United States General Accounting Office

GAO Testimony

For Release
on Delivery
Expected at
9:30 a.m.
Monday
September 17,
1990

Financial Management Reform

Statement of
Charles A. Bowsher, Comptroller General
of the United States

Before the
Committee on Government Operations
United States House of Representatives

049436 / 142217

GAO/T-AFMD-90-31

Mr. Chairman and Members of the Committee:

I am pleased to once again appear before this Committee to discuss the urgent need to strengthen federal financial management and the draft legislation developed by Chairman Conyers, the Financial Management Reform Act of 1990, and legislation introduced by Representative Horton, the Federal Management Reform Act of 1990, H.R.5492.

Recent events have provided ample reason for change. The mention of last year's Department of Housing and Urban Development (HUD) scandal conjures up an image of gross financial mismanagement. I mention HUD because it captured the public's attention, but it is not a member of an exclusive club. Unfortunately, most agencies could qualify for membership based upon their outdated financial management systems and practices and breakdowns of internal controls, which we highlighted in our November 1989 report, Financial Integrity Act: Inadequate Controls Result in Ineffective Federal Programs and Billions in Losses (GAO/AFMD-90-10). The problems are not limited to a few agencies or a few programs; rather, all of the major agencies have serious internal control and accounting deficiencies.

Earlier this year, we and the Office of Management and Budget (OMB) provided you information on areas likely to result in material losses to the government. These "high-risk" areas clearly show that federal financial management is fraught with problems--the lack of control over assets, inability to collect receivables, lax contract and grant management, warehouses bulging with unneeded inventories, and improper claim payments--many of which have been subject to congressional scrutiny and public concern for years.

Allowing long-standing internal control and accounting problems to continue reinforces a negative public perception of government and is a clear signal that financial management does not have a high priority. However, the twin monsters--massive budget deficits and the huge national debt--bring a sense of urgency to our financial management crisis.

We and others have discussed these issues before. And the discussions over time have nurtured a consensus that major financial management reform is needed. We cannot afford for the world's largest economic enterprise to be operated with a woefully inadequate financial management system. Managers should not be stuck in a morass of financial data with little relevant, timely, and comprehensive information to assist them in making decisions. Congressional authorization, appropriations, and oversight activities need not be constrained by poor quality data. In 1990, the federal government is operating with 1950s vintage accounting systems and concepts that just do not get the job done.

GOVERNMENTWIDE CHIEF FINANCIAL OFFICER

For a number of years, I have strongly advocated the establishment of a centralized leadership position to direct the government's financial management activities--a chief financial officer, or CFO. During that time, others have joined in calling for a chief financial officer. You might say that we have moved now to a chorus calling for centralized financial management leadership. That, in itself, represents progress. Chairman Conyers' draft and Representative Horton's bill each address the need for leadership by providing for a legislatively established CFO in OMB, although the organizational structures differ in the bills.

The current debate centers on the location of rather than the need for a chief financial officer. Consensus now exists for legislatively establishing a position to provide the long-term financial management leadership, which was not the case 2 years ago.

In the past, I have taken the position that the CFO should be independent and report to the President or be located within the Department of the Treasury, rather than OMB. As I testified before this Committee in September 1988,[1] my concern has been

[1]Federal Financial Management Reform (GAO/T-AFMD-88-18, September 22, 1988).

that OMB exists first and foremost to serve the President by helping define, develop, and implement the policy agenda with which he or she was elected. Other responsibilities are inherently of secondary importance and unlikely to receive long-term attention and commitment. I believed that major improvements would probably not occur if left to OMB, based on OMB's historical record in dealing with long-term management issues and the backseat the management side of OMB had typically taken relative to the budget side.

The importance of effective financial management to the financial well-being of the government necessitates a position of authority which is not weighed down by ancillary duties that divert attention from the effort needed to plan and implement the overhaul of the ailing federal financial management structure. Also, the position must have adequate resources--people and money--to carry out its duties. Otherwise, the government will find itself with a CFO in name only.

Because OMB has shown a recent willingness to tackle the challenge of financial management reform and has indicated it is serious about this, I would accept the CFO being in OMB as an alternative, subject to the following essential conditions.

1. The CFO position must be legislatively established. Otherwise, it will be left to the discretion of each succeeding administration whether to maintain or abandon the office.

2. The person selected must be qualified in terms of financial management education and practical experience. This is not going to be an easy job; therefore, personal expertise for the CFO is crucial. Both the bills deal adequately with this need.

3. The CFO must be equal in rank to the head of the budget side of OMB, have a sufficiently high organizational stature to command authority and respect throughout government, and have continuity. Chairman Conyers' and Representative Horton's proposals differ as to how the CFO would be set up. Basically, both provide for an executive level III official to carry out the CFO duties. Chairman Conyers' proposal calls for a term of office, which I believe is needed to ensure continuity.

   If the CFO is placed in OMB, I favor a three-deputy structure, all at executive level II: a deputy for budget, a deputy for management, and a CFO. This structure, which is provided for in S.2840 and is now being considered by the Senate Governmental Affairs Committee, would send a clear signal throughout government of the importance of financial management while at the same time recognizing the importance of OMB's other functions. We support strengthening OMB's entire management capacity.

4. The CFO must have adequate personnel and other resources to plan and direct the financial management improvement program. Chairman Conyers' and Representative Horton's bills each provide an Office of Federal Financial Management in OMB to assist the CFO. Concern over the adequacy of resources for financial management functions was one reason for my earlier opposition to placing the CFO in OMB. The question in my view is whether over the long-term OMB will provide this new office with adequate staff and other resources in view of the strong tendency to keep OMB's size to a minimum.

To deal with that concern, which realistically I believe will continue to be a problem at OMB, I prefer the establishment of an Office of Federal Financial Management in the Department of the Treasury. This office would provide technical assistance to the agencies, monitor agencies' activities, and assist the CFO. It would give the CFO access to additional staff resources for planning and controlling the financial management improvements, while at the same time leaving the day-to-day financial management functions in Treasury. Treasury already has lead responsibility for agency financial management systems improvements, credit management, debt collection and cash management. And the mission of Treasury's Financial Management Service is directly related to appropriate objectives for the CFO. An Office of Federal Financial Management could build on Treasury's resources currently in place.

AGENCY CHIEF FINANCIAL OFFICERS

Establishing agency CFOs is an integral part of the reform process because these individuals will form the network needed to undertake governmentwide financial management reform efforts while minimizing duplication of effort and maximizing the sharing of successes. Both Chairman Conyers' draft and Representative Horton's bill would provide for agency CFO positions, which I believe are essential.

Chairman Conyers' version provides for presidential appointment of CFOs in all 14 departments and in 13 agencies. Additionally, Deputy CFO positions would be filled by career reserved Senior Executive Service employees. Representative Horton's bill provides for Presidential appointment for the CFO positions in the 14 departments and 4 defense agencies and agency head appointment of the remaining 9 agencies' CFOs. Both bills call for qualified persons to fill the positions and are directed at continuity and top management visibility, which are key ingredients.

Another option is for the agency CFOs to hold career reserved positions in the Senior Executive Service. Placement of career civil servants in these key positions would guard against the frustrating and costly practice of revising approaches to financial management issues each time a new political officer is appointed. Political appointees generally spend 18 to 24 months on the job--a clearly insufficient tenure to guide major financial management system improvement projects. But time in office is not the only issue. It is my sense that over the years many of the appointed financial management officials may have come to the job lacking the needed financial management qualifications and experience. The combination of these two factors makes the challenge of improving financial management all the more difficult.

LONG-RANGE FINANCIAL MANAGEMENT IMPROVEMENT PLAN

Government officials did not suddenly come to the realization in 1990 that financial management improvements were needed. Improvement efforts have been ongoing in some form for years; initiatives have come and gone. The government has not succeeded, but it wasn't totally for a lack of money. In large part, the scarcity of central direction, the lack of leadership at the working level, and the absence of a clear plan have allowed chronic problems to persist.

Federal agencies have spent a lot of money over many years on ad hoc improvements that have collectively fallen far short of the mark. The government requires a vision of the financial management needs for the 1990s and beyond. This vision must be grounded in a long-range plan developed by the CFO and mirrored in corresponding agency level plans.

Both Chairman Conyers' draft and Representative Horton's bill direct the CFO to develop and maintain a 5-year governmentwide financial management plan which, among other things, would describe the current state of financial management, provide a strategy for improving agency financial systems, and identify the personnel and system requirements to achieve improvements. In the past, I have likened the 5-year plan to an architect's drawings which guide the job of building a modern financial management system and describe the finished product. The existence of a long-range plan will help government agencies share system development efforts, make greater use of cross-servicing arrangements, and provide continuity of improvement efforts.

Instituting improvements will not be free of charge. Major investments will be needed to make comprehensive financial management reform a reality. But, I believe strongly that the money invested will be returned many times over in terms of better quality information; more informed decisions; and reduced instances of fraud, waste, and abuse. The most obvious cost will be for the automated systems that support the operations of government. However, the government has spent billions of dollars in the past for ad hoc efforts that have not gotten the job done; with a CFO at the helm, guiding governmentwide system improvements, we will spend our money more wisely with a commensurate higher return on that investment.

Other equally important investments must be made in the people to direct and operate these financial management activities. The government must compete for the top college graduates and provide them a career path that is professionally and financially rewarding. Investments must be made to ensure that the employees maintain, and even increase, their professional skills to help the government keep pace with emerging technology and developments in the financial management environment.

AUDITED AGENCY LEVEL FINANCIAL STATEMENTS

Representative Horton's bill calls for the 14 executive departments and 8 major agencies to prepare financial statements and to undergo annual financial audits. Chairman Conyers' draft proposal limits financial statements and audits to agency revolving and trust funds and to those agency components which perform substantial commercial functions.

It is no secret that I strongly believe in the benefits of preparing and auditing financial statements which cover all the operations and activities of the departments and major agencies. Therefore, I support the thrust of Representative Horton's bill in this regard. Preparing and auditing financial statements should be a priority in the financial management improvement process and that it would be a mistake to narrowly limit, delay, or constrain this requirement in any way.

I recognize there are differences of opinion about when an agency should begin to prepare financial statements. Some think that agencies should first improve their systems and then begin to produce financial statements. At one time, I held this view. But experience, such as the financial disaster and recovery of New York City, has shown that just focusing on the systems is not the answer. Putting pressure on agencies to produce financial statements provides an inducement for them to improve their systems and train their staff.

Questions have also been raised about the usefulness of audited statements at the federal level. I feel very strongly that they are useful today and will become even more useful as we gain valuable experience using them at the federal level. I envision financial audit reports that will display cost trends, include financial indicators for government programs and operations, and provide the basis for future appropriation requests. We are now completing a financial audit of the Department of Veterans Affairs (VA) which exemplifies the reporting of this type of information.

Our soon-to-be issued report on the VA financial statement audit will include, for the first time, an extensive discussion and analysis of an agency's financial position and operations. For example, our analysis of VA showed that, while veterans benefit costs have stayed constant at about $15.5 billion to $16 billion a year, such benefits could increase significantly in the future due to a recent court ruling. The financial audit report will note that there are $5 billion in accrued expenses; most notably substantial future appropriations, amounting to possibly $2.5 billion, will be required to finance losses already incurred but payable during future years by the veterans housing credit assistance program. The financial audit will show that the present value of contingent liabilities for veterans compensation and pension benefits totaled about $135 billion. Further, the report will highlight that VA has serious problems collecting its receivables and has provided a reserve for doubtful accounts of $3.2 billion as of September 30, 1989. This type of information serves as an early warning to decision makers.

Financial statements do not only provide bad news. On the bright side, the financial audit shows that VA's life insurance program is in relatively good shape with adequate reserves for future benefits. Its net operating costs have remained relatively stable, rising slightly in nominal dollars, but decreasing about 5.3 percent annually over the last 4 years in 1986 constant dollars.

Financial statements that can withstand the scrutiny of an audit are the capstone of an agency's financial management improvement process. Audited financial statements can be viewed as a report card on agency financial management which points out deficient systems, helps quantify the extent of problems, and highlights what needs to be done to improve the systems. Until an agency can produce financial statements that comply with federal accounting standards, its systems will be deficient; the information derived from those systems that goes to the Congress and others will be misleading; and the government will be needlessly exposed to the risk of fraud, waste, and abuse.

Unfortunately, preparing financial statements at the federal level has not been the routine process that it should be. The financial management systems that should provide the information to prepare financial statements and, more importantly, to manage federal resources, are often unreliable and incomplete. Fundamental internal controls are missing, ineffective, or not being followed.

Our financial statement audits have disclosed account balances that are materially misleading, loans and accounts receivable that will never be collected, unreported liabilities for guarantees and insurance, and undeterminable values of other assets and liabilities. For the most part, the reported problems, which total in the tens of billions of dollars, stem from weak systems and controls.

Let me cite two recent examples. At the Department of the Air Force, as part of the first-ever financial audit of a military service, we conducted the most comprehensive review of financial management operations ever undertaken.[2] We reported critical weaknesses measured in billions of dollars in accounting for inventories and weapons systems. We identified the lack of reliable and adequate financial management systems and information to direct Air Force activities, such as inventory

---

[2] Financial Audit: Air Force Does Not Effectively Account for Billions of Dollars of Resources (GAO/AFMD-90-23, February 23, 1990).

procurement. We pointed out the negative impact of these problems on the Air Force's ability to operate in a cost-effective manner. We noted that the failure to properly account for tens of billions of dollars of resources opens the door to mismanagement, fraud, waste, and abuse.

This audit of Air Force's fiscal year 1988 financial statements resulted in 26 recommendations that covered most facets of the Air Force's financial management operations. In August 1990, the Air Force finalized a comprehensive action plan to implement our recommendations which includes both short- and long-term corrective actions. We plan to follow up on the Air Force's corrective actions to ascertain the progress and improvements made.

Also, in response to our report on the Air Force financial audit, the Department of Defense reviewed the Departments of the Army and the Navy to see if similar problems existed. Defense's review identified numerous conditions in these services that paralleled the deficiencies we reported for Air Force. While the Department of Defense has a number of comprehensive, long-range plans to deal with these and other issues on a departmentwide basis, we believe our continued emphasis on financial audits--currently ongoing at Army, with Navy to follow--will raise other issues and, equally importantly, will focus on the kinds of actions needed to bring about meaningful improvements in financial management as quickly as possible.

In this regard, we recently concluded work on our 1989 financial audit of Air Force components. As a result of that audit work, the Air Force has agreed to make adjustments totaling about $75 billion to its fiscal year 1989 Treasury reports and resubmit the reports to the Department of the Treasury.

The financial audit of the Federal Housing Administration (FHA) for fiscal year 1988 provided, for the first time, an accurate picture of the financial state of affairs of the government's largest guaranteed loan program.[3] The audit, done by an independent public accounting firm under contract to GAO, established the true magnitude of program losses for fiscal year 1988 at about $4.2 billion--nearly five times more than reported by the agency--and laid out the serious financial management problems facing the FHA. The losses alarmed the Congress which, for the first time, had reliable information on the magnitude and the seriousness of the problems facing FHA.

I see greater concern expressed by agency heads about the lack of complete, reliable, and timely financial information to manage and control their operations. In the wake of the HUD

---

[3]Financial Audit: Federal Housing Administration Fund's 1988 Financial Statements (GAO/AFMD-90-23, February 9, 1990).

scandal, Secretary Kemp has called for a financial audit of the entire Department. I also see more focus from OMB and the Congress on high risk areas throughout the government--areas ripe for mismanagement, waste, fraud, and abuse--and an ever-increasing recognition of the importance of audited financial statements.

OMB has established an initial governmentwide goal of having the 14 executive departments, the Environmental Protection Agency, and the National Air and Space Administration prepare financial statements by fiscal year 1994 and have them audited. Ten of the 16 agencies are targeted for fiscal year 1991. On September 10, 1990, the President sent to the Congress requests for fiscal year 1991 budget amendments that reallocated funds to reform the federal financial management systems. Included were amendments to permit agencies to reallocate funds for financial statement audits in fiscal year 1991.

The President's action sends an unmistakably clear message to the executive branch that the administration supports the concept of preparing and auditing financial statements. Ultimately, we would expect financial audits of all the departments and major agencies. We will work with OMB and the agencies as they begin the process of instilling greater discipline and enhanced accountability in government financial operations through annually audited financial statements.

Establishment of an advisory audit committee for each department and major agency, which is now not provided for in either Chairman Conyers' draft or Representative Horton's bill, would further strengthen this process. An audit committee, including members from outside of government, would help the agency head and the CFO in overseeing the audit plan, reviewing the selection process and criteria for any outside auditor if the agency Inspector General or GAO is not the auditor, monitoring the audit work and results, and reviewing the auditor's opinion and the audited financial statements, as well as the agency's Financial Integrity Act reports. Existence of an audit committee could improve management's receptivity to auditors' findings and reinforce the auditors' independence. The audit committee concept, while widely used in the private sector for many years, is gaining acceptance by government: a number of states, including New York and California, now have audit committees.

AGENCY HEAD ANNUAL REPORT

In addition to audited financial statements, a legislative requirement for an annual report from the agency head to the President, the Congress, and the CFO will further strengthen accountability by providing a comprehensive source of information on agency financial operations. I envision that the agency head's annual report would include the agency's financial statements and the auditor's opinion, as well as a discussion and analysis of the agency's financial position and operations. Other important information would be included, such as the auditor's reports on internal controls and on compliance with laws and regulations. In addition, it would summarize the agency's reports submitted under the Federal Managers' Financial Integrity Act and the results and status of corrective actions taken to address material internal control and accounting weaknesses.

Information in the agency head's annual report could form the basis for OMB management reviews as part of the annual budget process; help define the agenda for annual congressional hearings by the authorization, appropriations, and oversight committees; and strengthen disclosure to the public. Such annual attention and pressure on financial management issues should help correct long-standing internal control weaknesses and improve agency financial operations.

ENSURING APPROPRIATE ACCOUNTING STANDARDS

Financial statements are linked to the underlying accounting standards which govern the recording and summarizing of financial information. Accounting standards promote uniformity in recording and reporting financial activities and, thus, promote useful financial comparisons among entities. An underlying accounting principle is that like events and circumstances are to be treated similarly. This is crucial because it guards against individual managers portraying their financial situation in a more favorable light than is deserved.

Legislation enacted by the Congress in 1950 made GAO legally responsible for establishing federal accounting standards since 1950. During the ensuing 40 years, we have been mindful of the need to ensure that the standards keep pace with developments in the accounting profession as well as changes in the governmental environment. We are now taking additional steps to fulfill those objectives.

We have reached tentative agreement with the Director of the Office of Management and Budget and the Secretary of the Treasury to establish a Federal Government Accounting Standards Advisory Board which will be a fundamental element of a revised standard-setting process. The board, which we are hopeful will be operating in the near future, will include representatives from GAO, OMB, Treasury, the Congressional Budget Office, a defense agency, and a civilian agency, and three nonfederal members. The new process will formalize our efforts to obtain comments on proposed accounting standards from interested and affected parties. And, it will increase the openness of the process and facilitate coordination among the Comptroller General, the Director of OMB, and Secretary of the Treasury.

These steps will help ensure the relevance and the acceptance of accounting standards for the federal government and will improve the financial reporting on governmental activities. We will periodically advise the Congress about our work involving accounting standards.

SUMMARY

Mr. Chairman, I appreciate the leadership and support provided by you and Representative Horton in seeking legislative remedies to restore confidence and credibility in federal financial management.

Overall, I favor the legislation introduced in the Senate, S.2840, which I believe best addresses the critical elements for reform. From an organizational standpoint, the governmentwide CFO can provide the overall leadership needed to develop and implement a comprehensive, governmentwide financial management improvement plan. The agency CFOs can centralize financial management authority and responsibilities at a senior level within agencies so that financial systems, practices, and reporting can be orchestrated to best meet the agencies' needs.

Legislatively mandating the annual preparation and audit of agency financial statements for all executive departments and major agencies will help ensure that the financial systems are working, the government's assets are safeguarded, and reliable information is being provided to program managers. It will do so by focusing a high level of agency attention on improving systems and controls to produce reliable financial statements. Finally, requiring annual agency head reports should provide a foundation for the recognition of financial management problems and oversight.

The government must be willing to make systems and personnel investments or face collapse of the government's financial management structure. We must change the way people look at financial management and finally deal with problems that have plagued the federal government for years. CFO legislation, which includes the elements I have outlined today, is crucial to meaningful reform, and I urge its passage.

- - - - -

Mr. Chairman, this concludes my formal statement. I will be pleased to answer any questions that you or other members of the Committee may have.