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MANAGING FOR RESULTS

Strengthening Financial and
Budgetary Reporting

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss an issue that the Comptroller General has viewed as extremely important throughout his tenure--ensuring more timely, reliable, useful, and consistent information for managing and assessing the government's finances. GAO has been actively urging improvements in this area for over 20 years. Achieving such improvements is essential to enable more informed decision-making and oversight by congressional and executive branch policymakers and to enhance efforts to better inform the American public of its government's financial operations.

Fortunately, in the last 5 years, progress is beginning to be made toward these goals. This progress, in part, has been stimulated by the passage of the Chief Financial Officers (CFO) Act of 1990 and the creation of the Federal Accounting Standards Advisory Board (FASAB), as well as by efforts to strengthen the budget process. During this period, many professionals involved in budgeting, accounting, and management reporting have devoted much thought and effort to developing a vision for more effective and understandable financial management reporting for the federal government.

Today I will talk about what kinds of information and reports this vision entails to help policymakers to make well-informed decisions and provide effective oversight. Recognizing that the budget is the primary framework for making most decisions about the use of federal resources, I will also address how financial information and audited financial statements can better contribute to the budgetary debate as well as provide the foundation for ensuring accountability for achieving results and adequate stewardship over federal resources and assets. Finally, I want to discuss the status of efforts to inform the American taxpayer of the government's financial condition.

THE IMPORTANCE OF RELIABLE
INFORMATION ON FEDERAL
FINANCIAL CONDITION AND
COMMITMENTS

The nation is faced with fiscal pressures which will continue to occupy the center of public debate for years to come. We recently simulated the long-term outlook of current budgetary policies for Chairmen Kasich and Domenici.¹ Current trends are unsustainable over the longer term and would lead to deficits exceeding 20 percent of gross domestic product by 2025, due largely to the pressures an aging population will place on social security and health care programs as well as mounting interest costs to finance the debt. Congressional action to move to a balanced budget clearly will help address these concerns.

¹The Deficit and the Economy: An Update of Long-Term Simulations (GAO/AIMD/OCE-95-119, April 26, 1995).

Difficult resource allocation decisions are facing the nation in order to implement and sustain a new fiscal policy path. These decisions require good budgetary and financial information that fully discloses the current financial condition of programs and the stakes flowing from budgetary choices--both present and future. Moreover, public demands are high for the government to accurately account for the effective use of a dwindling pool of resources and to provide services cost efficiently.

The federal government's budget process as well as its financial reporting and management systems should be expected to collectively provide the information necessary to address difficult issues. The budget should provide sufficient information to permit decisionmakers to (1) effectively allocate scarce resources among competing programs, (2) formulate fiscal policy addressing macroeconomic goals, and (3) communicate budgetary priorities and program performance data to the public. The budget is a forward-looking plan that should help the nation assess the implications of choices; it should be formulated using accurate and reliable financial data on actual spending and program performance.

Financial statements and reports should also provide reliable and relevant information. In addition to ensuring basic accountability for the proper use of budgetary resources, we should expect such reports to address (1) the full costs of achieving program results, (2) the value of what the government owns and what it owes to others, (3) the government's ability to satisfy future commitments if current policies were continued, and (4) government's ability to detect and correct problems in its financial systems and controls.

FINANCIAL REPORTING AND MANAGEMENT: A WORK IN PROGRESS

I wish I could report to you today that current budgetary and financial reporting give us all the tools we need to address these critical questions. But I cannot. Financial accounting information in particular has not been reliable enough to use in federal decision-making or to provide the requisite public accountability for the use of taxpayers' money. Also, good information on the full costs of federal operations is frequently absent or extremely difficult to reconstruct. In addition, complete, useful financial reporting is not yet in place.

Significant problems have been revealed in agencies' financial management and accountability systems. For example, financial statement audits have identified hundreds of billions of dollars in accounting errors, mistakes and omissions that can render information provided to the Congress and managers virtually useless. Audits also have identified fraudulent payments and ghost employees at the Department of Defense as well as duplicate payments made to contractors. Moreover, audits are beginning to shed more light on the government's financial condition, including substantial problems of uncollected revenues and tens of billions of dollars of unrecognized liabilities and potential losses not previously fully disclosed.

However, I can report that financial reporting and information is a work in progress and that tools are now being put in place that promise to get the federal government's financial house in order. First, beginning for fiscal year 1996, all major agencies, covering about 99 percent of the government's outlays, are required to prepare annual financial statements and have them audited. Second, an audited governmentwide financial statement is required to be produced starting for fiscal year 1997. Since 1976, the Department of the Treasury has annually published "prototype" consolidated financial statements of the federal government. These statements, however, have not been auditable since they are based on agency accounting systems which audits have shown to have serious weaknesses that limit their ability to produce accurate financial data. Third, FASAB is recommending new federal accounting standards that will yield more useful and relevant financial statements and information.

In 1990, the CFO Act first required annual financial statement audits for a select group of agencies on a pilot basis, with their continuation subject to evaluations of their cost and benefits. Such audits highlighted problems of uncollected revenues and billions of dollars of unrecognized liabilities and potential losses from such programs as housing loans, veterans compensation and pension benefits, and hazardous waste cleanup. In our view, the audits bring important discipline to agencies' financial management and control systems. Thanks to the benefits achieved from these pilot audits, the Congress extended this requirement, in the 1994 Government Management and Reform Act, to all major agencies.

In the same act, the Congress also mandated a consolidated set of governmentwide financial statements--to be audited by GAO--for fiscal year 1997. These types of statements will provide an overview of the government's overall costs of operations. It will also provide information on the government's assets and contribution to long-term economic growth. The report's data on liabilities and potential future costs of current policies will give policymakers and the public valuable information to assess the sustainability of federal commitments.

Financial accounting standards currently being developed by FASAB will help ensure that these financial statements address issues in terms that are relevant to the federal environment. As you know, FASAB was established in 1990 to develop and recommend accounting principles for the federal government. The standards FASAB is now recommending will provide a sound foundation for federal financial statements that are relevant to both the budget allocation process as well as agencies' accountability for resources. FASAB's extensive consultations with users and potential users of financial statements showed that they were interested in getting answers to questions on such topics as:

- Budgetary integrity: What legal authority was provided to finance government activities and was it used correctly?
- Operating performance: How much do various programs cost and how were they financed? What was achieved for this spending? What are the government's assets and are they being effectively maintained and used? What are the government's liabilities and how will they be paid for?

- Stewardship: Has the government's overall financial capacity to satisfy current and future needs and costs improved or deteriorated? What are its future commitments and are they being provided for? How will the government's programs affect the future growth potential of the economy?
- Systems and control: Does the government have cost effective systems and controls over its programs and assets? Can it detect and correct problems?

These recent initiatives promise to improve financial controls and information in the federal government. However, they will require agencies to change the way they do business in the financial management arena. Their successful implementation will depend on support both from agency leadership and management as well as the Congress itself. We have been pleased by the support the Congress in general and this Subcommittee in particular have provided for these initiatives and hope to continue working with you on these important issues.

STRENGTHENING BUDGETING THROUGH USE OF FINANCIAL DATA

As financial information improves, it also will enable greater integration of financial accounting information and budgeting to better assist policymakers in sorting out claims and allocating resources. Budget decisions are strongly influenced by the type of information reported and the way choices are framed. We have consistently maintained that budgeting can be enhanced by more integrated consideration of financial data. However, such integration is highly dependent on improving the accessibility of financial information to budget decisionmakers. FASAB, in recommending accounting standards, has attempted to bridge the existing gaps by adopting budgetary approaches to the extent consistent with accrual accounting concepts appropriate for measuring operating performance and reporting on stewardship.

The areas of the budget where the prospects for integration appear most promising include (1) the selective use of accrual concepts to record budget authority and outlays, (2) the use of financial information on liabilities and long-term commitments to help address the sustainability of current budget policies, and (3) consideration of managerial cost accounting concepts in budget accounts to permit decisionmakers to consider more easily the full costs associated with program outputs or outcomes to be reported in financial statements.

WHEN SHOULD ACCRUED COSTS BE USED AS THE BASIS FOR BUDGETARY ALLOCATIONS?

The method of reporting budgetary transactions influences decision-making. Therefore, choices about the basis of budgetary reporting ultimately represent trade-offs among the

purposes of the budget. Cash and accrual represent two alternative measurement bases for budgetary reporting. Cash reporting recognizes transactions when cash is paid or received. Accrual-based reporting, used in financial statements, recognizes transactions or events when they occur regardless of when cash flows occur.

The current federal budget, with limited exceptions, is reported on a cash and obligation basis. Cash-based budgeting focuses on control over current spending and the assessment of the short-term economic impact of fiscal policy. Cash is advantageous as a method of control because it can be easily measured and tracked. Because of its simplicity, it is readily understandable by policymakers and the public. Cash-based budgeting also reflects the current borrowing needs of the federal government. For most federal programs, cash provides adequate information on and control over the government spending commitments. For example, for activities such as salaries or grant payments, costs recorded on a cash basis do not differ appreciably from accrual-based costs.

However, GAO and others have reported that for a select number of programs, cash-based budgeting does not adequately reflect the future costs of the government's commitments or provide appropriate signals on emerging problems. As a general matter, accrual-based reporting may improve budgetary decision-making in cases where the cash consequences of current decisions are not realized in the budget year but become evident in future years. In these cases, the accrual approach records the full cost to the government of a decision--whether to be paid now or in the future. As a result, it prompts decisionmakers to recognize the cost consequences of commitments made today. Financial statements based on FASAB standards will include accrual-based information for these kinds of programs.

Beginning in fiscal year 1992, accrual budgeting principles were applied to loans and loan guarantee programs with the implementation of credit reform. This recognized that the cash basis gave decisionmakers misleading signals on the cost comparisons among grants, loan guarantees, and direct loans. Other areas in the federal budget could potentially benefit from the accrual approach.

The Savings and Loan crisis of the 1980s illustrates an area where cash-based budget reporting was misleading. During the 1980's, as hundreds of thrifts failed, the cash-based budgetary system did not signal the Administration and the Congress of the deteriorating financial position and federal budgetary cost commitments associated with the nation's deposit insurance system until cash was actually paid out to depositors. The cash basis reporting in this case was a lagging indicator of trouble that failed to signal budget decisionmakers in time to avert or limit the damage.

Concerns that cash-based budgeting can be misleading for some programs led to proposals to extend the use of accrual budgeting to federal insurance programs. In the fiscal year 1993 budget, the Office of Management and Budget (OMB) proposed using a credit reform approach to budgeting for these programs. We are currently studying the use of accrual budgeting for federal insurance programs. Our work to date has revealed shortcomings with

the cash approach to budgeting for these programs, but also highlighted difficulties in estimating future costs for some of them due to the lack of adequate data or to sensitivity to the assumptions used to model future costs.

For example, for the Pension Benefit Guaranty Corporation (PBGC), the current cash-based budget estimates that collections will exceed outlays by about \$1.1 billion for fiscal year 1996. Analysts agree that this is not an accurate indicator of the financial condition of this program, but they disagree on how to measure the federal commitment. OMB has proposed recognizing future obligations for pension insurance at the point the government extends the commitment, using a probabilistic estimate involving long-term projections of bankruptcies of covered firms and the funding status of their pension plans. OMB's most recent estimate of PBGC's obligations, as shown in the Analytical Perspectives of the President's fiscal year 1996 budget, ranges from \$20 billion to \$40 billion. Financial statements, on the other hand, recognize future obligations based on terminated plans and those plans that are reasonably probable to terminate. On this basis, PBGC's 1994 financial statements, the most recent, reported the present value of future benefits as just over \$9 billion for these plans.²

Furthermore, future cost estimates may be subject to significant annual fluctuations. Estimates of PBGC's future cost for pension benefits decreased significantly in the last year. OMB's current estimate represents a downward revision of \$40 billion to \$50 billion from its fiscal year 1995 estimate. PBGC's September 30, 1994 financial statements also reported a downward adjustment of \$1.5 billion from its September 30, 1993 statements. Under an accrual method, these types of estimation fluctuations would have to be reflected in the budget through a reestimation process, which may raise more problems.

In light of these reestimation problems, substantial questions are raised about the practicality of an accrual budget approach for some of these programs. The challenge involves weighing the potential distortions arising from the cash-based approach with the risks and uncertainties involved in estimating longer-term accrued costs for some programs. In areas where accrual information is not considered reliable enough to be directly incorporated into the budget, such information could nevertheless be used as a supplement to the budget. Our upcoming report on budgeting for insurance will address these issues.

HOW CAN OTHER POTENTIAL FUTURE COSTS AND CLAIMS BE CONSIDERED IN BUDGETING?

There are a number of programs that under current policy could result in large future government payments but whose costs are appropriately not booked in the budget as budget

²FASAB's recommended standards will continue this method of reporting a liability and will also require disclosure of the probabilistic estimate if it differs from reported liability.

authority and outlays. The future costs of Social Security and Medicare are examples of claims or costs that will encumber future budgets for years to come. Decisionmakers need to consider these potential future costs in their current decisions but also need a framework to sort out the claims based on the strength of the underlying commitment and the reliability of the accompanying estimates.

Although cash may be a misleading indicator of the long-term costs for some of these programs, the long-term costs are typically too uncertain to be booked directly into the budget. Accrual-based cost estimates for them are sensitive to yearly changes in economic and demographic assumptions which can lead to large differences in the present value number used to book future costs. Moreover, the nature of the federal commitment for these kinds of payments generally represents an expectation for the continuation of current programs or benefits. The Congress is not legally bound to continue such commitments. As we have seen this year, government commitments can change.

Policymakers, nevertheless, need to be aware of these costs through understandable supplemental financial data that projects future costs under a range of different assumptions or scenarios. Such information enables early action to be taken to contain or reduce these costs before problems reach crisis proportions.

For example, some programs, such as Social Security and Medicare, pose very large potential future claims on resources. Because of the size and nature of these programs, understanding their financial condition is important to understanding the financial condition of the government as a whole. However, uncertainty surrounds long-range estimates. For example, the present value of Social Security's 75-year estimate of its actuarial deficit increased by about \$1 trillion between fiscal years 1993 and 1994. Nevertheless, decisionmakers need to be aware of this huge deficit--\$2.8 trillion as of September 30, 1994--which is looming on the horizon unless actions are taken to address it.

It is crucial for decisionmakers to take claims on future resources into account when budgeting, but the strength of the underlying claim must also be considered. The strength of claims on future resources is really a continuum ranging from very firm, as in the case of actual liabilities like the public debt, to less firm, as in the case of commitments to make payments like social insurance, and finally to the mere expectation that current policies will be continued, such as continued support for education.

There are even claims for future spending that are less firm than the expectation that current spending programs would be continued. These claims could be thought of as unmet needs--spending on needs that have not been addressed in current programs. Examples of estimates for such funding are as much as \$425 billion for maintenance and improvements to highway infrastructure and about \$130 billion for water treatment facilities to meet environmental standards. In considering these future claims, one must be careful because unmet needs, which create pressures for spending, are in no sense existing claims on the government. Any

effort to compile a list of future claims needs to discriminate among the various strengths of the claims to present a balanced picture of the future for decisionmakers.

Financial reports based on FASAB's recommended standards will provide valuable information to help sort out these various kinds of long-term claims. The recommended standards envision new reports on a broad range of liabilities and liability-like commitments and assets and asset-like spending. Liabilities, such as the federal debt, would be reported on a balance sheet, along with assets owned by federal agencies, like buildings.

Stewardship reporting will be provided on potential future claims that, although not traditional liabilities, represent the government's role in making future social insurance payments. Although these claims are not firm enough to warrant recognition as liabilities on balance sheets, FASAB, in developing standards for reporting on the claims, recognized the unique expectations placed on government for the delivery of services and benefits deemed to be important to the public. Social Security and Medicare are viewed by many people as having characteristics of long-term unfunded liabilities because of their "contributory" nature. Others view these programs as "pay-as-you-go" entitlements similar to those financed by general revenues, with a liability for only the amounts that are currently payable. There are strongly held views on both sides of the question. The majority view among FASAB members is that no long-term unfunded liability exists although there is a public perception of an enduring commitment and support for liability treatment. FASAB is exposing for public comment an accounting standard that would call for reporting amounts due and payable at year end as a liability and for full disclosure of several different estimates for various populations and time periods of these programs. FASAB believes this is the most feasible way to deal with the issue.

To give a picture of the government's capacity to sustain current public services, stewardship reporting will also include 6-year projections of receipt and outlay data for all programs based on data submitted for the President's budget. As I noted earlier, GAO's own simulations of current budget policies over the longer term helped policymakers understand the sustainability of current policies.

Information in new financial reports on assets owned by the federal government as well as federal investments intended to have future benefits for the nation can also provide a valuable perspective for budgeting. Stewardship reporting would cover federal investments and some performance information for programs intended to improve the nation's infrastructure, research and development, and human capital due to their potential contribution to the long-term productive capacity of the economy. These kinds of activities would not be reflected on the balance sheet because they are not assets owned by the federal government but rather programs and subsidies provided to state and local governments and the private sector for broader public purposes. Stewardship reporting recognizes that, although these investments lack the traditional attributes of assets, such programs warrant special analysis due to their potential impact on the nation's long-term future.

HOW CAN BUDGET DECISION-MAKING
BE STRUCTURED TO CONSIDER
MANAGERIAL COST CONCEPTS?

The way budget and financial accounts are organized also influences decision-making. Currently different account structures are used for budget and financial reporting. This makes using these reports together difficult and may prevent decisionmakers from benefiting from all available information.

We are currently finishing a study of the budget account structure for Senators Domenici, Roth, and Hatfield. The report describes the budget's current account structure, which is reflective of the multiple uses of the budget. Because the current account structure evolved over time in response to specific needs, it is both varied and complex. For example, some accounts are organized by object of expenditure while others are more closely aligned with programs. Accounts also vary in the coverage of costs. Some accounts include both program and operating spending for programs or activities while in other instances, separate accounts are used. Or, a given account may include multiple programs and activities.

FASAB's recent work has emphasized the need to consider the full cost of programs and outputs when making budget and management decisions. FASAB's recommended standards call for the collection of costs by responsibility segment, a component of an agency that is responsible for carrying out a mission or producing products or services. The standards require responsibility segments to capture the "full cost" defined as the costs of all resources used (indirectly or directly) and the cost of support services provided by others, net of any income earned as a result of the program's operations. Financial statements prepared on this basis will then show further breakdowns of cost by the various programs carried out by the responsibility segments. This emphasis on full cost will be crucial because it, rather than cash outlays, is the appropriate cost measure to use with performance measures when evaluating the cost and benefits of a program.

The information provided by these new standards will be useful in budgetary decision-making. Since this type of cost information is not currently clearly reported in the budget, financial statement reporting of it would provide decisionmakers a more complete picture of program costs. And because the budget account structure is generally not aligned with the responsibility segment concepts that will underlie financial reporting, additional analysis or crosswalks would be needed to enable decisionmakers to consider this information in allocating resources. In addition, if the account structure is re-examined in light of various cross-cutting initiatives like those in the Government Performance and Results Act, the question of whether to try to achieve a better congruence between budget accounts and the accounting system structure should be considered.

WHAT OPTIONS COULD PROMPT CONSIDERATION OF THE LONG-TERM FINANCIAL OUTLOOK?

The new financial reports based on FASAB's recommended standards will provide much-needed additional perspective on the long-term prospects for government programs and finances. This information can be used in conjunction with other kinds of actuarial and economic analyses already available. Although most budget decisions are made annually, they carry long-term consequences and potentially encumber future generations' resources. Periodically, the implicit long-term fiscal consequences can be made more explicit, thereby providing today's decisionmakers with tools to alter this course.

Several approaches could be considered to prompt decisionmakers to use this information when making resource allocation decisions. One approach would be to think of the budget and financial statements as a single package of financial reports. Ideally, they could be provided to decisionmakers at the same time. This would require that audited financial statements be completed earlier and that a formal mechanism be developed to ensure their joint distribution. Although this may seem a trivial issue, I cannot overemphasize the need to stress that the two types of reports are two parts of one whole. This would be most apparent if they are provided together. Even if the most recently audited financial statements are not available when the President's budget is submitted, a financial report showing the trends in financial statements over a period of time could benefit policymakers.

Other mechanisms could be considered to prompt consideration of financial information on the long-term consequences of choices in the budget. For example, long-term simulations of current budget policies, perhaps over a 30-year period, could be prepared periodically to help assess the future consequences of current decisions. The effects of policy changes as well as broader fiscal policy alternatives could be projected over the long term as well. Such projections could be prepared and presented in the President's budget document as well as in congressional budget documents.

The President's budget as well as congressional budget resolutions might also explicitly discuss how budget proposals would address long-term issues disclosed both by these projections and other financial information. At the very least, such a discussion could encourage a public dialogue focussed on the long-term outlook and might engender pressures for programmatic reform and fiscal changes.

HOW CAN WE COMMUNICATE THE ESSENTIALS TO THE PUBLIC?

The public will benefit from these changes in financial and budgetary reporting and management. Improved accountability for tax dollars and more informed decisions mindful of total costs may help raise the confidence of the public in the federal government.

The public can also benefit from a reporting mechanism that regularly provides them with information about how their federal taxes are spent and managed. To date, this information is provided as part of the tax forms, in special reports prepared by interest groups and the media, and most extensively, in the President's annual budget. Although the budget contains information on how taxes have been spent and estimates on how future taxes may be spent, it is not intended for the average citizen's use. OMB formerly published a Budget In Brief that was more accessible than the full budget document, but it was discontinued years ago. For fiscal year 1996, OMB once again included a citizen-oriented document as part of the budget documents. A Citizen's Guide to the Federal Budget, Fiscal Year 1996 provided an overview of the budget, highlighting such concepts as the deficit and the debt, and reviewing the President's 1996 proposals. It did not, however, provide much insight on the long-term implications of current spending policies.

The public needs a report that is easy to understand, concisely presented, and able to capture and focus its attention on critical issues. The information contained in such a report should be clear and understandable to the average person. Another essential element of the report would be an explanation of how the government has performed during the past year, including a statement on whether the government and its citizens are better off than they were last year. It also would be important for such a report to include some perspective on the long-term implications of current budget policies and provide a commentary on the relationship between federal fiscal policies and priorities and the future economic well-being of the nation.

While there is general agreement that such a report is needed, there has been no consensus to date on how best to inform the public. Based on a National Performance Review recommendation, the Department of the Treasury is developing a Financial Report to the Citizens which has as its goal the understandable presentation of basic financial data. In the future, when consolidated governmentwide financial statements are being produced and audited, excerpts from those statements could form the basis of such a report to the citizens. This would have the advantage of basing the report on data that have been audited.

CONCLUSION

Improved financial systems and reports are essential to improving the government's ability to provide accountability for public resources. Continuing fiscal pressures will place a premium on the proper stewardship of increasingly scarce public resources. Recent efforts to improve federal financial reporting will, if properly implemented, provide the tools needed to redress long-standing weaknesses.

Improved financial reports and data should also better help policymakers sort out competing claims in the budget process. Improved financial data on the current and future stakes

involved in our decisions may help policymakers make decisions focused more on the long-term consequences. The public also stands to gain from these initiatives, both from improved accountability for public resources and more informed decisions.

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