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AUDITING THE NATION'S FINANCES

Fiscal Year 1999 Results Continue to Highlight Major Issues Needing Resolution

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Accountability * Integrity * Reliability

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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 1999. Today's hearing comes at an especially appropriate juncture. First, we are nearing the 10th anniversary of the Chief Financial Officers Act's passage, which has provided the underpinning for financial management reform necessary to help improve the economy, efficiency, and effectiveness of government. Also, since the critical transition period to agency-level audited financial statements began in 1996, agencies have gained valuable experience in preparing financial statements, which is beginning to pay off. Then too, the lessons agencies have learned from successfully meeting the Year 2000 computing challenge are fresh in the minds of those who must now focus greater attention to achieve financial and other management improvements.

In passing the CFO Act and other financial management legislation, such as the Government Management Reform Act and the Federal Financial Management Improvement Act (FFMIA), the Congress sought to overcome the historical lack of reliable, useful, and timely information to assure financial accountability for the federal government. Without such information on the full costs of programs, the government cannot adequately ensure accountability, measure and control costs, manage for results, nor make timely and fully informed decisions about allocating limited resources.

A critical financial management reform component established by the Congress entails requirements for annual audited financial statements for 24 major federal departments and agencies beginning with fiscal year 1996. We have seen a steady increase in the number of agencies that have obtained unqualified opinions on their financial statements and in agencies' timeliness in issuing them. Thus far, 13 of 24 major agencies have received unqualified opinions on their fiscal year 1999 financial statements—for fiscal year 1996, only 6 agencies achieved that goal. However, further progress remains to be accomplished at the 4 agencies which received qualified opinions and the 5 agencies which received disclaimers thus far for fiscal year 1999. Also, for fiscal year 1999, 5 agencies were late in issuing their financial statements, compared with 11 agencies that were late in issuing financial statements for fiscal year 1997.

Further, several agencies, most notably the Social Security Administration (SSA), have made good progress toward achieving financial management reform goals. For the past 2 years, SSA issued its audited financial statements, for which it received an unqualified audit opinion, in November, only 6 weeks after the close of the fiscal year and over 3 months before the March 1 statutory deadline. Others have resolved certain previously reported financial statement deficiencies. For example, the Department of Energy resolved its previously reported deficiency related to its environmental and disposal liability associated with nuclear weapons.

In addition, in October 1999, the American Institute of Certified Public Accountants recognized federal accounting standards as a generally accepted basis of accounting, which represents a major milestone for the federal government. This is an important step in the process of improving the reliability and credibility of federal financial information in the eyes of the public.

At the same time, several major departments are not yet able to produce auditable financial statements on a consistent basis. The most significant in this regard is the Department of Defense (DOD), which represents a large percentage of the government's assets, liabilities, and net costs. None of the military services or the department as a whole has yet been able to produce auditable financial statements. We designated DOD financial management to be a high-risk area in 1995 and it remains so today, although we have seen increased attention to begin to address many of the issues. DOD recognizes the seriousness of its problems and has a number of improvement initiatives under way. We have designated as high risk financial management at IRS, the Forest Service, and the Federal Aviation Administration. As I will highlight today, challenges also continue in producing reliable statements for the entire U.S. government.

For the last 2 years, we reported that because of the serious deficiencies in the government's systems, recordkeeping, documentation, financial reporting, and controls, amounts reported in the U.S. government's financial statements and related notes may not provide a reliable source of information for decision-making by the government or the public.[1] Our report on the U.S. government's financial statements for fiscal year 1999 has reached the same conclusion. These deficiencies also affect the reliability of information contained in the accompanying Management's Discussion and Analysis and any other financial management information—including information used to manage the government day-to-day and certain budget information reported by agencies—which is taken from the same data source as the financial statements.

The executive branch recognizes that, because of the extent and severity of the financial management deficiencies, addressing them will require concerted improvement efforts across government. Annual financial audits represent an important means to assure continued progress in connection with improving federal financial management. Further, the President has designated financial management improvement as a priority management objective and efforts are underway across government to address pervasive, generally long-standing financial management problems.

However, while clean audit opinions are essential to providing an annual public scorecard, they do not guarantee that agencies have the financial systems needed to dependably produce reliable financial information. Modern systems and good controls are essential to reach the end goal of reliable, useful, and timely financial

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[1] *Financial Audit: 1997 Consolidated Financial Statements of the United States Government* (GAO/AIMD-98-127, March 31, 1998) and *Financial Audit: 1998 Consolidated Financial Statements of the United States Government* (GAO/AIMD-99-130, March 31, 1999).

information to support ongoing management and accountability. Some agencies have only been able to obtain unqualified audit opinions through heroic efforts, which include using consultants, statistical sampling, and other ad hoc procedures to derive numbers as of a single point in time—the end of the fiscal year. These efforts are often completed months after the end of the fiscal year. The fundamental problem is that their financial systems cannot routinely provide this information.

Agency financial systems overall are in poor condition and cannot provide reliable financial information for managing day-to-day government operations and holding managers accountable. Thus far, for fiscal year 1999, agency financial auditors have reported that 19 of 22 major agencies' financial systems did not comply with FFMIA, which requires agency financial management systems to comply substantially with federal accounting standards and financial systems and other requirements. Systems for the remaining two major agencies that have not yet issued audited fiscal year 1999 financial statements did not comply with the act's requirements for fiscal years 1998 and 1997.

Over the longer-term, improving financial systems will involve harnessing technology and applying the information technology management framework outlined in the Clinger-Cohen Act. A crucial aspect of this will be to strengthen internal control, particularly computer controls. Continuing serious and widespread computer security weaknesses, which we have also designated as a high-risk area, are placing enormous amounts of federal assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption.

Another integral part of financial management reform is revamping human capital practices to build greater capacity and implementing change management to achieve the discipline needed to follow sound financial management and reporting practices. While some attention to delineating core competencies and training has occurred, a great deal more needs to be done to improve financial management human capital practices. We have outlined some of these steps in our executive guide for creating value through world-class financial management.[2]

The leadership and partnerships established to successfully address the Year 2000 computing problem provide lessons learned that can also be used to address financial management reform across government. These lessons include providing high-level congressional and executive branch leadership, understanding the importance of addressing the issues, providing standard guidance, employing a constructive engagement approach, facilitating progress and monitoring performance, and implementing fundamental improvements. It will be especially important to prepare for a new administration next year and to

[2]*Executive Guide: Creating Value Through World-class Financial Management* (GAO/AIMD-99-45, August 1999 (Exposure Draft)).

put in place the mechanisms to sustain current improvement efforts. This would include a governmentwide plan, together with milestones, for addressing major weaknesses, as well as agency-level plans.

The audit community—the Inspectors General and GAO—must play a constructive role in recommending workable solutions to problems. 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. We are also continuing to work with the Office of Management and Budget (OMB), the Treasury, and agencies across government to recommend the actions necessary for achieving legislative reform goals. 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. Ultimately, providing such data in meaningful, user-friendly reports is key to assuring adequate accountability to taxpayers, managing for results, and helping decisionmakers make timely well-informed judgments.

The remainder of my testimony will focus on these matters and the findings of our report on the financial statements of the U.S. government for fiscal year 1999. But first, I would first like to discuss important financial information relating to the Social Security and Medicare programs, which are two important programs having major budget implications.

The U.S. government’s fiscal year 1999 Financial Report and, therefore, our report on our audit of these financial statements, include certain information concerning the Social Security and Medicare (Part A) trust funds, such as projected contributions and expenditures, dates when expenditures are expected to exceed contributions, and dates when such funds are expected to be exhausted. Such information is as of January 1, 1999, for Social Security and as of September 30, 1999, for Medicare (Part A), the most recent information publicly reported by the government.

Yesterday, the government issued updated information as of January 1, 2000, for both programs. The government’s issuance of dated information in this Financial Report at about the same time that it issues more current information may cause confusion to the Congress and the public. This can serve to reduce confidence in and the credibility of the government’s annual financial report. This is especially true when there are significant differences between the trustees’ new projections and those included in the annual report. As a result, steps should be taken, in future years, to ensure that the government’s Financial Report contains up-to-date information as of no earlier than the end of the most recent fiscal year in these important federal programs. Because current information on the solvency of the Social Security and Medicare programs is critical to assessing the financial condition of the nation, aiding in budget deliberations, and fostering public debate, we will include the updated information on these two important federal programs in a report that will also contain the *Fiscal Year 1999 Financial Report of the United States Government*.

Because of its importance, I would like to summarize the new Social Security and Medicare information and the differences from the information contained in the stewardship information accompanying the financial statements. This information is presented in the following figure.

	Trust Fund	Trustees' Report	Financial Report
First Year Outgo Exceeds Tax Income Excluding Interest	Social Security	2015	2014
	--OASI	2016	Not Reported
	--DI	2007	Not Reported
	Medicare – Part A	2010	Not Reported
Year Trust Fund Is Exhausted	Social Security	2037	2034
	--OASI	2039	2036
	--DI	2023	2020
	Medicare – Part A	2023	2015
Present Value of Additional Resources Needed	Social Security	Not Reported	$2,935 billion
	--OASI	Not Reported	2,413 billion
	--DI	Not Reported	522 billion
	Medicare – Part A	Not Reported	$2,935 billion
Actuarial Deficit as a Percentage of Taxable Payroll Over the 75 Year Projection Period	Social Security	1.89%	Not Reported
	--OASI	1.53%	Not Reported
	--DI	0.37%	Not Reported
	Medicare – Part A	1.21 %	Not Reported
Actuarial Deficit as a Percentage of Taxable Payroll in Year 75	Social Security	6.18 %	Not Reported
	--OASI	5.40 %	Not Reported
	--DI	0.78 %	Not Reported
	Medicare – Part A	3.28%	Not Reported

Key:
OASI – Federal Old-Age Survivors Trust Fund
DI – Federal Disability Insurance Trust Fund

I will now discuss the findings of the audit of the U.S. government’s fiscal year 1999 Financial Report.

<u>Results of GAO’s Audit of U.S. Government’s Financial Statements for Fiscal Year 1999</u>

Our report on the U.S. government’s financial statements for fiscal year 1999 states that certain significant financial systems weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal control, including computer controls, continue to prevent the government from accurately reporting a significant portion of its assets, liabilities, and costs.

Major challenges included the federal government's inability to

- properly account for and report (1) material amounts of property, equipment, materials, and supplies and (2) certain stewardship assets, primarily at the Department of Defense;

- properly estimate the cost of certain major federal credit programs and the related loans receivable and loan guarantee liabilities, primarily at the Department of Agriculture;

- estimate and reliably report material amounts of environmental and disposal liabilities and related costs, primarily at the Department of Defense;

- determine the proper amount of various reported liabilities, including postretirement health benefits for military employees and accounts payable and other liabilities for certain agencies;

- accurately report major portions of the net cost of government operations;

- ensure that all disbursements are properly recorded; and

- properly prepare the federal government’s financial statements, including balancing the statements, accounting for substantial amounts of transactions between governmental entities, properly and consistently compiling the information in the financial statements, and reconciling the results of operations to budget results.

In addition, we found that (1) the government is unable to determine the full extent of improper payments—estimated to total billions of dollars annually—and therefore cannot develop effective strategies to reduce them, (2) serious, long-standing computer security weaknesses expose the government's financial and other sensitive information to inappropriate disclosure, destruction, modification, and fraud, and critical operations to disruption, and (3) material control weaknesses affect the government's tax collection activities. Further, the financial management systems of almost all agencies were again found not to be in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996.

Major issues identified by our work are discussed below.

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 $472 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, and other military supplies. Also, the government cannot ensure that all assets are reported. For example, no Department of Defense (DOD) contractor-held personal property was reported. Further, national defense asset unit information reported as Stewardship Information was incomplete because (1) it did not include major national defense support equipment, such as uninstalled engines and communications equipment, and (2) amounts were reported in units, rather than in dollars as required by current generally accepted accounting principles. DOD, the largest holder of these assets, has acknowledged the challenges it faces to implement effective systems and accurately record data to properly account for and report its physical assets and has a number of initiatives underway that are intended to address this problem. These initiatives are expected to span several years.

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 inventory records contain significant error rates. Further, weak controls significantly impair the government's ability to detect and investigate fraud or theft of assets.

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

As of the end of fiscal year 1999, the government reported $184 billion of loans receivable and $35 billion of liabilities for estimated losses related to estimated future defaults of guaranteed loans. Certain federal credit agencies, responsible for significant portions of the government's lending programs, were unable to properly estimate the cost of these programs in accordance with generally accepted accounting principles and budgeting requirements. As an example, the Department of Agriculture, which represents a significant portion of loans receivable, could not estimate the net loan amounts expected to be collected because it does not maintain some of the key historical data needed to predict borrower behavior, such as the amount and timing of future defaults and prepayments. Agriculture's lack of historical data is largely the result of system inadequacies. Certain affected agencies are in the process of implementing action plans intended to develop reliable loan and loan guarantee information. 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

Significant portions of the liability for remediation of environmental contamination and disposal of hazardous waste, reported at $313 billion, lacked adequate support and may not be complete. For example, the estimated cost to remove unexploded ordnance and residual contaminants from training ranges, amounting to over 40 percent of DOD's recorded liability, is not adequately supported. Also, the cost of significant estimated liabilities associated with certain major weapons systems and training ranges, initially recorded in fiscal year 1999, was reported as a current year cost, rather than as a prior period adjustment as required by generally accepted accounting principles.

Properly stating environmental and disposal liabilities and improving internal control 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. DOD, which has significant exposure for environmental and disposal liabilities, improved its initial estimate in fiscal year 1999 by including additional categories of liabilities, such as nuclear weapons systems. Also, DOD has a project in progress that is intended to better identify and document all additional environmental and disposal liabilities.

Liabilities

Adequate systems and cost data were not available to accurately estimate the reported $196 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. In addition, some of the underlying patient workload data were not reliable. DOD is evaluating methods to develop a reliable estimate of this liability. Also, some agencies do not maintain adequate records or have systems to ensure that accurate and complete data were used to estimate a reported $86 billion of accounts payable and a reported $169 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 $1.76 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 and deficiencies in financial statement preparation, 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.

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. Although improvements in some agency reconciliation processes have been noted, there continued to be billions of dollars of unreconciled differences between agencies' and Treasury records of cash disbursements as of the end of fiscal year 1999. As a result, the government is unable to ensure that all disbursements are properly recorded. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by agencies for inclusion in the President's budget concerning fiscal year 1999 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. Also, certain financial information required by generally accepted accounting principles was omitted from the financial statements.

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, to agency adjustments that affected net position, and to errors. An additional net $12 billion of unreconciled transactions was improperly recorded in net cost. These unreconciled transactions result in material misstatements of assets, liabilities, revenues, and/or costs.

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.

In fiscal year 1999, the government required agencies to reconcile certain intragovernmental accounts. Some of these accounts, such as those related to employee benefits, could not be reconciled. Also, in fiscal year 1999, the government required agencies to report the detail of certain intragovernmental accounts by "trading partner" agency. Using this information, we estimated that the amounts reported for agency trading partners for these specific intragovernmental accounts were out-of-balance by more than $350 billion. With trading partner information, the government can begin to analyze the nature of these intragovernmental account differences and develop effective solutions. Solutions will also be required for significant differences reported in other intragovernmental accounts, primarily related to appropriations. The government stated that it plans to require agencies to reconcile additional intragovernmental accounts in fiscal year 2000 and has formed task forces to recommend solutions to this long-standing problem.

Unreconciled transactions also may arise because the government does not have effective controls over reconciling net position. The net position reported in the financial statements is derived by subtracting liabilities from assets, rather than through balanced accounting entries. Also, certain adjustments and eliminations do not balance. Such control weaknesses, combined with unbalanced transactions and the significant volume of transactions and number of reporting entities, result in misstatements in the financial statements, hinder the ability of the government to identify misstatements that may exist, and may contribute to the amount of reported unreconciled transactions.

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. 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. In fiscal year 1999, the Department of Treasury, which prepares the accompanying financial statements, implemented a new process for reconciling these financial statements with the related agency financial statements. While the process identified the nature of certain inconsistencies, the government was unable to reconcile all amounts included in these financial statements with agency financial statements. Further, 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. We identified over $350 billion of adjustments and reclassifications which the government subsequently recorded, such as a $66 billion overstatement of interest cost and a $70 billion overstatement of Medicare costs.

These problems are compounded by the substantial volume of information submitted and limitations in the federal government's general ledger (SGL) account structure. For example, some SGL accounts must be split between different financial statement line items. As a result, additional misclassifications and misstatements in the government's financial statements could exist. Also, the extensive manual intervention required to compile the federal government's financial statements requires significant resources which lessens the government's ability to perform effective financial analysis of the information. For example, because of SGL limitations, the government separately collects additional information needed to compile the financial statements. However, such additional information, historically, is initially inconsistent with the related SGL account balances by hundreds of billions of dollars. After substantial effort, such inconsistencies were reduced to an immaterial amount.

Reconciling the Results of Operations With Budget Results. The federal government does not yet have a process to obtain information to effectively reconcile the reported $77 billion excess of revenue over net cost and a reported unified budget surplus of $124 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 to be prepared on the accrual basis in accordance with generally accepted accounting principles, 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, 24 major agencies were required to reconcile their reported net costs to budget information, which could provide a basis for preparing the reconciliation. 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 amounts of DOD transactions were not applied or were incorrectly applied to specific budget appropriations, which could misstate certain reported budget information. Once the federal government produces reliable financial statements, an effective reconciliation could help provide additional assurance of the reliability of budget results.

Ineffective Internal Control

In addition to the material weaknesses related to the deficiencies discussed above, we found that (1) the government's inability to determine the full extent of improper payments impairs the effective reduction of such improper payments and (2) material control weaknesses affect the government's tax collection activities. We also found that widespread and serious computer control weaknesses, which are further discussed later in this testimony, affect virtually all federal agencies and significantly contribute to many of the material deficiencies.

Improper Payments. The government is unable to determine the full extent of improper or erroneous payments, which include payments made for unauthorized purposes, for excessive amounts, such as overpayments to program recipients or contractors and vendors, and/or not in accordance with applicable laws and regulations. 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.

The Department of Health and Human Services (HHS) has been reporting a national estimate of improper Medicare Fee-for-Service payments since fiscal year 1996. In fiscal year 1999, HHS reported estimated improper Medicare Fee-for-Service payments of $13.5 billion, or about 8 percent of such benefits—down from $23.2 billion or 14 percent for fiscal year 1996. HHS' reporting and analysis of improper Medicare payments has helped lead to the implementation of several initiatives to identify and reduce such payments. Annual estimates of improper payments in future audited financial statements will provide information on the progress of these initiatives.

However, most agencies have not estimated the magnitude of improper payments in their programs, nor have they considered this issue in their annual performance plans. For example, the Earned Income Tax Credit (EITC) program—a refundable tax credit available to low income, working taxpayers—has historically been vulnerable to high rates of invalid claims. During fiscal year 1999, IRS examined about 573,000 suspicious tax returns claiming $1.25 billion in EITCs and found that $1.08 billion (86 percent) were invalid. Although the full extent of refunds resulting from invalid EITCs is unknown, the IRS has not disclosed any improper payment estimates in its financial statement reports. In another example, HHS has not reported an estimate of improper payments in its $109 billion state-administered Medicaid program, but is currently studying methodologies for developing an estimate and has formed partnerships with various state auditors to share information on improper payments.

Improper 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.

Without a systematic measurement of the extent of the problem, agency management cannot determine (1) if the problem is significant enough to require corrective action, (2) how much to invest in internal control, or (3) the success of efforts implemented to reduce improper payments. Developing mechanisms to identify, estimate, and report the nature and extent of improper payments in annual financial statements is only a first step for agencies. Without this fundamental knowledge, agencies cannot be fully informed about the magnitude or trends of improper payments, nor can they pinpoint or target mitigation strategies.[3]

In October 1999, we recommended that OMB develop and implement a methodology for annually estimating and reporting improper payments and for addressing improper payments in agencies' annual performance and strategic plans and performance reports. OMB agrees with this recommendation. In this regard, the President has made estimating and preventing improper payments a priority management objective and OMB plans to require agencies to develop and implement procedures to estimate and report the nature and extent of material improper payments in annual financial statements and have such information audited.

<u>Tax Collection Activities</u>. The federal government continues to have material weaknesses in controls related to its tax collection activities, which affect its ability to efficiently and effectively account for and collect the government's revenue. This situation results in the need for extensive, costly, and time-

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[3] *Financial Management: Increased Attention Needed to Prevent Billions in Improper Payments* (GAO/AIMD-00-10, October 29, 1999).

consuming ad hoc programming and analysis, as well as material audit adjustments, to prepare basic financial information—an approach that cannot be used to prepare such information on a timely, routine basis to assist in ongoing decision-making. Additionally, the severity of the system deficiencies that give rise to the need to resort to such procedures for financial reporting purposes, as well as deficient physical safeguards, result in burden to taxpayers and lost revenue.

Serious financial management system deficiencies continue to affect the federal government's ability to effectively manage its taxes receivable and other unpaid assessments.[4] The lack of appropriate subsidiary systems to track the status of taxpayer accounts affects the government's ability to make informed decisions about collection efforts. This weakness has resulted in the government pursuing collection efforts against individual taxpayers who had already paid their taxes in full. In addition, the government does not always pursue collection efforts against taxpayers owing taxes to the federal government. This could result in billions of dollars not being collected and adversely affect future compliance.

The federal government also continues to be vulnerable to loss of tax revenue due to weaknesses in preventive and detective controls over disbursements for tax refunds. Although the government does have detective controls in place, they are not applied to millions of tax returns estimated to have billions of dollars in underreported tax liabilities. These conditions expose the government to potentially billions of dollars in losses due to inappropriate refund disbursements.

Also, the government does not perform sufficient up-front verification procedures to ensure the validity of amounts claimed by taxpayers as overpayments prior to making disbursements for refunds. Additionally, delays in recording tax amounts owed result in lost opportunities to retain or offset overpayments made by a taxpayer for one period to collect on outstanding amounts owed for another period, resulting in lost revenue. Finally, serious deficiencies in physical controls over cash, checks, and sensitive data received from taxpayers increase both the government's and the taxpayers' exposure to losses and increases the risk of taxpayers becoming victims of crimes committed through identity fraud.

IRS senior management has expressed a commitment to address many of these operational and financial management issues and has made a number of improvements to address some of these weaknesses. Successful implementation of long-term efforts to resolve these serious problems will require the continued commitment of IRS management as well as substantial resources and expertise.

[4]Other unpaid assessments consist of amounts for which (1) neither the taxpayer nor a court has affirmed are owed or (2) the government does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency.

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. As of March 20, 2000, 22 of the 24 agencies had received audit opinions or disclaimers on their fiscal year 1999 financial statements. These included 13 unqualified opinions,[5] 4 qualified opinions, and 5 disclaimers. In fiscal year 1998, 12 agencies received unqualified audit opinions, 11 in fiscal year 1997, and 6 in fiscal year 1996.

While the results continue to be mixed, effort is now being exerted by individual agencies 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.

We have designated as high risk, certain agencies with the most serious problems.[6] These include financial management at the Department of Defense, IRS, the Forest Service, and the Federal Aviation Administration. All, however, have concerted efforts underway to address their deficiencies, and we will continue to work with them and the cognizant Inspectors General to advance recommendations and evaluate progress.

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. 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.

The majority of 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. For many agencies, the preparation of financial statements requires considerable reliance on ad hoc programming and analysis of data produced by inadequate financial systems that are not integrated, reconciled, and often require significant

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[5]These agencies are the Social Security Administration, the National Science Foundation, the General Services Administration, the Department of Energy, the National Aeronautics and Space Administration, the Nuclear Regulatory Commission, the Department of Labor, the Small Business Administration, the Federal Emergency Management Agency, the Department of Commerce, the Department of Health and Human Services, the Department of Transportation, and the Department of Veterans Affairs.

[6]*High-Risk Series: An Update* (GAO/HR-99-1, January 1999).

adjustments. As a result, reliable financial information on a day-to-day basis is not available for effective financial management.

For example, the IRS relies on extensive, costly, and time-consuming ad hoc programming and analysis, as well as material audit adjustments, to prepare basic financial information. For fiscal year 1999, IRS was able to reliably report on the results of its custodial activities, including nearly $1.9 trillion of tax revenue, $185 billion of tax refunds, and $21 billion of net federal taxes receivable.[7] However, as in 1998, this was accomplished only after extensive use of ad hoc programming by IRS 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, among other things, to 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.

Thus far, for fiscal year 1999, agency financial auditors have reported that 19 of 22 major agencies' financial systems did not comply with the act's requirements. Systems of the remaining two major agencies that have not yet issued audited fiscal year 1999 financial statements did not comply with the act's requirements for fiscal years 1998 and 1997. Noncompliance with FFMIA, which we further discuss in our report *Financial Management: Federal Financial Management Improvement Act Results for Fiscal Year 1998* (GAO/AIMD-00-3, October 1, 1999), is indicative of the overall continuing poor condition of agency financial systems. Also, as we reported, agency remediation plans, required by FFMIA, may not adequately address the system deficiencies. Significant time and investments are needed for agencies to address and correct these long-standing financial management systems problems.

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.

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[7] *Financial Audit: IRS' Fiscal Year 1999 Financial Statements* (GAO/AIMD-00-76, February 29, 2000).

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.

Computer Security Weaknesses

Continuing serious and widespread computer security weaknesses are placing enormous amounts of federal assets at risk of inadvertent or deliberate 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 adequately segregating duties to help ensure that people do not conduct unauthorized actions without detection, preventing unauthorized software from being implemented, and mitigating and recovering from unplanned interruptions in 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. Recent media reports highlight the potential damage that can result from computer security breaches.

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 either not detected or not reported. GAO and agency reviews illustrate the potential for negative impacts. For instance, weaknesses in DOD information security continue to provide hackers and hundreds of thousands of authorized users the opportunity to modify, steal, and destroy DOD data including financial, procurement, logistics and other sensitive information. Also, identified weaknesses at HCFA, SSA, IRS, and VA place tax, medical and other sensitive records at risk of unauthorized disclosure, modification, and destruction. Unauthorized disclosure of sensitive information has led to instances of identity theft, in which individuals use such information to commit financial crimes, such as fraudulently establishing credit and running up debts. Likewise, serious and pervasive computer security problems at EPA increase the risk that mission-related systems and financial operations are vulnerable to tampering, disruption, and misuse. Further, pervasive weaknesses at the Department of Treasury, which collects virtually all of the government’s revenues and makes most of its disbursements, expose such collections and disbursements to significant risk of loss or fraud.

GAO and the IGs have issued numerous reports that identify information security weaknesses in the federal government and made recommendations to address them.[8] Also, GAO has reported information security as a high-risk area across government since February 1997.[9]

Information security problems continue to persist, in large part, because agency managers have not fully established comprehensive security management programs. An effective program would include a central security function and effective procedures for assessing risks, establishing appropriate policies and related controls, raising employee awareness of prevailing risks and mitigating controls, and monitoring and evaluating the effectiveness of established controls. Such programs, if properly implemented, would provide the government with a solid foundation for resolving computer security problems and managing computer security risks on an ongoing basis.

The Congress continues to express concern about the significant risks to federal government systems and information that result from computer security weaknesses. Congressional hearings have focused on specific agency deficiencies and have clarified the problem across government. Further, S. 1993, the Government Information Security Act of 1999, recently introduced in Congress, seeks to strengthen information security practices throughout the federal government.

The administration has recognized the importance of computer security and has taken some steps to prompt improvement from a governmentwide perspective. In January 2000, the President released the *National Plan for Information Systems Protection*,[10] which calls for new initiatives to strengthen the nation's defenses against threats to public and private sector information systems that are critical to the country's economic and social welfare. In addition, the President designated computer security as a priority management objective.

Financial Management Human Capital Challenges

An integral part of financial and information management is building, maintaining, and marshaling the human capital needed to achieve results. Leading organizations understand that using a strategic approach to human capital is essential to reaching and maintaining maximum performance.

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[8] See, for example, *Critical Infrastructure Protection: Comprehensive Strategy Can Draw on Year 2000 Experiences* (GAO/AIMD-00-1, October 1, 1999) and *Information Security: Serious Weaknesses Place Critical Federal Operations at Risk* (GAO/AIMD-98-92, September 23, 1998).

[9] *High-Risk Series: An Update* (GAO/HR-99-1, January 1999), *High-Risk Series: An Overview* (GAO/HR-97-1, February 1997), and *High-Risk Series: Information Management and Technology* (GAO/HR-97-9, February 1997).

[10] *Defending America's Cyberspace: National Plan for Information Systems Protection: Version 1.0: An Invitation to a Dialogue.* Released January 7, 2000. The White House.

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.

To effectively evaluate and improve the value derived from government programs and spending, the Congress and other decisionmakers must have accurate and reliable financial information on program cost and performance. Further, they must be able to rely on federal finance organizations to provide analysis and insight about the financial implications of program decisions and the impact of those decisions on agency performance goals and objectives. Today, the overall widespread lack of attention to strategic human capital management may be creating a fundamental weakness in federal management.[11]

While some attention to delineating core competencies and training has occurred, a great deal more needs to be done to improve financial management human capital. The Office of Management and Budget has designated the development of human capital as a priority financial management objective. In fiscal year 1999, we issued a draft *Executive Guide: Creating Value Through World Class Financial Management*, which describes best practices in financial management.[12] In this report, we point out that world class financial management organizations provide added value to management's operating decisions and emphasize the importance of strategic human capital management in financial management organizations.

To help agencies better implement performance-based management, we have identified common principles that underlie the human capital strategies and practices of private sector organizations regularly cited as leaders in the area of human capital management.[13] Further, we have issued a human capital self-assessment checklist for agency leaders to use in taking practical steps to improve their human capital practices.[14]

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. That is why it is so essential that efforts continue to build the necessary fundamental foundation through lasting financial management reform. Only by generating reliable and useful information, can the government assure adequate accountability to

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[11] *Human Capital: Managing Human Capital in the 21st Century* (GAO/T-GGD-00-77, March 9, 2000).
[12] (GAO/AIMD-99-45, August 1999).
[13] *Human Capital: Key Principles From Nine Private Sector Organizations* (GAO/GGD-00-28, January 31, 2000).
[14] *Human Capital: A Self-Assessment Checklist for Agency Leaders* (GAO/GGD-99-179, September 1999).

taxpayers, manage for results, and help decisionmakers make timely well-informed judgments.

Reliable financial information is critical in assessing the long-term fiscal consequences of decisions that must be made today. The nation's demographics are changing; for government, the most direct long-term fiscal consequence of these changes is in connection with retirement and health care entitlement programs. Our analyses continue to show that the combination of longer life expectancy, the aging baby boom generation, and a relatively smaller working population will lead to renewed fiscal pressures as entitlement programs for the elderly increasingly encumber a greater share of available budgetary resources. In deliberations affecting the nation's future resources, decisionmakers need reliable financial information, including the perspectives that can be provided by accrual and present value data.[15]

Providing reliable financial data in meaningful, user-friendly reports is also critical. Accountability is enhanced when Congress can examine the relationship between agency financial information and program results. A pilot program under the Government Management Reform Act resulted in 10 agencies issuing accountability reports for 1996. These reports consolidate reporting requirements under several statutes, including the CFO Act, GPRA, the Federal Managers' Financial Integrity Act, the Prompt Payment Act, and the Debt Collection Improvement Act. The accountability reports include both program and financial information, such as the audited financial statements and performance measures reflecting performance in meeting key agency goals. They provide the opportunity for agencies to report a balanced set of measures that link an agency's strategic objectives to its financial performance, customer satisfaction, the results of its business processes and its effort to improve. Twenty-two agencies are expected to prepare accountability reports for fiscal year 1999. The initial experience with accountability reports has been promising and we support congressional adoption of this concept, or at a minimum, reauthorization of these pilots, which are to expire on June 30, 2000.

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.

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[15] *Managing in The New Millennium: Shaping a More Efficient and Effective Government for the 21st Century* (GAO/T-OCG-00-9, March 29, 2000).

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In closing, Mr. Chairman, I want to again commend your Subcommittee for its diligent oversight of actions to improve financial management of government. Your hearings continue to 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.

Contact

For future contacts regarding this testimony, please contact Robert Dacey, Director, Consolidated Audit and Computer Security Issues, at (202) 512-3317.

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