FISCAL YEAR 2003
U.S. GOVERNMENT
FINANCIAL
STATEMENTS

Sustained Improvement in Federal Financial Management Is Crucial to Addressing Our Nation’s Future Fiscal Challenges

Statement of David M. Walker
Comptroller General of the United States
FISCAL YEAR 2003 U.S. GOVERNMENT FINANCIAL STATEMENTS

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What GAO Found

As in the 6 previous fiscal years, certain material weaknesses in internal control and in selected accounting and reporting practices resulted in conditions that continued to prevent GAO from being able to provide the Congress and American citizens an opinion as to whether the consolidated financial statements of the U.S. government are fairly stated in conformity with U.S. generally accepted accounting principles. Three major impediments to an opinion on the consolidated financial statements continue to be (1) serious financial management problems at DOD, (2) the federal government’s inability to fully account for and reconcile transactions between federal government entities, and (3) the federal government’s ineffective process for preparing the consolidated financial statements.

For fiscal year 2003, 20 of 23 Chief Financial Officers (CFO) Act agencies received unqualified opinions, the same number received by these agencies in fiscal year 2002, up from 6 for fiscal year 1996. However, only 3 of the CFO Act agencies had neither a material weakness in internal control, an issue involving compliance with applicable laws and regulations, nor an instance of lack of substantial compliance with Federal Financial Management Improvement Act requirements.

The requirement for timely, accurate, and useful financial and performance information is greater than ever as our nation faces major long-term fiscal challenges that will require tough choices in setting priorities and linking resources to results. Given the nation’s large and growing long-term fiscal imbalance, which is driven largely by known demographic trends and health care costs, coupled with new homeland security and defense commitments, the status quo is unsustainable. Current financial reporting does not clearly and transparently show the wide range of responsibilities, programs, and activities that may either obligate the federal government to future spending or create an expectation for such spending and provides an unrealistic and even misleading picture of the federal government’s overall performance and financial condition. In addition, too many significant federal government commitments and obligations, such as Social Security and Medicare, are not adequately addressed in the federal government’s financial statements and budget process, and current federal financial reporting standards do not require such disclosure.

A top-to-bottom review of government activities to ensure their relevance and fit for the 21st century and their relative priority is long overdue. The federal government needs a three-pronged approach to (1) restructure existing entitlement programs, (2) reexamine the base of discretionary and other spending, and (3) review and revise the federal government’s tax policy and enforcement programs. New accounting and reporting approaches, budget control mechanisms, and metrics are needed for considering and measuring the impact of spending and tax policies and decisions over the long term.
Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our report on the U.S. government’s consolidated financial statements for fiscal years 2003 and 2002.¹ Both the consolidated financial statements and our report are included in the fiscal year 2003 Financial Report of the United States Government, which was issued by the Department of the Treasury (Treasury) on February 27, 2004, and is available through GAO’s Internet site, at www.gao.gov, and Treasury’s Internet site, at www.fms.treas.gov/fr/index.html.

As in the 6 previous fiscal years, certain material weaknesses² in internal control and in selected accounting and reporting practices resulted in conditions that continued to prevent us from being able to provide the Congress and American citizens an opinion as to whether the consolidated financial statements of the U.S. government are fairly stated in conformity with U.S. generally accepted accounting principles (GAAP). Until the problems discussed in our report are adequately addressed, they will continue to (1) hamper the federal government’s ability to accurately report a significant portion of its assets, liabilities, and costs; (2) affect the federal government’s ability to accurately measure the full cost as well as the financial and nonfinancial performance of certain programs while effectively managing related operations; and (3) significantly impair the federal government’s ability to adequately safeguard certain significant assets and properly record various transactions.

While the federal government has not yet been able to prepare auditable financial statements, the requirement to do so at the consolidated level as well as at the agency level has already yielded important results. We see continuous movement toward the ultimate goals of annual accountability


²A material weakness is a condition that precludes the entity’s internal control from providing reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis.
and, more importantly, of development of the day-to-day financial information that the federal government will need to best address today’s budgetary challenges and the looming longer-term fiscal imbalance driven by demographic trends, rising health care costs, and new homeland security and defense commitments. Across government, financial management improvement initiatives are under way that, if effectively implemented, have the potential to appreciably improve the quality of the federal government’s financial management and reporting. Federal agencies continue to make progress in their efforts to modernize their financial management systems and improve financial management performance as called for in the President’s Management Agenda.\(^3\)

The Principals of the Joint Financial Management Improvement Program (JFMIP)\(^4\) agreed with the Office of Management and Budget’s (OMB) initiative to accelerate the agency financial statements reporting date to November 15 for fiscal year 2004. For fiscal year 2003, OMB required the Chief Financial Officers (CFO) Act agencies\(^5\) to deliver their Performance and Accountability Reports, including their audited financial statements, to OMB by January 30, 2004. However, to prepare for meeting the required November 15 accelerated reporting date for fiscal year 2004, OMB encouraged the CFO Act agencies to accelerate the issuance of their fiscal year 2003 audited financial statements to November 15, 2003, or as close to that date as possible. OMB reported that 8 CFO Act agencies—the Department of Education, the Environmental Protection Agency, the Department of Health and Human Services, the National Science Foundation, the Social Security Administration, the Department of the

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\(^3\)The President’s Management Agenda is the Bush administration’s strategy for improving the management and performance of the federal government. Its purpose is to identify and address the most significant problems facing the federal government. It contains five government-wide and nine agency-specific goals to improve federal management and deliver results to the American people.

\(^4\)JFMIP is a joint and cooperative undertaking of the Department of the Treasury, GAO, the Office of Management and Budget (OMB), and the Office of Personnel Management working in cooperation with each other and other federal agencies to improve financial management practices in the federal government. Leadership and program guidance are provided by the four Principals of the JFMIP—the Comptroller General of the United States, the Secretary of the Treasury, and the Directors of OMB and the Office of Personnel Management.

\(^5\)31 U.S.C. § 901(b). One of the 24 CFO Act agencies, the Federal Emergency Management Agency, was transferred to the new Department of Homeland Security effective March 1, 2003. With this transfer, the Federal Emergency Management Agency will no longer be required to prepare and have audited stand-alone financial statements under the CFO Act, leaving 23 CFO Act agencies.
Treasury, the Agency for International Development, and the Department of Veterans Affairs—were able to issue their fiscal year 2003 financial statements with unqualified audit opinions by mid-November 2003. Another 10 CFO Act agencies issued their financial statements by December 31, 2003, and the remaining 5 CFO Act agencies issued by the end of January 2004. A 24th major agency, the Department of Homeland Security (DHS),\(^6\) issued its financial statements on February 13, 2004. DHS faced a herculean challenge with respect to issuing audited financial statements, since the department had been in operation only for the last 7 months of the fiscal year and involved a transfer of operations from a number of diverse entities, some with known financial management problems.

While these results represent a significant improvement over previous years in the timeliness of CFO Act agencies’ issuance of audited financial statements, they also demonstrate the significant challenges that the federal government will face in meeting the November 15 accelerated reporting date for fiscal year 2004. Auditors at several of the CFO Act agencies reported that the agencies may not be able to produce auditable financial statements within the accelerated time frame for fiscal year 2004 without making fundamental changes to improve a number of their financial management practices. For example, certain federal agency auditors reported that major improvements are needed in (1) management controls to monitor established policies and procedures for conducting financial analyses and reconciliations throughout the year, (2) fully integrating financial management systems, and (3) providing adequate and skilled staff to support efficient, effective preparation of federal agency consolidated financial statements. Our experience as the auditor of the financial statements of the Internal Revenue Service, which successfully accelerated its reporting to November 15 beginning with its fiscal year 2002 financial statements, showed that significant changes had to be made to improve routine financial management procedures in order to be able to accelerate reporting.

\(^6\)DHS is not a CFO Act agency and is therefore not subject to CFO Act requirements. However, along with most other executive branch agencies not covered by the CFO Act, DHS is required to prepare and have audited financial statements under the Accountability of Tax Dollars Act of 2002, Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002). For fiscal year 2003, the act provided that OMB could grant executive branch agencies’ requests for waivers from having audited financial statements for fiscal year 2003. However, DHS and certain other agencies chose to prepare and have their fiscal year 2003 financial statements audited.
For fiscal year 2003, as in fiscal year 2002, 20 of 23 CFO Act agencies were able to attain unqualified audit opinions on their financial statements (see table 1 and app. I), up from 6 agencies for fiscal year 1996. This is the same number of unqualified opinions received by these CFO Act agencies for fiscal year 2002. However, 2 agencies’ fiscal year 2003 opinions were different from those they received for fiscal year 2002. The Agency for International Development received an unqualified opinion on all of its fiscal year 2003 financial statements for the first time, while the National Aeronautics and Space Administration (NASA), which for fiscal year 2002 received an unqualified opinion on its financial statements, received a disclaimer of opinion for fiscal year 2003. DHS, which as I mentioned before prepared consolidated financial statements for fiscal year 2003 covering its first 7 months of operations, received a qualified opinion on two of the six required financial statements.8

In identifying improved financial performance as one of its five governmentwide initiatives, the President’s Management Agenda recognized that a clean (unqualified) financial audit opinion is a basic prescription for any well-managed organization. At the same time, it recognized that “most federal agencies that obtain clean audits only do so after making extraordinary, labor-intensive assaults on financial records” at or after year-end. The President’s Management Agenda further recognized that without sound internal control and accurate and timely financial information, it is not possible to accomplish the agenda and secure the best performance and highest measure of accountability for the American people. The JFMIP Principals have defined certain measures, in addition to receiving an unqualified financial statement opinion, for achieving financial

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7 At least 4 CFO Act agencies restated certain of their audited fiscal year 2002 financial statements to correct misstatements in such financial statements. All 4 of the agencies had received unqualified opinions on their fiscal year 2002 financial statements. These restatements were not material to the consolidated financial statements.

8DHS began operations as an agency 5 months after the start of the fiscal year, on March 1, 2003. Transfers of funds, assets, liabilities, and obligations from 22 existing federal agencies to DHS began on March 1, 2003. DHS’s auditors issued a qualified opinion on the consolidated balance sheet and statement of custodial activity as of September 30, 2003, and disclaimed on the consolidated statement of net cost, consolidated statement of changes in net position, combined statement of budgetary resources, and consolidated statement of financing for the 7 months ended September 30, 2003. In accordance with Federal Accounting Standards Advisory Board Technical Bulletin 2003-1, Certain Questions and Answers Related to the Homeland Security Act of 2002, the fiscal year 2003 activities that occurred prior to the transfer of operations to DHS were to be reflected in the transferring agencies’ financial statements.
management success. These additional measures include being able to routinely provide timely, accurate, and useful financial and performance information and having no material internal control weaknesses or material noncompliance with laws and regulations and the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).\(^9\) As shown in table 1, while the severity and magnitude of the problems identified vary greatly, reports of inspectors general and their contract auditors indicated that for fiscal year 2003 only 3 of the 23 CFO Act agencies had neither a material weakness in internal control, an issue involving compliance with applicable laws and regulations, nor an instance of lack of substantial compliance with the requirements of FFMIA.

<table>
<thead>
<tr>
<th>Agencies with unqualified opinions</th>
<th>Agencies with unqualified opinions and no material weaknesses or noncompliances</th>
</tr>
</thead>
<tbody>
<tr>
<td>20(^a)</td>
<td>3(^b)</td>
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Source: GAO.


\(^b\)Energy, National Science Foundation, and Social Security Administration.

In this testimony, I will highlight the major issues relating to the consolidated financial statements for fiscal years 2003 and 2002, discuss systems problems that continue to hinder federal agency accountability, and describe progress that has been made toward addressing major impediments to an opinion on the consolidated financial statements. I will also discuss why sound financial management today and in the future is critical to meeting tomorrow’s fiscal needs and the need for “truth and transparency” in connection with our nation’s financial condition and fiscal outlook.

As I mentioned earlier, as has been the case for the previous 6 fiscal years, the federal government continues to have a significant number of material weaknesses related to financial systems, fundamental recordkeeping and financial reporting, and incomplete documentation. Several of these material weaknesses (referred to hereafter as material deficiencies) resulted in conditions that continued to prevent us from forming and expressing an opinion on the U.S. government’s consolidated financial statements for the fiscal years ended September 30, 2003 and 2002.10 There may also be additional issues that could affect the consolidated financial statements that have not been identified.

Major challenges include the federal government’s inability to

- properly account for and report property, plant, and equipment and inventories and related property, primarily at the Department of Defense (DOD);

- reasonably estimate or adequately support amounts reported for certain liabilities, such as environmental and disposal liabilities and related costs at DOD, and ensure complete and proper reporting for commitments and contingencies;

- support major portions of the total net cost of government operations, most notably related to DOD, and ensure that all disbursements are properly recorded;

- fully account for and reconcile intragovernmental activity and balances;

- demonstrate how net outlay amounts reported in the consolidated financial statements were related to net outlay amounts reported in the underlying federal agencies’ financial statements; and

- effectively prepare the federal government’s financial statements, including ensuring that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP.

In addition to these material deficiencies, we identified four other material weaknesses in internal control related to loans receivable and loan guarantee liabilities, improper payments, information security, and tax collection activities.

The material weaknesses identified by our work are discussed in more detail in appendix II, and their primary effects are described in appendix III.

Recurring Systems Problems Hinder Accountability

The ability to produce the data needed to efficiently and effectively manage the day-to-day operations of the federal government and provide accountability to taxpayers and the Congress has been a long-standing challenge at most federal agencies. The results of the fiscal year 2003 assessments performed by agency inspectors general or their contract auditors under FFMIA show that these problems continue to plague the financial management systems used by most of the CFO Act agencies. While the problems are much more severe at some agencies than at others, their nature and severity indicate that overall, management at most CFO Act agencies lacks the full range of information needed for accountability, performance reporting, and decision making. These problems include nonintegrated financial systems, lack of accurate and timely recording of data, inadequate reconciliation procedures, and noncompliance with accounting standards and the U.S. Government Standard General Ledger (SGL).

Agencies’ inability to meet the federal financial management systems requirements continues to be the major barrier to achieving compliance with FFMIA. Under FFMIA, CFO Act agency auditors are required to report, as part of the agencies’ financial statement audits, whether agencies’ financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the SGL at the transaction level. As shown in figure 1, auditors most frequently reported instances of noncompliance with federal financial management systems requirements. These instances of noncompliance involved not only core financial systems, but also administrative and programmatic systems.
For fiscal year 2003, auditors for 17 of the 23 CFO Act agencies reported that the agencies' financial management systems did not comply substantially with one or more of FFMIA's three requirements. For the remaining 6 CFO Act agencies, auditors provided negative assurance, meaning that nothing came to their attention indicating that the agencies' financial management systems did not substantially meet FFMIA requirements. The auditors for these 6 agencies did not definitively state whether the agencies' systems substantially complied with FFMIA requirements, as is required under the statute. DHS is not subject to the requirements of the CFO Act and, consequently, is not required to comply with FFMIA. Accordingly, DHS's auditors did not report on DHS's compliance with FFMIA. However, the auditors identified and reported deficiencies that related to the aforementioned three requirements of FFMIA.

Federal agencies have recognized the seriousness of their financial systems weaknesses and have efforts under way to implement or upgrade their financial systems to alleviate long-standing problems, but some of these
efforts face significant challenges. For example, as we testified in May 2004, we have identified several issues related to NASA’s financial management systems modernization effort: (1) NASA did not involve key stakeholders in the design and implementation of the agency’s new financial management system’s core financial module; (2) NASA did not follow key best practices for acquiring and implementing this system; and (3) the new system lacks key external reporting capabilities for property and budgetary data. In addition, as I will discuss later in this testimony, DOD faces major challenges in its efforts to develop a business enterprise architecture. We recognize that it will take time, investment, and sustained emphasis to improve agencies’ underlying financial management systems.

Addressing Major Impediments to an Opinion on Consolidated Financial Statements

As I mentioned earlier, for the past 7 fiscal years, the federal government has been required to prepare, and have audited, consolidated financial statements. Successfully meeting this requirement is tightly linked to the requirements for the CFO Act agencies to also have audited financial statements. This has stimulated extensive cooperative efforts and considerable attention by agency chief financial officers, inspectors general, Treasury and OMB officials, and GAO. With the benefit of the past 7 years’ experience by the federal government in having the required financial statements subjected to audit, more intensified attention will be needed on the most serious obstacles to achieving an opinion on the U.S. government’s consolidated financial statements. Three major impediments to an opinion on the consolidated financial statements are (1) serious financial management problems at DOD, (2) the federal government’s inability to fully account for and reconcile transactions between federal government entities, and (3) the federal government’s ineffective process for preparing the consolidated financial statements.

Financial Management at DOD

Essential to achieving an opinion on the consolidated financial statements is resolution of the serious financial management problems at DOD, which

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we have designated as high risk since 1995. In accordance with section 1008 of the National Defense Authorization Act for Fiscal Year 2002, DOD reported that for fiscal year 2003, it was not able to provide adequate evidence supporting material amounts in its financial statements. DOD stated that it is unable to comply with applicable financial reporting requirements for (1) property, plant, and equipment (PP&E); (2) inventory and operating materials and supplies; (3) environmental liabilities; (4) intragovernmental eliminations and related accounting adjustments; (5) disbursement activity; and (6) cost accounting by responsibility segment. Although DOD represented that the military retirement health care liability data had improved for fiscal year 2003, the cost of direct health care provided by DOD-managed military treatment facilities was a significant amount of DOD's total recorded health care liability and was based on estimates for which adequate support was not available.

DOD continues to confront pervasive decades-old financial management and business problems related to its systems, processes (including internal controls), and people (human capital). These problems preclude the department from producing accurate, reliable, and timely information to make sound decisions and to accurately report on its billions of dollars of assets. DOD's long-standing business management systems problems adversely affect the economy, effectiveness, and efficiency of its operations and have resulted in a lack of adequate accountability across all major business areas. To date, none of the military services or major DOD components has passed the test of an independent financial audit because of pervasive weaknesses in financial management systems, operations, and controls.

Additionally, the department’s stovepiped, duplicative, and nonintegrated systems contribute to its vulnerability to fraud, waste, and abuse. In this

\[\text{Page 10} \quad \text{GAO-04-886T}\]
regard, we have recently testified on problems related to military pay\textsuperscript{15} and unused airline tickets.\textsuperscript{16} Vulnerability to fraud, waste, and abuse continues despite substantial systems investment. For fiscal year 2004, DOD requested approximately $19 billion to operate, maintain, and modernize its reported 2,274 business systems. The duplicative and stovepiped nature of DOD’s systems environment is illustrated by the numerous systems it has in the same functional areas. For example, DOD reported that it has 565 systems to support logistics functions. These systems are not integrated and thus have multiple points of data entry, which can result in significant data integrity problems.

Further, DOD continues to lack effective management oversight and control over business systems modernization investments. The actual funding continues to be distributed among the military services and defense agencies, thereby enabling the numerous DOD components to continue to develop stovepiped, parochial solutions to the department’s long-standing financial management and business operation challenges. Lacking a departmentwide focus and effective management oversight and control of business systems investment, DOD continues to invest billions of dollars in systems that fail to provide integrated corporate solutions to its long-standing business operations problems.

Over the past 14 years, DOD has initiated several broad-based reform efforts intended to fundamentally reform its business operations and improve the reliability of information used in the decision-making process. While these initiatives produced some incremental improvements, they did not result in the fundamental reform necessary to resolve the department’s long-standing management challenges. Secretary Rumsfeld has made business transformation a priority. For example, through its Business Management Modernization Program, DOD is continuing its efforts to develop and implement a business enterprise architecture and establish effective management and control over its business system modernization investments.


However, we recently reported that after about 3 years of effort and over $203 million in obligations, we have not seen significant change in the content of DOD’s architecture or in DOD’s approach to investing billions of dollars annually in existing and new systems. Few actions have been taken to address the recommendations we made in our previous reports, which were aimed at improving DOD’s plans for developing the next version of the architecture and implementing the institutional means for selecting and controlling both planned and ongoing business systems investments. To date, DOD has not addressed 22 of our 24 recommendations.

Currently, DOD has various initiatives under way to support its efforts to obtain an unqualified audit opinion on its fiscal year 2007 financial statements. Because there are not yet detailed plans guiding these activities, however, it is unclear whether and how they support each other and whether they support this goal. Therefore, the feasibility of meeting this goal is as yet unknown.

The seriousness of DOD’s business management weaknesses underscores the importance of no longer condoning “status quo” business operations at DOD. Cultural resistance to change, military service parochialism, and stovepiped operations have all contributed significantly to the failure of previous attempts to implement broad-based management reforms at DOD. The department has acknowledged that it confronts decades-old problems deeply grounded in the bureaucratic history and operating practices of a complex, multifaceted organization and that many of these practices were developed piecemeal and evolved to accommodate different organizations, each with its own policies and procedures.

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To improve the likelihood that the department’s current business transformation efforts will be successful, we have previously suggested\textsuperscript{19} that a chief management official\textsuperscript{20} position be created. Previous failed attempts to improve DOD’s business operations illustrate the need for sustained involvement of DOD leadership in helping to assure that DOD’s financial and overall business process transformation efforts remain a priority. While the Secretary and other key DOD leaders have demonstrated their commitment to the current business transformation efforts, the long-term nature of these efforts requires the development of an executive position capable of providing strong and sustained executive leadership over a number of years and various administrations.

This position would provide the sustained attention essential for addressing key stewardship responsibilities such as strategic planning, performance and financial management, and business systems modernization in an integrated manner. This position could be filled by an individual, appointed by the President and confirmed by the Senate, for a set term of 7 years with the potential for reappointment. Such an individual should have a proven track record as a business process change agent in large, complex, and diverse organizations—experience necessary to spearhead business process transformation across the department, and potentially administrations, and serve as an integrator for the needed business transformation efforts.

Further, in a recent report\textsuperscript{21} we also suggest that to improve management oversight, accountability, and control of the department’s business systems funding, Congress may wish to consider providing the funds to operate, maintain, and modernize DOD’s business systems to the functional areas,


\textsuperscript{20}On September 9, 2002, GAO convened a roundtable of executive branch leaders and management experts to discuss the Chief Operating Officer concept. For more information, see U.S. General Accounting Office, Highlights of a GAO Roundtable: The Chief Operating Officer Concept: A Potential Strategy to Address Federal Governance Challenges, GAO-03-192SP (Washington, D.C.: Oct. 4, 2002).

known as domains, rather than the military services and the defense agencies. Currently, each military service and defense agency receives its own funding and is largely autonomous in deciding how to spend these funds, thereby hindering the development of broad-based, integrated corporate system solutions to common DOD-wide problems. We believe it is critical that funds for DOD business systems be appropriated to the domain owners in order to provide for accountability and the ability to prevent the continued parochial approach to systems investment that exists today. The domains would establish a hierarchy of investment review boards with DOD-wide representation, including the military services and defense agencies. These boards would be responsible for reviewing and approving investments to develop, operate, maintain, and modernize business systems for the domain portfolio, including ensuring that investments were consistent with DOD's business enterprise architecture.

DOD still has a long way to go, and top leadership must continue to stress the importance of achieving lasting improvement that truly transforms the department's business systems and operations. Only through major transformation, which will take time and sustained leadership from top management, will DOD be able to meet the mandate of the CFO Act and achieve the President’s Management Agenda goal of improved financial performance.

**Intragovernmental Transactions**

OMB and Treasury require the CFOs of 35 executive departments and agencies, including the 23 CFO Act agencies, to reconcile selected intragovernmental activity and balances with their “trading partners” and to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts. A substantial number of the agencies continue to be unable to fully perform reconciliations of intragovernmental activity and balances with their trading partners, citing reasons such as (1) trading partners not providing needed data; (2) limitations and incompatibility of agency and trading partner information systems; and (3) lack of human resources. Amounts reported for federal agency trading partners for certain intragovernmental accounts were significantly out of balance in the aggregate for both fiscal years 2003 and 2002.

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22Trading partners are U.S. government agencies, departments, or other components included in the consolidated financial statements that do business with each other.
We reported in previous years that the heart of the intragovernmental transactions issue was that the federal government lacked clearly articulated business rules for these transactions so that they would be handled consistently by agencies. In this regard, at the start of fiscal year 2003, OMB issued business rules to transform and standardize intragovernmental ordering and billing. To address long-standing problems with intragovernmental exchange transactions between federal agencies, Treasury provided federal agencies with quarterly detailed trading partner information during fiscal year 2003 to help them better perform their trading partner reconciliations. In addition, the federal government began a three-phase Intragovernmental Transactions e-gov project to define a governmentwide data architecture and provide a single source of detailed trading partner data. On April 20, 2004, however, OMB announced that it was appropriate to pause and evaluate the results of the project to date. OMB estimated that the evaluation will take 120 days and will be followed by a phased deployment. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a commitment by the CFO Act agencies and continued strong leadership by OMB.

Preparing the Consolidated Financial Statements

The federal government did not have adequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP. In this regard, Treasury is developing a new system and procedures to prepare the consolidated financial statements beginning with the statements for fiscal year 2004. Treasury officials have stated that these actions are intended to, among other things, directly link information from federal agencies’ audited financial statements to amounts reported in the consolidated financial statements and resolve many of the issues we identified in the process for preparing the consolidated financial statements. As part of our fiscal year 2004 audit, we will evaluate the new system and procedures as they are fully developed and implemented and determine the extent of linkage accomplished for the fiscal year 2004 financial statements. Resolving issues surrounding preparing the consolidated financial statements has been a significant challenge and will require continued strong leadership by Treasury management.
Our nation’s large and growing long-term fiscal imbalance, which is driven largely by known demographic trends and rising health care costs—coupled with new homeland security and defense commitments—serves to sharpen the need to fundamentally review and re-examine basic federal entitlements, as well as other mandatory and discretionary spending, and tax policies. As we look ahead, our nation faces an unprecedented demographic challenge with significant implications, among them budgetary and economic. Between now and 2035, the number of people who are 65 years old or over will double, driving federal spending on the elderly to a larger and ultimately unsustainable share of the federal budget. As a result, tough choices will be required to address the resulting structural imbalance.

GAO prepares long-term budget simulations that seek to illustrate the likely fiscal consequences of the coming demographics and rising health care costs. Our latest long-term budget simulations reinforce the need for change in the major cost drivers—Social Security and health care programs. As shown in figure 2, by 2040, absent reform of these entitlement programs, projected federal revenues may be adequate to pay little beyond interest on the debt.
Current financial reporting does not clearly and transparently show the wide range of responsibilities, programs, and activities that may either obligate the federal government to future spending or create an expectation for such spending and provides an unrealistic and even misleading picture of the federal government's overall performance and financial condition. Few agencies adequately show the results they are getting with the taxpayer dollars they spend. In addition, too many significant federal government commitments and obligations, such as Social Security and Medicare, are not fully and consistently disclosed in the
federal government’s consolidated financial statements and budget, and current federal financial reporting standards do not require such disclosure.\(^{23}\) Figure 3 shows some selected fiscal exposures. The spectrum of these exposures ranges from covering only the explicit liabilities that are shown on the consolidated financial statements to implicit promises embedded in current policy or public expectations. These liabilities, commitments, and promises have created a fiscal imbalance that will put unprecedented strains on the nation’s spending and tax policies. Although economic growth can help, the projected fiscal gap is now so large that the federal government will not be able to simply grow its way out of the problem. Tough choices are inevitable.

\(^{23}\)The Federal Accounting Standards Advisory Board has a project under way to consider recognition, measurement, and display of social insurance obligations.
Figure 3: Selected Fiscal Exposures: Sources and Examples

<table>
<thead>
<tr>
<th>Type</th>
<th>Example (dollars in billions)</th>
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<tbody>
<tr>
<td>Explicit liabilities</td>
<td>Publicly held debt ($3,913)</td>
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<tr>
<td></td>
<td>Military and civilian pension and post-retirement health ($2,857)</td>
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<tr>
<td></td>
<td>Veterans benefits payable ($955)</td>
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<tr>
<td></td>
<td>Environmental and disposal liabilities ($250)</td>
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<tr>
<td></td>
<td>Loan guarantees ($35)</td>
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<tr>
<td>Explicit financial commitments</td>
<td>Undelivered orders ($596)</td>
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<tr>
<td></td>
<td>Long-term leases ($47)</td>
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<tr>
<td>Explicit financial contingencies</td>
<td>Unadjudicated claims ($9)</td>
</tr>
<tr>
<td></td>
<td>Pension Benefit Guaranty Corporation ($86)</td>
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<tr>
<td></td>
<td>Other national insurance programs ($7)</td>
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<tr>
<td></td>
<td>Government corporations, e.g., Ginnie Mae</td>
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<tr>
<td>Implicit exposures implied by current policies or the public's expectations about the role of government</td>
<td>Debt held by government accounts ($2,859)$^b$</td>
</tr>
<tr>
<td></td>
<td>Future Social Security benefit payments ($3,699)$^c$</td>
</tr>
<tr>
<td></td>
<td>Future Medicare Part A benefit payments ($8,236)$^c$</td>
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<tr>
<td></td>
<td>Future Medicare Part B benefit payments ($11,416)$^c$</td>
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<td></td>
<td>Future Medicare Part D benefit payments ($8,119)$^c$</td>
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<tr>
<td></td>
<td>Life-cycle cost, including deferred and future maintenance and operating costs (amount unknown)</td>
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<td></td>
<td>Government-Sponsored Enterprises, e.g., Fannie Mae and Freddie Mac</td>
</tr>
</tbody>
</table>

Source: GAO analysis of data from the Department of the Treasury; the Office of the Chief Actuary, Social Security Administration; and the Office of the Actuary, Centers for Medicare and Medicaid Services.

$^a$All figures are as of the end of fiscal year 2003, except Social Security and Medicare estimates, which are as of the end of calendar year 2003.

$^b$This amount includes $774 billion held by military and civilian pension funds that would offset the explicit liabilities reported by those funds.

$^c$Figures for Social Security and Medicare are net of debt held by the trust funds ($1,531 billion for Social Security, $256 billion for Medicare Part A, and $24 billion for Medicare Part B) and represent net present value estimates over a 75-year period. Over an infinite horizon, the estimate for Social Security would be $10.4 trillion, $21.8 trillion for Medicare Part A, $23.2 trillion for Medicare Part B, and $16.5 trillion for Medicare Part D.

Particularly troubling are the many big-ticket items that taxpayers will eventually have to deal with. The federal government has pledged its support to a long list of programs and activities, including pension and health care benefits for senior citizens, medical care for veterans, and contingencies associated with various government-sponsored entities,
whose claims on future spending total trillions of dollars. Despite their serious implications for future budgets, tax burdens, and spending flexibilities, these unfunded commitments get short shrift in the federal government’s current financial statements and in budgetary deliberations.

The federal government’s gross debt as of September 2003 was about $7 trillion, or about $24,000 for every man, woman, and child in this country today. But that number excludes many big-ticket items, including the gap between promised and funded Social Security and Medicare benefits, veterans’ health care, and a range of other commitments and contingencies. If these items are factored in, the total burden in current dollars is at least $42 trillion. To put that number into perspective, $42 trillion is 18 times the current federal budget, or 3.5 times our current annual gross domestic product. One of the biggest contributors to this total bill will be the new Medicare prescription drug benefit, whose estimated current-dollar cost over the next 75 years is more than $8 trillion. Stated differently, the current total burden for every American is more than $140,000—and every day that burden is growing larger. GAO’s long-term budget simulations show that by 2040, the federal government may have to cut federal spending by 60 percent or raise taxes to about 2.5 times today’s level to pay for the mounting cost of the federal government’s current unfunded commitments. Either would be devastating.

Proper accounting and reporting practices are essential in the public sector. After all, the U.S. government is the largest, most diverse, most complex, and arguably the most important entity on earth today. Its services—homeland security, national defense, Social Security, mail delivery, and food inspection, to name a few—directly affect the well-being of almost every American. But sound decisions on the future direction of vital federal government programs and policies are made more difficult without timely, accurate, and useful financial and performance information.

Fortunately, we are starting to see efforts to address the shortcomings in federal financial reporting. The President’s Management Agenda, which closely reflects GAO’s list of high-risk government programs, is bringing attention to troubled areas across the federal government and is taking steps to better assess the results that programs are getting with the resources they are given. The Federal Accounting Standards Advisory Board is also making progress on many key financial reporting issues.
In addition to these efforts, we have published frameworks for analyzing various Social Security reform proposals and for analyzing health care reform proposals. We have also helped to create a consortium of “good government” organizations to stimulate the development of a set of key national indicators to assess the United States’ overall position and progress over time and in comparison to those of other industrialized nations.

Budget experts at the Congressional Budget Office (CBO) and GAO continue to encourage reforms to the federal budget process to better reflect the federal government’s commitments and signal emerging problems. Among other things, we have recommended that the federal government issue an annual report on major fiscal exposures. The President’s fiscal year 2005 budget also proposes that future President’s budgets report on any enacted legislation in the past year that worsens the unfunded obligations of programs with long-term actuarial projections, with CBO to make a similar report. Such reporting could be a good starting point.

Although these are positive initial steps, much more must be done given the magnitude of the federal government’s fiscal challenge. A top-to-bottom review of government activities to ensure their relevance and fit for the 21st century and their relative priority is long overdue. As I have spoken about in the past, the federal government needs a three-pronged approach to (1) restructure existing entitlement programs, (2) reexamine the base of discretionary and other spending, and (3) review and revise the federal government’s tax policy, including major tax preferences, and enforcement programs. New accounting and reporting approaches, budget control mechanisms, and metrics are needed for considering and measuring the impact of spending and tax policies and decisions over the long term.


Our report on the U.S. government’s consolidated financial statements for fiscal years 2003 and 2002 highlights the need to continue addressing the federal government’s serious financial management weaknesses. With the significantly accelerated financial reporting time frame for fiscal year 2004 and beyond, it is essential that the federal government move away from the extraordinary efforts many federal agencies continue to make to prepare financial statements and toward giving prominence to strengthening the federal government’s financial systems, reporting, and controls. This is the only way the federal government can meet the end goal of making timely, accurate, and useful financial and performance information routinely available to the Congress, other policymakers, and the American public. The requirement for timely, accurate, and useful financial and performance management information is greater than ever as our nation faces major long-term fiscal challenges that will require tough choices in setting priorities and linking resources to results.

The Congress and the President face the challenge of sorting out the many claims on the federal budget without the budget enforcement mechanisms or fiscal benchmarks that guided the federal government through the previous years of deficit reduction into the brief period of surplus. While a number of steps will be necessary to address this challenge, truth and transparency in federal government reporting are essential elements of any attempt to address the nation’s long-term fiscal challenges. The fiscal risks I mentioned earlier can be managed only if they are properly accounted for and publicly disclosed. A crucial first step will be to face facts and identify the significant commitments facing the federal government. If citizens and federal government officials come to understand various fiscal exposures and their potential claims on future budgets, they are more likely to insist on prudent policy choices today and sensible levels of fiscal risk in the future. In addition, new budget control mechanisms will be required, along with effective approaches to successfully engage in a fundamental review, reassessment, and reprioritization of the base of federal government programs and policies that I have recommended previously.

Public officials will have more incentive to make difficult but necessary choices if the public has the facts and comes to support serious and sustained action to address the nation’s fiscal challenges. Without meaningful public debate, however, real and lasting change is unlikely. Clearly, the sooner action is taken, the easier it will be to turn things around.
I believe that nothing less than a national education campaign and outreach effort is needed to help the public understand the nature and magnitude of the long-term financial challenge facing this nation. An informed electorate is essential for a healthy democracy. Members of Generations X and Y especially need to become active in this discussion because they and their children will bear the heaviest burden if policymakers fail to act in a timely and responsible manner.

We at GAO are committed to doing our part, but others also need to step up to the plate. By working together, I believe we can make a meaningful difference for our nation, fellow citizens, and future generations of Americans.

In closing, Mr. Chairman, I want to reiterate the value of sustained congressional interest in these issues, as demonstrated by the Congress’s annual hearings on the results of our audit of the consolidated financial statements and of audits of certain federal agencies’ financial statements. It will also be key that the appropriations, budget, authorizing, and oversight committees hold agency top leadership accountable for resolving these problems and that they support improvement efforts.

Contacts

For further information regarding this testimony, please contact Jeffrey C. Steinhoff, Managing Director, or Gary T. Engel, Director, Financial Management and Assurance, at (202) 512-2600.
## Appendix I

### Selected Major Federal Agencies: Fiscal Year 2003 Audit Results, Principal Auditors, and Number of Other Audit Contractors

<table>
<thead>
<tr>
<th>23 CFO Act agencies</th>
<th>Audit results</th>
<th>Principal auditor</th>
<th>Number of other audit contractors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agency for International Development</td>
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<td>Inspector General</td>
<td>1</td>
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<tr>
<td>Agriculture</td>
<td>Unqualified</td>
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</tr>
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<td>Commerce</td>
<td>Unqualified</td>
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<td>Disclaimer</td>
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<td>1</td>
</tr>
<tr>
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<td>Unqualified</td>
<td>Ernst &amp; Young LLP</td>
<td>0</td>
</tr>
<tr>
<td>Energy</td>
<td>Unqualified</td>
<td>KPMG LLP</td>
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<tr>
<td>Environmental Protection Agency</td>
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<td>Inspector General</td>
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<tr>
<td>Housing and Urban Development</td>
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<tr>
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<tr>
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<td>Veterans Affairs</td>
<td>Unqualified</td>
<td>Deloitte &amp; Touche LLP</td>
<td>0</td>
</tr>
</tbody>
</table>

### Other major agency

| Homeland Security                         | Disclaimer<sup>b</sup> | KPMG LLP                          | 0                                 |

Source: GAO.

<sup>a</sup>In addition, GAO audited the Internal Revenue Service's financial statements and the Schedules of Federal Debt Managed by the Bureau of the Public Debt.

<sup>b</sup>DHS began operations as an agency 5 months after the start of the fiscal year, on March 1, 2003. Transfers of funds, assets, liabilities, and obligations from 22 existing federal agencies to DHS began on March 1, 2003. DHS's auditors issued a qualified opinion on the consolidated balance sheet and statement of custodial activity as of September 30, 2003, and disclaimed on the consolidated statement of net cost, consolidated statement of changes in net position, combined statement of budgetary resources, and consolidated statement of financing for the 7 months ended September 30, 2003.
Appendix II

Material Deficiencies

The federal government did not maintain adequate systems or have sufficient, reliable evidence to support information reported in the consolidated financial statements of the U.S. government, as described below. These material deficiencies contributed to our disclaimer of opinion on the consolidated financial statements and also constitute material weaknesses in internal control.

Property, Plant, and Equipment and Inventories and Related Property

The federal government could not satisfactorily determine that all PP&E and inventories and related property were included in the consolidated financial statements, verify that certain reported assets actually exist, or substantiate the amounts at which they were valued. Most of the PP&E and inventories and related property are the responsibility of DOD. As in past years, DOD did not maintain adequate systems or have sufficient records to provide reliable information on these assets. Other agencies, most notably the National Aeronautics and Space Administration, reported continued weaknesses in internal control procedures and processes related to PP&E.

Liabilities and Commitments and Contingencies

The federal government could not reasonably estimate or adequately support amounts reported for certain liabilities. For example, DOD was not able to estimate with assurance key components of its environmental and disposal liabilities. In addition, DOD could not support a significant amount of its estimated military postretirement health benefits liabilities included in federal employee and veteran benefits payable. These unsupported amounts related to the cost of direct health care provided by DOD-managed military treatment facilities. Further, the federal government could not determine whether commitments and contingencies, including those related to treaties and other international agreements entered into to further the U.S. government’s interests, were complete and properly reported.

Cost of Government Operations and Disbursement Activity

The previously discussed material deficiencies in reporting assets and liabilities, material deficiencies in financial statement preparation, as discussed below, and the lack of adequate disbursement reconciliations at certain federal agencies affect reported net costs. As a result, the federal government was unable to support significant portions of the total net cost of operations, most notably related to DOD.
With respect to disbursements, DOD and certain other federal agencies did not adequately reconcile disbursement activity. For fiscal years 2003 and 2002 there were unsupported adjustments to federal agencies’ records and unreconciled disbursement activity, including unreconciled differences between federal agencies’ and Treasury’s records of disbursements, totaling billions of dollars, which could also affect the balance sheet.

Accounting for and Reconciliation of Intragovernmental Activity and Balances

OMB and Treasury require the CFOs of 35 executive departments and agencies, including the 23 CFO Act agencies, to reconcile selected intragovernmental activity and balances with their “trading partners”\(^1\) and to report to Treasury, the agency’s inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts. A substantial number of the agencies did not fully perform the required reconciliations for fiscal years 2003 and 2002, citing reasons such as (1) trading partners not providing needed data, (2) limitations and incompatibility of agency and trading partner information systems, and (3) lack of human resources. For both of these years, amounts reported for federal agency trading partners for certain intragovernmental accounts were significantly out of balance. Treasury’s ability to eliminate certain intragovernmental activity and balances is impaired by these federal agencies’ problems in handling their intragovernmental transactions.

Net Outlays

OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*,\(^2\) states that outlays in federal agencies’ Statements of Budgetary Resources (SBR) should agree with the respective agency’s net outlays reported in the budget of the U.S. government. In addition, Statement of Federal Financial Accounting Standards (SFFAS) No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requires explanation of any material differences between the information required to be disclosed (including net outlays)

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1Trading partners are U.S. government agencies, departments, or other components included in the consolidated financial statements that do business with each other.

and the amounts described as “actual” in the budget of the U.S. government.

We found material differences between the total net outlays reported in selected federal agencies’ audited SBRs and the records used to prepare the Statement of Changes in Cash Balance from Unified Budget and Other Activities (Statement of Changes in Cash Balance), totaling about $140 billion and $186 billion for fiscal years 2003 and 2002, respectively. Two agencies (Treasury and the Department of Health and Human Services (HHS)) accounted for about 83 percent and 75 percent of the differences identified in fiscal years 2003 and 2002, respectively. We found that the major cause of the differences for the two agencies was the treatment of offsetting receipts. Some offsetting receipts for these two agencies had not been included in the agencies’ SBRs, which would have reduced the agencies’ net outlays and made the amounts more consistent with the records used to prepare the Statement of Changes in Cash Balance. For example, we found that HHS reported net outlays for fiscal year 2003 as $596 billion on its audited SBR, while the records that Treasury uses to prepare the Statement of Changes in Cash Balance showed $505 billion for fiscal year 2003 for this agency. Until these differences between the total net outlays reported in the federal agencies’ SBRs and the records used to prepare the Statement of Changes in Cash Balance are reconciled, the effect that these differences may have on the U.S. government’s consolidated financial statements will be unknown. OMB has stated that it plans to work with the agencies to address this issue.

OMB and U.S. generally accepted accounting principles (GAAP) require agencies to report net outlays in the SBR. The Statement of Changes in Cash Balance also reports unified budget outlays-actual. Both are intended to represent the same amount and be consistent with the information presented in the budget of the U.S. government.

In some agencies’ fiscal year 2003 financial statements, the comparable fiscal year 2002 amounts were restated.

Offsetting receipts are collections that are credited to general fund, special fund, or trust fund receipt accounts and that offset gross outlays at the agency or governmentwide level.

These two agencies did not adequately explain their fiscal year 2002 differences between the net outlays reported on the SBR and the budget of the U.S. government in their notes to the fiscal year 2003 financial statements.
## Preparation of Consolidated Financial Statements

The federal government did not have adequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with generally accepted accounting principles (GAAP). During our fiscal year 2003 audit, we found the following: \(^7\)

- The process for compiling the consolidated financial statements does not directly link information from federal agencies’ audited financial statements to amounts reported in the consolidated financial statements, and therefore does not ensure that the information in the consolidated financial statements is consistent with the underlying information in federal agencies’ audited financial statements and other financial data.

- Internal control weaknesses exist in Treasury’s process for preparing the consolidated financial statements, such as a lack of (1) segregation of duties and (2) appropriate documentation of certain policies and procedures for preparing the consolidated financial statements.

- The net position reported in the consolidated financial statements is derived by subtracting liabilities from assets, rather than through balanced accounting entries. To make the fiscal years 2003 and 2002 consolidated financial statements balance, Treasury recorded a net $24.5 billion and a net $17.1 billion decrease, respectively, to net operating cost on the Statements of Operations and Changes in Net Position, which it labeled “Unreconciled Transactions Affecting the Change in Net Position.” \(^8\) An additional net $11.3 billion and $12.5 billion of unreconciled transactions were recorded in the Statements of Net Cost for fiscal years 2003 and 2002, respectively. Treasury does not

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\(^7\)The same issues we identified in fiscal year 2003 existed in fiscal year 2002, and some have existed for a number of years. In October 2003, we reported in greater detail on the issues we identified, in U.S. General Accounting Office, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Improvement*, GAO-04-45 (Washington, D.C.: Oct. 30, 2003). This report included 44 recommendations to address weaknesses we identified. It also included recommendations related to 16 disclosure areas that are required by GAAP. We recommended that the 16 disclosures that are not included in the consolidated financial statements either be included or that the rationale for their exclusion be documented.

\(^8\)Although Treasury was unable to determine how much of the unreconciled transactions, if any, relate to operations, it reported unreconciled transactions as a component of net operating cost in the consolidated financial statements.
identify and quantify all components of these unreconciled activities, nor does Treasury perform reconciliation procedures, which would aid in understanding and controlling the net position balance as well as eliminating the unreconciled transactions associated with compiling the consolidated financial statements.

- Significant differences in other intragovernmental accounts, primarily related to appropriations, still remain unresolved. Intragovernmental activity and balances are “dropped” or “offset” in the preparation of the consolidated financial statements rather than eliminated through balanced accounting entries. This contributes to the federal government’s inability to determine the impact of these differences on amounts reported in the consolidated financial statements.

- The federal government did not have an adequate process to identify and report items needed to reconcile the operating results, which for fiscal year 2003 showed a net operating cost of $665 billion, to the budget results, which for the same period showed a unified budget deficit of $374.8 billion.

- The consolidated financial statements include certain financial information for the executive, legislative, and judicial branches, to the extent that federal agencies within those branches have provided Treasury such information. However, there are undetermined amounts of assets, liabilities, costs, and revenues that are not included, and the federal government did not provide evidence or disclose in the consolidated financial statements that such excluded financial information was immaterial.

- Treasury lacks an adequate process to ensure that the financial statements, related notes, Stewardship Information, and Supplemental Information are presented in conformity with GAAP. We found that certain financial information required by GAAP was not disclosed in the consolidated financial statements. Treasury did not provide us with documentation of its rationale for excluding this information. As a result of this and certain material deficiencies noted above, we were unable to determine if the missing information was material to the consolidated financial statements.
### Other Material Weaknesses

In addition to the material deficiencies noted above, we found four other material weaknesses in internal control as of September 30, 2003: (1) several federal agencies continue to have deficiencies in the processes and procedures used to estimate the costs of their lending programs and value their related loans receivable; (2) most federal agencies have not reported the magnitude of improper payments in their programs and activities; (3) federal agencies have not yet fully institutionalized comprehensive security management programs; and (4) material internal control weaknesses and systems deficiencies continue to affect the federal government's ability to effectively manage its tax collection activities.

### Loans Receivable and Loan Guarantee Liabilities

In general, federal agencies continue to make progress in reducing the number of material weaknesses and reportable conditions related to their lending activities. However, significant deficiencies in the processes and procedures used to estimate the costs of certain lending programs and value the related loans receivable still remain. These deficiencies continue to adversely affect the government's ability to support annual budget requests for these programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities. The most notable deficiencies existed at the Small Business Administration (SBA), which, while improved from last year, continues to have a material weakness related to this area. For example, SBA did not adequately document its estimation methodologies, lacked the management controls necessary to ensure that appropriate estimates were prepared and reported based on complete and accurate data, and could not fully support the reasonableness of the costs of its lending programs and valuations of its loan portfolio. We are currently assessing SBA's actions to resolve certain of these deficiencies related to accounting for previous loan sales and cost estimates for disaster loans.

### Improper Payments

Across the federal government, improper payments occur in a variety of programs and activities, including those related to health care, contract

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9Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control that could adversely affect the federal government's ability to meet the internal control objectives relating to financial reporting and compliance with laws and regulations.
management, federal financial assistance, and tax refunds.\textsuperscript{10} While complete information on the magnitude of improper payments is not yet available, based on available data, OMB has estimated that improper payments exceed $35 billion annually. Many improper payments occur in federal programs that are administered by entities other than the federal government, such as states. Improper payments often result from a lack of or an inadequate system of internal controls. Although the President's Management Agenda includes an initiative to reduce improper payments, most federal agencies have not reported the magnitude of improper payments in their programs and activities.

The Improper Payments Information Act of 2002\textsuperscript{11} provides for federal agencies to estimate and report on their improper payments. It requires federal agencies to (1) annually review programs and activities that they administer to identify those that may be susceptible to significant improper payments, (2) estimate improper payments in susceptible programs and activities, and (3) provide reports to the Congress that discuss the causes of improper payments identified and the status of actions to reduce them. In accordance with the legislation, OMB issued guidance for federal agencies’ use in implementing the act. Among other things, the guidance requires federal agencies to report on their improper payment-related activities in the Management Discussion and Analysis section of their annual Performance and Accountability Reports (PAR). While the act does not require such reporting by all federal agencies until fiscal year 2004, OMB required 44 programs and 14 CFO Act agencies to report improper payment information in their fiscal year 2003 PARs. Our preliminary review of the PARs found that 12 of the 14 agencies reported improper payment amounts for 27 of the 44 programs identified in the guidance. We also found that, for the programs where improper payments were identified, the reports often contained information on the causes of the payments but little information that addressed the other reporting requirements cited in the legislation.

\textsuperscript{10} Improper payments include inadvertent errors, such as duplicate payments and miscalculations, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from fraud and abuse by program participants and/or federal employees.

\textsuperscript{11} Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002). The act’s reporting requirement on actions taken by agencies to reduce improper payments applies only to an agency program or activity with estimated improper payments exceeding $10 million.
Information Security

Although progress has been made, serious and widespread information security weaknesses continue to place 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. GAO has reported information security as a high-risk area across government since February 1997. Such information security weaknesses could result in compromising the reliability and availability of data that are recorded in or transmitted by federal financial management systems. A primary reason for these weaknesses is that federal agencies have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security weaknesses, resolving information security problems, and managing information security risks on an ongoing basis. The Congress has shown continuing interest in addressing these risks, as evidenced by recent hearings on information security and enactment of the Federal Information Security Management Act of 2002 and the Cyber Security Research and Development Act. In addition, the administration has taken important actions to improve information security, such as integrating information security into the Executive Branch Management Scorecard.

Tax Collection Activities

Material internal control weaknesses and systems deficiencies continue to affect the federal government’s ability to effectively manage its tax collection activities. Due to errors and delays in recording activity in taxpayer accounts, taxpayers were not always credited for payments made on their taxes owed, which could result in undue taxpayer burden. In addition, the federal government did not always follow up on potential unreported or underreported taxes and did not always pursue collection efforts against taxpayers owing taxes to the federal government.

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14The Executive Branch Management Scorecard highlights agencies’ progress in achieving management and performance improvements embodied in the President’s Management Agenda.
### Areas Involving Material Weaknesses

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<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Property, plant, and equipment and inventories and related property</td>
<td>Without accurate asset information, the federal government does not fully know the assets it owns and their location and condition and cannot effectively (1) safeguard assets from physical deterioration, theft, or loss, (2) account for acquisitions and disposals of such assets, (3) ensure the assets are available for use when needed, (4) prevent unnecessary storage and maintenance costs or purchase of assets already on hand, and (5) determine the full costs of programs that use these assets.</td>
</tr>
<tr>
<td>Liabilities and commitments and contingencies</td>
<td>Problems in accounting for liabilities affect the determination of the full cost of the federal government’s current operations and the extent of its liabilities. Also, improperly stated environmental and disposal liabilities and weak internal control supporting the process for their estimation affect the federal government’s ability to determine priorities for cleanup and disposal activities and to allow for appropriate consideration of future budgetary resources needed to carry out these activities. In addition, when disclosures of commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government’s obligations.</td>
</tr>
<tr>
<td>Cost of government operations and disbursement activity</td>
<td>Inaccurate cost information affects the federal government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by federal agencies for inclusion in the President's budget concerning obligations and outlays.</td>
</tr>
<tr>
<td>Accounting for and reconciliation of intragovernmental activity and balances</td>
<td>Problems in accounting for and reconciling intragovernmental activity and balances impair the government’s ability to account for billions of dollars of transactions between governmental entities.</td>
</tr>
<tr>
<td>Net outlays</td>
<td>Until the differences between the total net outlays reported in federal agencies’ Statements of Budgetary Resources and the records used by the Department of the Treasury to prepare the Statement of Changes in Cash Balance from Unified Budget and Other Activities are reconciled, the effect that these differences may have on the U.S. government's consolidated financial statements will be unknown.</td>
</tr>
<tr>
<td>Preparation of consolidated financial statements</td>
<td>Because the federal government did not have adequate systems, controls, and procedures to prepare its consolidated financial statements, the federal government's ability to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with U.S. generally accepted accounting principles was impaired.</td>
</tr>
<tr>
<td>Improper payments</td>
<td>Without a systematic measurement of the extent of improper payments, federal agency management cannot determine (1) if improper payment problems exist that require corrective action, (2) mitigation strategies and the appropriate amount of investments to reduce them, and (3) the success of efforts implemented to reduce improper payments.</td>
</tr>
<tr>
<td>Loans receivable and loan guarantee liabilities</td>
<td>Weaknesses in the processes and procedures for estimating credit program costs affect the government’s ability to support annual budget requests for these programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities.</td>
</tr>
<tr>
<td>Information security weaknesses</td>
<td>Information security weaknesses over computerized operations 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.</td>
</tr>
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</table>
Source: GAO.

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<tbody>
<tr>
<td>Tax collection activities</td>
<td>Weaknesses in controls over tax collection activities continue to affect the federal government's ability to efficiently and effectively account for and collect revenue. Additionally, weaknesses in financial reporting affect the federal government's ability to make informed decisions about collection efforts. As a result, the federal government is vulnerable to loss of tax revenue and exposed to potentially billions of dollars in losses due to inappropriate refund disbursements.</td>
</tr>
</tbody>
</table>
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