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Testimony

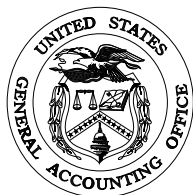
Before the Subcommittee on Government Management,
Information and Technology, Committee on Government
Reform, House of Representatives

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**AUDITING THE NATION'S
FINANCES**

**Fiscal Year 1998 Results
Highlight Major Issues
Needing Resolution**

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



Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our report on the U.S. government's financial statements for fiscal year 1998 and to underscore the importance of improving how federal departments and agencies manage the finances of our national government. Historically, timely, accurate and useful information has not been available across government to ensure financial accountability and to help improve the economy, efficiency, and effectiveness of government. Fortunately, the Congress has legislated major reforms that if successfully implemented, will help achieve these objectives and build the necessary foundation to effectively run a performance-based government.

A critical reform component entails requiring annual audited financial statements for 24 major federal departments and agencies beginning with fiscal year 1996--a best practice in the private sector for decades and in state and local governments for many years. Considerable effort is being made by agencies to achieve this mandate, and steady improvements in financial accountability are occurring. However, several major agencies are not yet able to produce auditable financial statements on a consistent basis, and major obstacles need to be overcome.

Similar challenges exist in producing reliable statements for the entire U.S. government. Last year, in the first-ever report on the U.S. government's financial statements,¹ we reported that because of the serious deficiencies in the government's systems, recordkeeping, documentation, financial reporting, and controls, amounts reported in the financial statements and related notes do not provide a reliable source of information for decision-making by the government or the public. Our report on the U.S. government's financial statements for fiscal year 1998 has reached the same conclusion.² These deficiencies affect the reliability of the financial statements and the government's ability to accurately measure the full cost and financial performance of programs and manage its operations.

¹Financial Audit: 1997 Consolidated Financial Statements of the United States Government (GAO/AIMD-98-127, March 31, 1998) and U.S. Government Financial Statements: Results of GAO's Fiscal Year 1997 Audit (GAO/T-AIMD-98-128, April 1, 1998).

²Financial Audit: 1998 Financial Report of the United States Government (GAO/AIMD-99-130, March 31, 1999).

The government must overcome significant challenges to improve this situation. The historic, long-standing inattention to financial management issues combined with the size and complexity of government operations makes corrective actions difficult. Moreover, the pace of improvement will be greatly influenced by the progress government organizations are able to make in modernizing their information systems and internal controls, in revamping human capital practices to build greater capacity, and in implementing change management to achieve the discipline needed to follow sound financial management and reporting practices.

The executive branch recognizes the extent and severity of existing deficiencies and that addressing them will continue to require concerted improvement efforts across government. In response to our March 1998 report, the President required heads of agencies with significant financial management deficiencies to submit corrective action plans to the Office of Management and Budget (OMB). Further, the President has designated financial management reform as a top management priority.

We are continuing to work with OMB, the Treasury, and agencies across government to recommend the actions necessary for achieving legislative reform goals. Additionally, working cooperatively with the inspectors general, we are continuing to evaluate progress and make specific suggestions for fixing weaknesses in recordkeeping, financial reporting, and internal controls. With concerted effort, the federal government can continue to make progress toward achieving accountability and generating reliable financial and management information on a regular basis.

My testimony will focus on

- outlining the findings of our report on the financial statements of the U.S. government for fiscal year 1998;
- underscoring the critical need to fully implement legislative reforms;
- emphasizing that unqualified “clean” opinions must be accompanied by timely and reliable data, stronger controls, and better financial and management information systems that will help to continuously improve the economy, efficiency, and effectiveness of government;
- highlighting the fact that human capital must become a more critical part of the management reform agenda; and
- urging that the focus be on accountability and not just accounting.

Results of GAO's Audit of U.S. Government's Financial Statements for Fiscal Year 1998

Our report on the U.S. government's financial statements for fiscal year 1998 states that overall, significant financial systems weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal controls, including computer controls, continue to prevent the government from accurately reporting a significant portion of its assets, liabilities, and costs.

Major challenges include the federal government's inability to

- properly account for and report (1) billions of dollars of property, equipment, materials, and supplies and (2) certain stewardship assets;
- properly estimate the cost of most major federal credit programs and the related loans receivable and loan guarantee liabilities;
- estimate and reliably report material amounts of environmental and disposal liabilities and related costs;
- determine the proper amount of various reported liabilities, including postretirement health benefits for military employees, accounts payable, and other liabilities;
- accurately report major portions of the net cost of government operations;
- determine the full extent of improper payments that occur in major programs and that are estimated to involve billions of dollars annually;
- ensure that all disbursements are properly recorded; and
- properly prepare the federal government's financial statements, including balancing the statements, accounting for billions of dollars of transactions between governmental entities, and properly and consistently compiling the information in the financial statements.

In addition, we found that (1) widespread and serious computer control weaknesses affect virtually all federal agencies and significantly contribute to many of the material deficiencies discussed above and (2) material control weaknesses affect the government's tax collection activities. Major issues identified by our work are discussed below.

General Property, Plant, and Equipment and Inventories and Related Property

The federal government--one of the world's largest holders of physical assets--does not have adequate systems and controls to ensure the accuracy of information about the amount of assets held to support its domestic and global operations. A majority of the \$466 billion of these reported assets is not adequately supported by financial and/or logistical records. Assets that are not adequately supported include (1) buildings,

structures, facilities, and equipment, (2) various government-owned assets that are in the hands of private sector contractors, and (3) operating materials and supplies comprised largely of ammunition, defense repairable items (such as navigational computers, landing gear, and transmissions), and other military supplies. Also, the government cannot ensure that all assets are reported. Further, national defense asset unit information reported as Stewardship Information was incomplete.

Because the government lacks complete and reliable information to support its asset holdings, it could not satisfactorily determine that all assets were included in the financial statements, verify that reported assets actually exist, or substantiate the amounts at which they were valued. For example, periodic physical counts have shown that property records contain significant error rates. Further, weak controls significantly impair the government's ability to detect and investigate fraud or theft of assets. Also, deferred maintenance information was not reported.

Accurate asset information is necessary for the government to (1) know the assets it owns and their location and condition, (2) safeguard its assets from physical deterioration, theft, or loss, (3) account for acquisitions and disposals of such assets, (4) prevent unnecessary storage and maintenance costs or purchase of assets already on hand, and (5) determine the full costs of government programs that use these assets.

Loans Receivable and Loan Guarantee Liabilities

Most federal credit agencies responsible for federal lending programs were unable to properly estimate the cost of these programs in accordance with federal accounting standards and budgeting requirements. As of the end of fiscal year 1998, the government reported \$167 billion of loans receivable and \$38 billion of liabilities for estimated losses related to estimated future defaults of guaranteed loans. However, the net loan amounts expected to be collected and guarantee amounts expected to be paid could not be reasonably estimated because of a lack of adequate historical data or other evidence. Reliable information about the cost of credit programs is important in supporting annual budget requests for these programs, making future budgetary decisions, managing program costs, and measuring the performance of credit activities. Federal credit programs include direct loans and loan guarantees for farms, rural utilities, low and moderate income housing, small businesses, veterans' mortgages, and student loans.

Environmental and Disposal Liabilities

Liabilities for remediation of environmental contamination and disposal of hazardous waste, reported at \$225 billion, were materially understated by at least tens of billions of dollars primarily because no estimate was reported for environmental and disposal liabilities associated with certain major weapons systems, such as aircraft, missiles, ships and submarines, and with ammunition. Further, only a small portion of the total cost, estimated to be over \$10 billion, to remove unexploded ordnance from training ranges has been reported. Additionally, significant portions of the government's reported liability for environmental management and legacy waste related to nuclear weapons development lacked adequate support, were not complete, and did not reflect material changes in cleanup scope, costs, or schedules. Properly stating these liabilities and improving internal controls supporting the process for their estimation could assist in determining priorities for cleanup and disposal activities and allow for appropriate consideration of future budgetary resources needed to carry out these activities.

Liabilities

Adequate systems and cost data were not available to accurately estimate the reported \$223 billion military postretirement health benefits liability included in federal employee and veteran benefits payable. Information used to develop such estimates did not include the full cost of providing health care benefits. Also, some agencies do not maintain adequate records or have systems to ensure that accurate and complete data were used to estimate a reported \$90 billion of accounts payable and a reported \$155 billion in other liabilities. For example, a liability was not reported for certain amounts owed to contractors that, under the terms of the contracts, were held by the government pending the acceptance of goods or services. Further, the government was unable to provide adequate information to determine whether commitments and contingencies were complete and properly reported. These problems significantly affect the determination of the full cost of the government's current operations, the value of its assets, and the extent of its liabilities.

Cost of Government Operations

The government was unable to support significant portions of the more than \$1.8 trillion reported as the total net cost of government operations. The previously discussed material deficiencies in reporting assets and liabilities and the lack of effective cash disbursement reconciliations, as discussed below, affect reported net costs. Further, we were unable to determine whether the amounts reported in the individual net cost

categories on the Statement of Net Cost and in the subfunction detail in Supplemental Information were properly classified. Accurate cost information is important to the federal government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs, where required.

Improper Payments

The government is unable to determine the full extent of improper payments--that is, payments made for other than valid, authorized purposes. Across government, improper payments occur in a variety of programs and activities, including those related to contract management, federal financial assistance, and tax refunds. Reported estimates of improper payments total billions of dollars annually. Such payments can result from incomplete or inaccurate data used to make payment decisions, insufficient monitoring and oversight, or other deficiencies in agency information systems and weaknesses in internal control. The risk of improper payments is increased in programs involving (1) complex criteria for computing payments, (2) a significant volume of transactions, or (3) an emphasis on expediting payments. The reasons for improper payments range from inadvertent errors to fraud and abuse.

The full extent of improper payments, however, is unknown because many agencies have not estimated the magnitude of improper payments in their programs, nor have they considered this issue in their annual performance plans. The use of appropriate performance measures relating to improper payments can provide management focus on reducing related losses. For example, the Department of Health and Human Services (HHS) has reported a national estimate of improper payments in its Medicare fee-for-service benefits since fiscal year 1996. For fiscal year 1998, the department reported estimated improper payments of \$12.6 billion, or more than 7 percent, of Medicare fee-for-service benefits--down from about \$20 billion, or 11 percent, reported for fiscal year 1997 and \$23.2 billion, or 14 percent, for fiscal year 1996. Analysis of improper Medicare payments helped lead to the implementation of several initiatives intended to reduce improper payments. Annual estimates of improper payments in future audited financial statements will provide information on the progress of these initiatives.

Cash Disbursement Activity

Several major agencies are not effectively reconciling cash disbursements. These reconciliations are intended to be a key control to detect and correct errors and other misstatements in financial records in a timely manner--

similar in concept to individuals reconciling personal checkbooks with a bank's records each month. There continued to be billions of dollars of unresolved gross differences between agencies' and Treasury records of cash disbursements as of the end of fiscal year 1998. As a result, the government is unable to ensure that all disbursements are properly recorded. Improperly recorded disbursements could result in misstatements in the (1) financial statements and (2) certain data provided by agencies for inclusion in the President's budget concerning fiscal year 1998 obligations and outlays.

Preparation of Financial Statements

The government does not have sufficient systems, controls, or procedures to properly prepare financial statements for the U.S. government. Such deficiencies, described below, impair the government's ability to (1) properly balance the government's financial statements and account for billions of dollars of transactions between governmental entities, (2) properly and consistently compile the information in the financial statements, and (3) effectively reconcile the results of operations reported in the financial statements with budget results.

Unreconciled Transactions

To make the financial statements balance, Treasury recorded a net \$24 billion item on the Statement of Operations and Changes in Net Position, which it labeled unreconciled transactions. Treasury attributes this net out-of-balance amount to the government's inability to properly identify and eliminate transactions between federal government entities and to agency adjustments that affected net position. Certain intragovernmental accounts do not reconcile by a total of more than \$250 billion (e.g., intragovernmental receivables exceeded intragovernmental payables by over \$200 billion).

Agencies' accounts can be out of balance with each other, for example, when one or the other of the affected agencies does not properly record a transaction with another agency or the agencies record the transactions in different accounting periods. These out-of-balance conditions can be detected and corrected by instituting procedures for reconciling transactions between agencies on a regular basis and in a timely manner. Generally, such reconciliations are not performed. These unreconciled transactions result in material misstatements of assets, liabilities, revenues, and/or costs.

Financial Statement Compilation

The federal government cannot ensure that the information in the financial statements of the U.S. government is properly and consistently compiled in

an accurate manner. To prepare the federal government's financial statements, about 70 agencies submit data to Treasury on approximately 2,000 separate reporting components, each having many account balances. However, several major agencies were unable to provide assurance that all agency amounts included in these financial statements reconciled with their agency financial statements. In addition, material adjustments and reclassifications were required to (1) make the financial statements more consistent with agency financial statements, (2) correct identified inconsistencies in reporting similar transactions, (3) conform footnote information to related financial statement line items, and (4) record other audit adjustments.

These problems are compounded by the substantial volume of information submitted and limitations in the federal government's general ledger account structure. As a result, additional misclassifications and misstatements in the government's financial statements could exist.

Reconciling the Results of Operation With Budget Results

The federal government did not have a process to obtain information to effectively reconcile the reported \$134 billion excess of net cost over revenue and a reported unified budget surplus of \$69 billion. Consequently, it could not identify all of the items needed to reconcile these amounts. Certain differences are expected to occur because the financial statements of the U.S. government are prepared on the accrual basis in accordance with federal accounting standards, which is a different basis than the budget. Under accrual accounting, transactions are reported when the events giving rise to the transactions occur, rather than when cash is received or paid. By contrast, federal budgetary reporting is generally on the cash basis, in accordance with accepted budget concepts and policies.

Beginning in fiscal year 1998, major agencies were required by federal accounting standards to reconcile their reported net costs to budget information, which could provide a basis for preparing the reconciliation in the 1998 Financial Report of the United States Government. However, significant amounts reported in certain agency reconciliations, including unliquidated obligations and certain other budget information, lacked adequate supporting information and may be unreliable. For example, significant weaknesses in Department of Defense (DOD) systems and controls resulted in reported obligations incurred that may have exceeded available budget authority for certain appropriations. Once the federal government produces reliable financial statements, an effective reconciliation could help provide additional assurance of the reliability of budget results.

Need to Continue Reform Efforts

In addition to financial statements for the U.S. government, 24 major individual departments and agencies across government have been required to prepare annual audited financial statements, beginning with fiscal year 1996. Eleven of these agencies received unqualified audit opinions for fiscal year 1997--up from 6 for fiscal year 1996. As of March 19, 1999, 15 of the 24 agencies had received audit opinions or disclaimers on their fiscal year 1998 financial statements. These included 7 unqualified opinions,³ 3 qualified opinions, and 5 disclaimers.

While the results continue to be mixed, individual agencies are now endeavoring to address financial management problems. Several agencies that have received unqualified opinions on their financial statements are continuing to work on resolving significant weaknesses in financial systems and internal controls.

Producing audited financial statements on time--by the March 1 statutory deadline--is still a challenge, but improvements were made this year by certain agencies, such as the Department of Health and Human Service. Also, the Social Security Administration continues to demonstrate a best practice by producing its audited financial statements and accountability report in November, less than 2 months after the close of the fiscal year.

We have designated as high risk the serious financial management problems at certain agencies (the Department of Defense, IRS, the Forest Service, and the Federal Aviation Administration).⁴ All, however, have concerted efforts underway to address their deficiencies, and we will continue to work with them and the cognizant inspectors general (IGs) to advance recommendations and evaluate progress.

³The Social Security Administration, the Department of Labor, the General Services Administration, the National Science Foundation, the National Aeronautics and Space Administration, the Nuclear Regulatory Commission, and the Federal Emergency Management Agency.

⁴High-Risk Series: An Update (GAO/HR-99-1, January 1999).

Clean Opinion Must Be Accompanied by Modern Systems and Better Controls

Audited financial statements are essential to providing an annual public scorecard on accountability. However, an unqualified audit opinion, while certainly important, is not an end in itself. For some agencies, the preparation of financial statements requires considerable reliance on ad hoc programming and analysis of data produced by inadequate systems that are not integrated or reconciled and often require significant audit adjustments. Efforts to obtain reliable year-end data that are not backed up by fundamental improvements in underlying financial management systems and operations to support ongoing program management and accountability will not achieve the intended results of the Chief Financial Officers Act over the long term.

For example, after several years of concerted effort by IRS and GAO, for fiscal year 1997 we were for the first time able to conclude that IRS' custodial financial statements, covering most of the government's revenue, were reliable. Prior to fiscal year 1997, weaknesses in IRS' internal controls and financial management systems prevented it from producing reliable year-end financial information. Our ability to conclude that the fiscal year 1997 custodial financial statements were reliable was a mark of progress. For fiscal year 1998, IRS was able to reliably report on the results of its custodial activities, including nearly \$1.8 trillion of tax revenue, \$151 billion of tax refunds, and \$26 billion of net federal taxes receivable.⁵ However, as in 1997, this was accomplished only after IRS' extensive use of ad hoc programming to extract data from its systems, followed by numerous adjustments to these data totaling tens of billions of dollars to produce final financial statements. IRS' controls and systems remain plagued by weaknesses that affect its ability to, among other things, report reliable financial information throughout the year.

Improving Systems

The central challenge in generating timely, reliable data throughout the year is overhauling financial and related management information systems. To help stimulate attention to this challenge, the Congress passed the Federal Financial Management Improvement Act (FFMIA) of 1996, which requires auditors performing financial audits to report whether agencies' financial management systems comply substantially with federal accounting standards, financial systems requirements, and the government's standard general ledger at the transaction level. For fiscal

⁵Financial Audit: IRS' Fiscal Year 1998 Financial Statements (GAO/AIMD-99-75, March 1, 1999).

year 1997, agency financial auditors reported that 20 of 24 major agency financial systems did not comply with the act's requirements, indicating the systems' overall continuing poor condition.⁶ As we noted in our report on the government's financial statements for fiscal year 1998, similar results are expected for fiscal year 1998.

Most federal agencies' financial management systems do not meet systems requirements and cannot provide reliable financial information for managing day-to-day government operations and holding managers accountable. Therefore, it will take time and effort to raise federal financial systems to the level of quality and reliability envisioned in FFMIA. In addition, agencies face the Year 2000 computing challenge of ensuring that their systems function properly at the turn of the century. This task is appropriately taking priority and will likely temporarily sidetrack longer term systems modernization.

Over the longer term, agencies must address their serious systems problems by applying the framework outlined in the Clinger-Cohen Act and implementing guidance. This includes adopting sound information technology investment and control processes, designing well-developed architectures to guide information flows and technical standards, and establishing disciplined approaches for developing and acquiring computer software. Strong partnerships between chief financial officers and chief information officers are essential to achieve these goals.

Strengthening Computer Controls

Continuing serious and widespread computer security weaknesses are placing enormous amounts of federal assets at risk of fraud and misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. Significant computer security weaknesses in systems that handle the government's unclassified information have been reported in each of the major federal agencies. The most serious reported problem is inadequately restricted access to sensitive data. Other types of weaknesses pertain to not (1) adequately segregating duties to help ensure that people do not conduct unauthorized actions without detection, (2) preventing unauthorized software from being implemented, and (3) mitigating and recovering from unplanned interruptions in

⁶Financial Management: Federal Financial Management Improvement Act Results for Fiscal Year 1997 (GAO/AIMD-98-268, September 30, 1998).

computer service. In today's highly computerized and interconnected environment, such weaknesses are vulnerable to exploitation by outside intruders as well as authorized users with malicious intent.

The consequences of computer security weaknesses could be devastating and costly--for instance, placing billions of dollars of payments and collections at risk of fraud and impairing military operations. Also, identified weaknesses at federal entities such as IRS, the Department of Health and Human Service's Health Care Financing Administration, SSA, the Department of State, and the Department of Veterans Affairs place tax, medical, and other sensitive records at risk of unauthorized disclosure, modification, and destruction.

The government cannot estimate the full magnitude of actual damage and loss resulting from federal computer security weaknesses because it is likely that many such incidents are neither detected nor reported. However, GAO and agency reviews and documented incidents, such as the following, illustrate the potential for negative impacts.

- Attackers have accessed systems and stolen, modified, and destroyed both data and software at DOD and shut down entire systems.
- We have been successful, as part of computer security reviews, in readily gaining unauthorized access to systems that would allow intruders to read, modify, or delete data for whatever purpose they had in mind. Tests by agencies have revealed similar results.
- SSA's IG has reported criminal convictions involving SSA employees, most of which involved creating fictitious identities, fraudulently selling SSA cards, misappropriating refunds, or abusing access to confidential information.
- IRS has identified incidents of employees browsing taxpayer data and inappropriately using other systems containing taxpayer data.

GAO and the IGs have issued numerous reports that identify information security weaknesses in the federal government and made recommendations to address them. Also, GAO has reported information security as a high-risk area across government since February 1997. Agencies need to fully institute a framework for assessing risk and ensuring

that necessary policies and controls are in place and remain effective on an ongoing basis.⁷

Human Capital Initiatives Must Become a More Critical Part of Reform Agenda

An integral part of financial and information management reform and, indeed, any management initiative is building, maintaining, and marshaling the human capital needed to achieve results. Leading organizations understand that effectively managing employees--or human capital--is essential to reaching and maintaining maximum performance. Organizational success is possible only when the right employees are on board and provided the training, tools, structure, incentives, and accountability to work effectively.

Specifically, in relation to financial management, the Chief Financial Officers (CFO) Act recognized the importance of leadership in creating CFO positions throughout government and in establishing a goal for improving the qualifications of financial management personnel throughout government. While some attention to delineating core competencies and training has occurred, a great deal more needs to be done. We plan to give greater attention to this area, with emphasis on recommending ways to improve strategic approaches to human capital planning, the acquisition and development of staff with skills to meet critical needs, and the creation of performance-oriented organizational cultures while protecting merit principles.⁸

Strengthening Financial Management Key to Assuring Accountability

Without a firm foundation of reliable and timely financial and management information, the many reforms underway across government to move to a performance-based focus will never be successfully fulfilled. For this reason, efforts to continue to build the necessary fundamental foundation through lasting financial management reform are so essential. Only by generating reliable and useful information can the government assure adequate accountability to taxpayers, manage for results, and help decisionmakers make timely, well-informed judgments.

⁷Information Security: Serious Weaknesses Place Critical Federal Operations and Assets at Risk (GAO/AIMD-98-92, September 23, 1998) and Information Security: Strengthened Management Needed to Protect Critical Federal Operations and Assets (GAO/T-AIMD-98-312, September 23, 1998).

⁸Performance and Accountability Series: Major Management Challenges and Program Risks: A Governmentwide Perspective (GAO/OCG-99-1, January 1999).

Providing such data in meaningful, user-friendly reports is also critical. Experimentation is now underway across government to develop single accountability reports on individual departments and agencies. These reports will consolidate and integrate audited financial statements and reporting under the Government Performance and Results Act and other related laws, to (1) show the degree to which an agency met its goals and at what costs and (2) aid the reader in determining whether the agency was well run.

Accountability reports that present an agency's financial condition and the results of its operations in an integrated way hold great promise for enhancing the usefulness of performance information. Such reports and independent audits will help correct the problem of the lack of complete and reliable information that has been a source of concern for congressional and agency decisionmakers for decades. Reliable accountability reports that include information on the full cost and results of carrying out federal activities will greatly aid decision-making for our national government.

Reliable financial information also is essential for analyzing the government's financial condition and helping inform budget deliberations by providing additional information beyond that provided in the budget. The budget of the federal government is primarily formulated on a cash basis, which also is generally the basis for calculating the annual budget surplus or deficit. The financial statements are prepared generally on the accrual basis of accounting. The most significant difference between the two bases is the timing of recognition and measurement of revenues and costs. Accrual information can be used along with budgetary information to provide a valuable perspective on the costs of agency programs and the government's assets and long-term commitments.

In closing, Mr. Chairman, I want to commend your Subcommittee for its diligent oversight of actions to improve financial management of government. Your hearings have helped underscore the critical importance of the issue and the need to make greater progress. I look forward to working with you and other Members of the Congress, along with the executive branch, in bringing about the type of quality financial management envisioned by legislative goals and expected by the American people.

I would be pleased to answer questions.

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