

GAO

Testimony

For Release
on Delivery
Expected at
2:00 p.m.
Wednesday
April 18,
1990

**Federal Internal Control and
Financial Management Systems:
Major Reform Efforts Are Needed**

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Before the
Subcommittee on HUD/Moderate Rehabilitation
Investigation
Committee on Banking, Housing and Urban Affairs
U.S. Senate



048295/141157

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to provide GAO's perspective on the condition of internal control and financial management systems in the federal government and actions needed to help eliminate the system weaknesses that exist throughout the government.

In 1982, the Congress passed the Federal Managers' Financial Integrity Act to strengthen internal control and accounting systems throughout the federal government and reduce fraud, waste, abuse, and mismanagement. At that time, audits of government programs and media reports had identified a large number of serious problems in areas that cut across all agencies and programs. Unfortunately, as discussed in our November 1989 report, Financial Integrity Act: Inadequate Controls Result in Ineffective Federal Programs and Billions in Losses (GAO/AFMD-90-10), 7 years after passage of the act, little has changed. Agency reviews, audits, and newspaper and other media reports continue to identify serious problems that paint the picture of a government unable to manage its programs, protect its assets, or provide taxpayers with the effective and economical services they expect and deserve.

WEAK INTERNAL CONTROL SYSTEMS
EXIST THROUGHOUT THE GOVERNMENT

Despite the performance of thousands of internal control evaluations and agency plans to correct the material internal control weaknesses identified, we see little overall improvement in the condition of controls throughout the government since passage of the Financial Integrity Act. Frequently, agency actions to improve controls have taken the form of systems improvement plans that were not well executed. In addition, many systems have continued to deteriorate or failed to keep pace with new demands and additional control weaknesses have appeared. Some long-standing weaknesses, hidden before, have been identified. The Financial Integrity Act has opened our eyes to the problems of government, and we now have identified most of the weaknesses that put the government at high risk to fraud, abuse, waste, and mismanagement. But, we have not done enough to correct the problems that are being reported.

Mr. Chairman, to illustrate a point, I would like to read an excerpt from an article entitled, "The Stench at FHA."

"FHA has approved marginal or hopeless projects, let promoters milk them. . . and then abandon them. And while FHA has sat dumbly by, other promoters have gone from city to city defaulting on project after project.

It has permitted still others to default on loans but continue to collect rents for up to five years. . . . In the last 30 months, the GAO has submitted to Congress 11 reports indicting FHA for derelictions ranging from misrepresentations of its income to slovenly neglect of its own foreclosed property."

That quotation is similar to many others written over the past year. However, there is one significant difference. It comes from an April 1966 Reader's Digest article.

In this respect, we have learned little in 24 years. Also, we have accomplished little in the 7 years since the passage of the Financial Integrity Act. We must have a new and larger commitment from all levels of agency management, the Office of Management and Budget (OMB), and the Congress to take appropriate and timely actions to make a real change that will materially reduce the number of serious internal control weaknesses. Commitment means people, new ways of doing things over a sustained period of time, and money. The debacle at the Department of Housing and Urban Development (HUD) has had one positive result; it has refocused needed governmentwide attention on the importance of strengthening the Financial Integrity Act. If we are ever to achieve the act's objectives, however, emphasis must shift from merely reporting under the act to correcting long-standing weaknesses. The situation at HUD has

also opened many eyes to the need for additional legislative and administrative actions to strengthen financial management in the federal government. I will mention these actions later in my testimony.

FINANCIAL MANAGEMENT SYSTEMS ARE
WEAK AND IMPROVEMENTS ARE SLOW,
COSTLY, AND OFTEN INEFFECTIVE

As with internal controls, we see very little progress in the government's efforts to strengthen its financial management systems. Many of the existing systems are weak, outdated, and inefficient, and cannot routinely produce relevant, timely, and comprehensive information. We have old systems that provide a flood of information but little reliable operational and cost data that are essential to monitor program performance, control costs, anticipate overruns, and provide a basis for program and budget planning.

The ever increasing size and complexity of federal programs and overall pressures to reduce the budget deficit will require the availability of adequate and accurate financial information for the successful performance of program management and oversight functions. As the President's fiscal year 1989 Management Report stated, "Once a leader in the early days of automation, the Government's financial systems and operations

have eroded to the point that they do not meet generally accepted standards."

The federal government has planned corrective actions and provided billions of dollars for financial management improvement programs. However, these efforts to improve existing systems and develop and acquire new automated systems have and continue to experience massive problems. For example, design flaws, misjudgments in requirements, and poor program management caused the Navy to halt installation of a new automated management information system after spending an estimated \$230 million over 9 years to develop the system. Unfortunately, the Navy's experience is not uncommon.

If the government is to strengthen its programs and run them in an efficient and economical manner, it must better manage its system improvement projects.

A STRONG WORK FORCE IS NEEDED TO
MEET CURRENT AND FUTURE CHALLENGES

A key factor in the development, implementation, and maintenance of sound federal programs is a strong federal work force. Today, the federal government needs to attract, motivate, and retain committed people at all levels who can develop new ideas and innovative approaches and see them through

to effective implementation. Concern is mounting over the impact that both the federal pay structure and the turnover in leadership positions are having on the government's ability to acquire and retain top quality people to carry out its programs.

As experienced employees retire or leave government service and additional staffing needs develop, it is becoming increasingly difficult to hire individuals with the experience and qualifications needed to accomplish the government's mission. The government's general pay scale causes additional problems because it severely restricts the financial incentive programs an agency can implement to reward and retain quality personnel. In addition, we do not really have a governmentwide training program for accountants and financial management systems personnel. We have to make an investment in people, both in terms of compensation and training. Otherwise, I am afraid problems will continue to manifest themselves.

ACTIONS NEEDED TO STRENGTHEN
CONTROLS AND ACCOUNTING SYSTEMS

The legislative and executive branches of government must form a partnership, with the common goal of achieving effective and economical federal programs through, in part, the development of sound internal control and financial management systems. We cannot merely think in terms of tomorrow, waiting for something

to happen. The poor state of the government's systems demands that we think and act today.

The Problems Should Not
Be Left to the Auditor

Agency top management must be committed to strong internal control and financial management systems and should be directly involved in ensuring that needed corrective actions are identified and implemented in a timely manner. With this commitment must also come increased coordination between agency management officials and those in audit organizations such as the Offices of Inspectors General and GAO. For example, last year GAO and the Inspector General and top agency officials at the Department of Transportation worked closely together to identify agency programs needing management attention and actions that could help resolve the existing problems. We need more of this interaction where management and auditors come to grips with major agency problems.

The Administration Must Strengthen
the Financial Integrity Act Program

The government's basic internal control and financial management deficiencies are known and, in many instances, have been known for many years, but they remain uncorrected. The

identification of deficiencies is an important step, but it is not enough. Agencies must also act effectively to correct them. In the past, no effective mechanism existed to ensure that agencies took the needed corrective actions. In our November 1989 report, we urged, among others, the following actions.

- Agencies should be required to link the Financial Integrity Act internal control review and reporting process with the budget process. Agencies should identify corrective actions that require incremental funding and major reprogramming in the current budget. This should assist senior decisionmakers in assessing the magnitude of corrective action funding requirements.

- Agencies should establish senior-level policy committees or take other steps to provide top management oversight of the internal control and reporting process. This should result in better anticipation and consideration of critical issues and more actions to resolve them.

- Agencies should be encouraged to include a narrative statement in their Financial Integrity Act reports explaining the processes used to ensure that completed corrective actions were effective. The validation process should provide assurance that material weaknesses no longer exist and allow managers to focus their

attention and resources on other issues.

The administration is clearly aware that serious problems exist in the federal government. As the Director of the Office of Management and Budget stated in testimony before the Senate Committee on Governmental Affairs,

"The recently exposed HUD problems are not unique, not merely peculiar to a particular agency under what some describe as absentee management. . . . There are analogous problems in other agencies."

For its part, OMB has established a management integrity program that is intended to minimize and prevent fraud and waste in federal programs and operations. It has assigned responsibility to deputy secretaries and deputy administrators in each agency to ensure the success of this program. Through the reviews and evaluations conducted under this effort, OMB has identified over 100 high risk areas in the 16 largest and many smaller federal agencies and plans oversight and agency reporting on the actions to correct the problems.

Increased Congressional Oversight and
Financial Management Legislation Needed

The Congress can also significantly contribute to effective

corrective action through its oversight role. We have recommended that its authorizing, appropriations, and oversight committees hold annual hearings using Financial Integrity Act reports, plans for corrective actions, and audited agency financial statements as the focal point in the process of reviewing agency actions to correct internal control and accounting system weaknesses. Such hearings could help assure the Congress that corrective measures are implemented and that they are effective.

In this connection, the widespread occurrence and significant dollar and programmatic impact of federal accounting system weaknesses, in particular, highlight the need for a new approach to federal financial management. We have long been a strong advocate of legislation which would

- establish a chief financial officer (CFO) structure for the federal government, with counterpart chief financial officers in each of the major agencies and
- require the annual preparation and audit of agency financial statements and a report to the President and the Congress.

The legislatively established chief financial officer would develop a long-range governmentwide financial management plan.

The supporting structure would provide direction and continuity when leadership changes occur in the administration as well as at the agency level. Establishing a CFO structure would help give financial management the prominence, permanence, and continuity necessary to achieve reform and enable the government to better manage its financial affairs, save billions of dollars, and help restore the accountability of managers and the credibility of government.

The report to the President and the Congress would include (1) the annual financial statements, (2) the audit report on those financial statements, (3) a summary of the Financial Integrity Act reports on the systems of internal control, (4) a report summarizing the corrective actions taken with respect to the material weaknesses identified in the Financial Integrity Act reports, and (5) other information the agency head considers appropriate to fully inform the President and the Congress concerning the agency's financial management.

The preparation of audited financial statements is an essential part of the solution. It is critical because it demonstrates whether an organization's financial systems and personnel are capable of accumulating, analyzing, summarizing, and reporting on its financial condition and operating results. Preparing the statements also forces agencies to acknowledge their systems problems.

For years, the federal government has insisted that publicly traded companies, as well as state and local governments, submit their financial statements to the scrutiny of an independent audit. The federal government should do no less. Annual audits promote discipline in the recording and processing of data simply because people know that the information is subject to review. Further, the improved quality of the financial information that can be obtained when accurate financial statements can be prepared enables agencies to place greater reliance upon this information in making decisions and monitoring program implementation. Hopefully, until legislation is passed, the administration will continue to work with GAO to expand the number of agencies and departments preparing financial statements and submitting them for audit.

Our recent financial audit of the Federal Housing Administration (FHA) is a good example of why accurate and audited financial statements are needed. FHA's financial reports, which identified losses of \$858 million for fiscal year 1988, were misleading in the extreme. In fact, after making the required adjustments identified during the audit, the losses were \$4.2 billion, or almost five times greater than management's best information showed them to be.

Our initial financial audits throughout government have

revealed problems with financial systems. Frequently they are so severe that information needed to manage agency operations, as well as to prepare agency financial statements, is unreliable and seriously deficient. Generally, these problems are more serious and deep-seated than either we or agency managers realized before our audits. Subsequent audits of the same agencies show improvements, but also show that systems cannot be fixed overnight. Many times, it takes 2 or 3 years to cure some of these situations. Subsequent audits serve to monitor the improvement effort, give guidance, and keep the pressure on. We believe that the preparation of audited financial statements has had a major positive impact on the improvement of systems and, correspondingly, the reduction in the government's exposure to fraud, waste, and abuse.

HUD's Leadership Has Recognized the
Department's Financial Management Needs

For its part, HUD's leadership has recognized the need for central direction and qualified leadership in the financial management of its programs. HUD reported in its 1989 Financial Integrity Act report, and the Secretary has publicly announced, that in order to bring financial integrity to agency programs, it

-- had established a special task force on Program Financial

Management headed by an under secretary to strengthen financial management in 26 program activities;

- would soon appoint a chief financial officer for the Department who will be responsible for overhauling accounting and financial reporting policies, ensuring the development and operation of a sound financial management system, and establishing comptrollers for the major HUD activities such as FHA; and
- would prepare annual financial statements and have them audited by an independent accounting firm beginning with fiscal year 1990.

Further, in December 1989, the Congress passed legislation that, among other things, created a CFO position in HUD, created comptrollers in each of HUD's major programs, and required annual audited financial statements for each of HUD's major programs. Legislation such as this should have a very positive effect on HUD and is needed across the government.

Improvements Will Require

Monetary Investment

One final point needs to be stressed: it will take a substantial monetary investment across the government to acquire

the financial management systems that are needed and to attract and train personnel to operate them. In an era of severe budget restraint, there may be a temptation to take shortcuts to hold down these costs. I strongly believe, however, that new systems will ultimately pay for themselves. The payoff will come not only in terms of better efficiency and prevention of loss from fraud, waste, abuse, and mismanagement, but also in greater confidence in the integrity of government operations and program decisions.

GAO'S "HIGH RISK" PROGRAM

Are there other HUDs today? Unfortunately, I believe there are. To what extent, we are not quite sure, but there are unexploded bombs out there that need to be defused before they explode. We have developed a "high risk" program that focuses on what we think are some of the more vulnerable areas in the government today. Under the program, we

- have identified 14 major areas (see attachment I) we believe to be highly vulnerable;

- are focusing, in conjunction with efforts of agency management and the inspectors general, on the root causes of serious long-standing weaknesses to develop approaches to solve the problems associated with these

programs;

-- are monitoring agency corrective actions and reporting the results to the appropriate congressional committees; and

-- will recommend legislative actions necessary to ensure that corrective measures are implemented.

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Mr. Chairman, the active involvement of the Congress and hearings such as this one, directed at improving HUD's programs, are critical to correcting the internal control and financial management systems problems facing the government today. Without strong congressional oversight, the changes needed to safeguard federal assets and ensure the efficient and economical operation of federal programs will not occur. I look forward to working with you and other interested members of the Congress to achieve the internal control and financial management improvement initiatives discussed today.

This concludes my formal statement. I will be happy to answer any questions you or members of the Subcommittee may have.

INITIAL AREAS SELECTED
FOR SPECIAL GAO AUDIT OR REVIEW

Resolution Trust Corporation - The management and disposal of approximately \$200 to \$300 billion of thrift assets will pose unprecedented management problems. A sale of this magnitude is unparalleled in history. The desire and potential to acquire these assets at bargain basement prices will make this area highly susceptible to fraud, waste, and abuse.

Internal Revenue Service Receivables - The existence of accounts receivable in excess of \$60 billion which have grown about 300 percent since 1980 places this issue in the significant potential loss area. In light of the budget deficit, the potential for reducing or stabilizing the growth rate offers major dollar savings and thus warrants special review and oversight.

Management of Seized and Forfeited Assets - This issue has been characterized by mismanagement which has been the subject of considerable press attention. Responsibility for managing the program rests with the Customs Service and the U.S. Marshall's Service. Both organizations have been identified by their respective departments as having significant internal control weaknesses. Improvements in the management and control of this program will lend support to the war on drugs and increase public and congressional confidence in the program.

Medicare Questionable Claims - The tens of billions of program dollars coupled with considerable potential for fraud and abuse indicates a high potential for financial savings from our efforts. Identified payments of \$527 million by Medicare in 1985 that should have been paid by private insurance carriers illustrate the magnitude of potential savings.

ERISA/PBGC - The Department of Labor's and IRS's enforcement of ERISA has a significant impact on ensuring that employee benefit plans are free of mismanagement, fraud and abuse that place plan assets at risk and threaten the benefits of plan participants. The adequacy of their oversight has a direct financial effect on the potential for loss by the Pension Benefit Guaranty Corporation, an organization that has been unauditible in the past. The underfunding of approximately 20 percent of the plans insured by PBGC is estimated at \$20 to \$30 billion but is concentrated in particular industries where downturns could have a significant impact. The potential \$2.2 billion impact on the fund of one company's bankruptcy, LTV Corporation, demonstrates the vulnerability of this program, and thus the taxpayers' exposure to potential losses.

Guaranteed Student Loans - The large number of banks, state agencies, and schools participating in guaranteed student loan programs coupled with poor systems to protect the federal government's financial interest creates the potential for significant abuses and losses. A high proportion of defaults and publicized abuse by certain proprietary schools suggest the need for improved program controls.

State Department Real Property Management Overseas - There is adequate evidence of waste, mismanagement, and poor controls in this area as illustrated by the construction fiasco at the U.S. Embassy in Moscow. There is high potential for financial savings through better property management. Corrective action over the years has been minimal, but recently State has begun to show an interest in addressing these issues.

DOD Inventory Management Systems - Department of Defense inventories exceed \$100 billion of which unneeded or excess inventory exceeds \$30 billion. The excess inventory along with numerous other indicators (e.g., the failure to cancel orders where excess stock is already on hand) reflect financial management problems. Management incentives focus on filling orders and obligating funds. There is no corresponding focus on reducing costs or controlling or securing stock, i.e., economy and efficiency. The current pressure to reduce the DOD budget in response to recent world events provides additional incentives to make major improvements in the supply system.

DOD Major Systems Acquisition - The total estimated cost of major systems currently being developed or produced exceeds \$900 billion. Following established management controls to deliver capable and supportable weapons to the user when and where needed, and at reasonable cost, has been the exception rather than the rule. As a result, DOD continually buys higher cost systems which substantially exceed original estimates, are delivered much later than originally scheduled, and do not meet the capabilities advertised. GAO will review the effectiveness of management initiatives to address these long-term problems and their means of achieving savings.

NASA Contract Management - NASA will spend \$11 billion in 1990 on contracts and has a very decentralized contract administration process. In this environment, there is considerable potential for mismanagement, fraud, and abuse. The potential for large savings exists if better contract controls and oversight can be achieved.

Farmers Home Administration Loan Programs - FmHA has made billions of dollars of credit available to the nation's farmers. Delinquent farm loan borrowers held \$11.1 billion, or 48 percent, of the agency's \$23.3 billion in outstanding loans as of September 30, 1989. FmHA is responsible for protecting the government's interest, as well as helping farmers who cannot get help elsewhere. Recognizing congressional concern to reduce the deficit, any potential for controlling loan losses warrants added review and oversight.

Superfund Enforcement and Contractor Oversight - The Congress has authorized \$10 billion for the Superfund program but estimates of federal funds needed to complete the cleanups are many times that amount. To avoid wasting federal resources, the Environmental Protection Agency (EPA) needs to (1) ensure that parties who contaminate sites pay their fair share of the clean-up costs and (2) effectively manage clean-up contractors who get over 75 percent of Superfund's outlays. GAO will explore cost and conflict of interest control and whether EPA uses its full authority to compel private party cleanup.

Urban Mass Transportation Administration Grants - UMTA currently manages active grants totaling \$30 billion with over \$3 billion in new grants each year. The number of staff available to UMTA for project oversight is limited. Based on recent GAO survey work, increased oversight of the grant application review process and adherence to grant provisions is needed. The criteria for deciding what projects get funded and in what amounts is limited, and, in some cases, projects are funded at the sole discretion of the Administrator.

Department of Energy Contractor Oversight - DOE relies on contractors and consultants for most of the work needed to fulfill its mission. For example, DOE obligated about \$15 billion for procurement in 1988. The Department has had a history of inadequate contractor oversight and bonus awards to contractors in situations that would appear to be highly questionable. While this may be due in part to lack of expertise or inadequate staffing, it also may be due to DOE's philosophy of "least interference" with its operating contractors. GAO will examine DOE's potential for improvements in control, accountability, and efficiency.