencies did not have systems of accounting for credit programs which produced accurate and reliable information on amounts owed to the government.[1] In November 1989, we reported that the full magnitude of losses already incurred had not been reported because of long-standing deficiencies in financial management systems and the inconsistent application of accounting principles by some agencies responsible for administering federal credit assistance programs.[2] In April 1990, we reported that the government's credit picture in fiscal year 1988 was worse than reported because some credit agencies' financial information was inaccurate or inconsistent. (See footnote 4.) More recently, in October 1991, we testified before the House Budget Committee that credit program financial information problems adversely affect the government's ability to minimize and control losses.[3]

In addition, the major domestic lending agencies have themselves disclosed similar deficiencies in their reports under the Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. 3512). For fiscal year 1991, for example, (1) VA reported that it did not have a modern automated loan guarantee servicing system and its present system did not efficiently provide timely basic information, such as the status of these loans; (2) Education reported serious financial management systems deficiencies, including inadequate accounting for loss reserve estimates, interest subsidy liabilities, and loans receivables; and (3) Agriculture reported that FmHA's system cannot meet guaranteed loan and credit management initiative requirements, including accurate financial reporting.

[1]Debt Collection: Billions Are Owed While Collection and Accounting Problems Are Unresolved (GAO/AFMD-86-39, May 23, 1986).

[2]Federal Credit and Insurance: Programs May Require Increased Federal Assistance in the Future (GAO/AFMD-90-11, November 16, 1989).

[3]Federal Credit and Insurance Programs: Actions That Could Minimize a Growing Risk (GAO/T-AFMD-92-1, October 24, 1991).

In January 1990, we began a special effort to review and report on high risk programs within the federal government. FmHA's and Education's credit programs were identified among the 16 high risk programs, which suffer from poor internal controls and weak financial management systems. Further, OMB's high risk initiative has targeted for corrective actions several critical areas that affect the reliability of major domestic agencies' credit program data, including Education's guaranteed student loan program, HUD's inefficient and incompatible financial systems, and VA's loan guarantee program which lacks a system for assessing credit risk exposure.

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