Testimony

FEDERAL FINANCIAL MANAGEMENT

Critical Accountability and Fiscal Stewardship Challenges Facing Our Nation

Statement of David M. Walker
Comptroller General of the United States
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What GAO Found

Since the enactment of key financial management reforms, the federal government has made substantial progress in improving financial management activities and practices. Federal financial systems requirements have been developed, and internal control has been strengthened. Nonetheless, the federal government still has a long way to go to address the six principal challenges to fully realizing strong federal financial management: (1) transforming financial management and business practices at DOD, (2) improving agency financial and performance reporting, (3) modernizing financial management systems, (4) addressing key remaining internal control weaknesses, (5) building a financial management workforce for the future, and (6) strengthening consolidated financial reporting.

From a broad financial management perspective, the federal government's financial condition and fiscal outlook are worse than many understand. We are currently experiencing strong economic growth and yet running large on-budget (operating) deficits that are largely unrelated to the Global War on Terrorism. The federal government faces large and growing structural deficits in future years due primarily to known demographic trends and rising health care costs. As shown in the chart below, if it is assumed that recent tax reductions are made permanent and discretionary spending keeps pace with the growth of our economy, GAO's long-term simulations suggest that by 2040, federal revenues may be adequate to pay little more than interest on debt held by the public and some Social Security benefits. Neither slowing the discretionary spending growth nor allowing certain tax provisions to expire—nor both together—would eliminate the imbalance.

Source: GAO's January 2007 analysis.

Note: The Alternative Minimum Tax (AMT) exemption amount is retained at the 2006 level through 2017 and expiring tax provisions are extended. After 2017, revenue as a share of GDP is held constant—implicitly assuming that action is taken to offset increased revenue from real bracket creep, the AMT, and tax-deferred retirement accounts.


<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>2006</th>
<th>2015</th>
<th>2030</th>
<th>2040</th>
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<tbody>
<tr>
<td>Revenue</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
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<tr>
<td>Medicare &amp; Medicaid</td>
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<td>20</td>
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<td>Social Security</td>
<td>20</td>
<td>20</td>
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<td>20</td>
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<tr>
<td>Net interest</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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Percent of GDP

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to testify on the progress made towards a results-oriented, accountable, and relevant government and the challenges that must be addressed to provide accountability and exercise stewardship. The foundation laid by the Chief Financial Officers (CFO) Act of 1990\(^1\) and other management reform legislation provides a basis to improve the accountability of government programs and operations as well as to routinely produce valuable cost and operating performance information. While certain material weaknesses in internal control and in selected accounting and financial reporting practices continue to prevent GAO from being able to issue an opinion on the consolidated financial statements of the U.S. government, the federal government has come a long way since enactment of the CFO Act. At the same time, there is a continuing need to address persistent, long-standing accountability problems and to take financial management to the next level. This will be important as the federal government faces difficult fiscal challenges that will require reliable cost and performance information to support timely decisions on spending and, at the same time, pressures to address fraud, waste, abuse, and mismanagement will only intensify.

From a broad financial management perspective, the federal government’s deteriorating long-range financial condition and long-term fiscal imbalance are matters of increasing concern. We face large and growing structural deficits due primarily to known demographic trends and rising health care costs. There is a need to engage in a fundamental review, reprioritization, and reengineering of the base of government. Understanding and addressing the federal government’s financial condition and long-term fiscal imbalance are critical to maintain fiscal flexibility so that we can respond to emerging social, economic, and security challenges.

Your decision to begin this Congress with a hearing on these important issues demonstrates the seriousness with which this Subcommittee views the financial management challenges facing the federal government and your commitment to address them. Today I would like to:

- outline progress made to date and the key challenges in improving federal financial management practices, and

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highlight the challenges posed by the government’s fiscal condition and my views on a possible way forward.

Our prior work on which this testimony is based was performed in accordance with generally accepted government auditing standards.

Summary

Since the enactment of key financial management reforms, the federal government has made substantial progress in strengthening financial management. Since passage of the CFO Act, all of the administrations have made financial management reform a priority. Improving financial management has been one of the cornerstones of the President’s Management Agenda from the outset of the current administration, and the Executive Branch Management Scorecard, which tracks the status of progress at agencies, has been an effective tool to drive improvement. We have seen a cultural change in how financial management is viewed and carried out in most agencies and a recognition of the value and need for good financial management throughout government, which was not the case in 1990 when the Congress passed the CFO Act. Financial management systems have been improved. Internal control has been strengthened, and the Office of Management and Budget (OMB) has increased emphasis on establishing, assessing, correcting, and reporting on internal control. Generally accepted government accounting standards have been developed. For fiscal year 2006, 19 of 24 CFO Act agencies received clean audit opinions on their financial statements, up from just 6 for fiscal year 1996. Audited financial statements for federal agencies were issued just 1½ months after the close of this fiscal year as opposed to 5 months, which was the case just a few years ago.

A number of challenges remain to fully realizing the world-class financial management anticipated by the Congress through the enactment of financial management reform legislation. It will be critical that the federal government meet these challenges so that reliable, useful, and timely financial information is available not only for day-to-day management, decision making, and oversight, but also to provide the key cost and performance data needed to help address our nation’s looming fiscal crisis. I see six principal challenges, which I will highlight in my testimony today against the backdrop of our nation’s deteriorating long-range financial condition and long-term fiscal imbalance.

• There is a need to transform financial management and business practices at the Department of Defense (DOD) that adversely affect the department’s and the federal government’s ability to control costs;
ensure basic accountability; anticipate future costs and claims on the budget; measure performance; maintain funds control; prevent fraud, waste, and abuse; and address pressing and persistent management problems. Of the 27 areas on GAO’s high-risk list, 15 relate wholly or partially to DOD. The problems at DOD are deeply rooted and I do not anticipate they will be resolved in the near future, but meaningful progress should be expected. Today, we see a commitment from top DOD management, and actions are under way, such as the Financial Improvement and Audit Readiness (FIAR) plan, to address serious problems. In our view, DOD needs to (1) develop and implement a viable strategic plan with goals, objectives, key milestones, and measures to monitor and report on progress in transforming its key business operations, and (2) establish a chief management officer to oversee its overall business transformation efforts.

- Improvements in financial and performance reporting practices are needed so that for the remaining 23 CFO Act agencies, unqualified opinions on financial statements become routine. In particular, the Department of Homeland Security (DHS)—an agency whose implementation and transformation we have designated as high risk since its inception—faces significant challenges to achieve this milestone. Developing and implementing corrective action plans to improve the underlying financial management systems and internal control will be necessary to address financial reporting problems.

- Financial management systems must be modernized to provide the complete range of information needed for accountability, performance reporting, and decision making. While the problems are much more severe at some agencies than others, overall, agencies’ current financial systems do not meet basic statutory systems requirements and, more importantly, do not provide timely, reliable, and useful information for day-to-day management. Our work has shown that best practices in systems implementation that can reduce risk are not being consistently applied when agencies undertake a major financial management system modernization effort. Full adoption of these best practices is equally important as OMB moves forward on its initiative to migrate agencies to shared service providers.

- The federal government continues to face a myriad of material weaknesses and reportable conditions in internal control related to property, plant, and equipment; inventories and related property; liabilities and commitments and contingencies; and disbursement activities, just to mention a few of the problem areas. Particularly problematic to the U.S. government’s consolidated financial statements
is the lack of internal control to adequately account for and reconcile intragovernmental activity and balances. Agencies need to tackle long-standing internal control weaknesses by fully embracing the assessment, reporting, and corrective action approach called for in OMB’s revised Circular No. A-123 and following intragovernmental procedures developed by OMB and the Department of the Treasury (Treasury). Another key problem area is the tens of billions of dollars federal agencies waste on improper payments.\(^2\) Adopting our specific recommendations to improve reporting under the Improper Payments Information Act of 2002\(^3\) is important to fully understand the nature and extent of this problem.

- The federal financial workforce that supports the business needs of today is not well positioned to support the needs of tomorrow. The lack of a sufficient number of staff with the requisite knowledge, skills, and experience has hampered financial management operations at key agencies such as DOD and DHS. At Treasury, during our work on the U.S. government consolidated financial statements, we found that there were not enough personnel with specialized financial reporting experience to help ensure reliable financial reporting by the reporting date. Building a sufficient and sustainable financial management workforce for the future to support program managers and decision makers will require a workforce transformation strategy developed in partnership between agency CFOs and Chief Human Capital Officers, working with OMB and the Office of Personnel Management (OPM). To sustain financial management reform given the leadership changes that occur at the end of any administration, establishing management accountability at an appropriate level with significant authority, experience, and tenure to provide sustained leadership is needed to achieve successful and sustainable transformation. Establishing such positions at selected agencies, such as DOD and DHS, will be a critical success factor.

\(^2\)The Improper Payments Information Act of 2002 (Public Law 107-300) defines improper payments as any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. It includes any payment to an ineligible recipient, any payment for an ineligible service, any duplicate payment, payments for services not received, and any payment that does not account for credit for applicable discounts.

Three major impediments—that have existed for the entire 10-year period GAO has been required to perform this annual audit—continue to prevent us from rendering an opinion on the U.S. government’s consolidated financial statements: (1) the deeply rooted, long-standing, and pervasive financial management problems in DOD; (2) the federal government’s inability to adequately account for and reconcile significant amounts in intragovernmental activity and balances between federal agencies; and (3) the federal government’s ineffective process for preparing the consolidated financial statements. As I previously discussed, addressing the first two impediments will be difficult challenges. Resolving the weaknesses in the systems, controls, and procedures for preparing the consolidated financial statements will require a strong commitment from Treasury and OMB.

Notwithstanding the difficulties to overcome current challenges, we should consider the need for further revisions to the current federal financial reporting model to recognize the unique needs of the federal government, which would affect both consolidated and agency financial reporting. While the current reporting model recognizes some of these needs, a broad reconsideration of issues such as the kind of information that may be relevant and useful for a sovereign nation, could stimulate needed discussion and lead to reporting enhancements that might help the Congress deliberate strategies to address our growing long-term fiscal imbalance. In this regard, we support the current efforts of the Federal Accounting Standards Advisory Board (FASAB) to begin a project on fiscal sustainability reporting. We also support a Statement of Fiscal Sustainability that clearly shows the extent to which future revenues are sufficient to support the federal government’s growing entitlement and other spending. We believe that such reporting needs to reflect the significant commitments associated with the Social Security and Medicare programs while recognizing a liability for the net assets (principally investments in special U.S. Treasury securities) of the “trust funds.” We also believe that any such statements need to consider the intergenerational implications of our current fiscal path. Other areas to reconsider might include the reporting of key outcome-based performance information, as well as the role of a balance sheet in the federal government reporting model. In addition, we support the preparation and publication of an easily understandable summary annual report that includes in a clear, concise, and transparent manner, key financial and performance information embodied in the Financial Report of the United States Government.

Addressing the six principal financial management challenges I just discussed will help ensure that the financial and performance data
provided to decision makers are reliable, useful, and timely. Having such information will be critical to deal with our nation’s significant challenges regarding the long-term fiscal imbalance of the government—that is, the sustainability of the federal government’s programs, commitments, and responsibilities in relation to the resources expected to be available. I recently provided all members of the new Congress with a package of materials to help them understand the facts, why we should start sooner rather than later, and what types of changes need to be considered. More troubling than the persistent short-term budget deficits, long-range fiscal simulations by GAO and others show that over the long term, we face large and growing structural deficits in future years due primarily to known demographic trends and rising health care costs. The federal government’s fiscal exposures now total over $50 trillion, representing close to four times gross domestic product (GDP) in fiscal year 2006 and up from about $20 trillion or two times GDP in 2000. We all know that it is hard to make sense of what “trillions” means. One way to think about it is: if we wanted to put aside today enough to cover these promises, it would take about $440,000 per American household, up from $190,000 in 2000. Clearly, despite recent progress on our short-term deficits, we have been moving in the wrong direction in connection with our long-range imbalance in recent years.

As members of this Subcommittee know, continuing on our current fiscal path would gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately even our domestic tranquility and national security. Many of the federal government’s current policies, programs, functions, and activities are based on conditions that existed decades ago, are not results-based, and are not well aligned with 21st century realities. Our report, 21st Century Challenges: Reexamining the Base of the Federal Government provided a suggested list of specific

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federal activities for reexamination, and perspectives on various strategies, processes, and approaches for congressional consideration that could be used in reexamining the federal base. I have proposed a number of ideas for improving the transparency of long-term costs and the attention paid to these costs before decisions are made. For example, in addition to the Statement of Fiscal Sustainability I just described, a portfolio of outcome-based key national indicators could also be a useful tool to help measure progress, assess trends, and communicate complex issues. The Congress should consider supporting a public/private partnership approach to making key national indicators a reality.

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<tr>
<th>Progress Made and the Key Challenges that Remain in Improving Federal Financial Management Practices</th>
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<td>The federal government has made substantial progress in financial management. If I were to summarize in just a few words the environment in 2007 as compared to prior to enactment of key financial management laws, financial management has gone from the backroom to the boardroom. There has been a cultural change in how financial management is viewed and carried out in the agencies and a recognition of the value and need for good financial management throughout government, which was not the case in 1990 when the Congress passed the CFO Act. Financial management systems and internal control have been strengthened. Generally accepted government accounting standards have been developed. For fiscal year 2006, 19 of 24 CFO Act agencies received clean audit opinions on their financial statements, up from just 6 for fiscal year 1996. While there has been marked progress in federal financial management, a number of challenges still remain, including transforming financial management and business practices at DOD, modernizing financial management systems, and building a financial management workforce for the future. Fully meeting these challenges will enable the federal government to provide the world-class financial management anticipated by the CFO Act and other management reform legislation.</td>
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<th>Progress Made since Passage of Key Federal Financial Management Legislation</th>
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<td>First, I would like to briefly highlight the legislative framework that governs federal financial management. The Congress has long recognized the importance of the federal government implementing strong financial management practices. Towards this end, the Congress has passed a series of management reform legislation aimed at improving and providing a strong foundation for federal financial management. This series of legislation started with the Federal Managers’ Financial Integrity Act of</td>
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1982 (FMFIA),\textsuperscript{6} which the Congress passed to strengthen internal control and accounting systems throughout the federal government, among other purposes. In accordance with FMFIA, GAO has issued \textit{Standards for Internal Control in the Federal Government},\textsuperscript{7} which provides the standards that are directed at helping agency managers implement effective internal control, an integral part of improving financial management systems.

While agencies had achieved some early success in identifying and correcting material internal control and accounting system weaknesses, their efforts to implement FMFIA had not produced the intended results. Therefore, the Congress passed additional management reform legislation to improve the general and financial management of the federal government. This legislation includes the (1) CFO Act of 1990, (2) Government Performance and Results Act of 1993 (GPRA),\textsuperscript{8} (3) Government Management Reform Act of 1994 (GMRA),\textsuperscript{9} (4) Federal Financial Management Improvement Act of 1996 (FFMIA),\textsuperscript{10} (5) Clinger-Cohen Act of 1996,\textsuperscript{11} (6) Accountability of Tax Dollars Act of 2002 (ATDA),\textsuperscript{12} and (7) Improper Payments Information Act of 2002 (IPIA).\textsuperscript{13}

The CFO Act is the most comprehensive and far-reaching financial management improvement act since the Budget and Accounting Procedures Act of 1950. The CFO Act established a leadership structure, provided for long-range planning, required audited financial statements and modern financial systems, and strengthened accountability reporting for certain agencies. Three years later, the Congress enacted GPRA, which required certain agencies to develop strategic plans, set performance goals, and report annually on actual performance compared to goals.

\textsuperscript{6}FMFIA is codified at 31 U.S.C. § 3512(c), (d).


GPRA’s emphasis on performance management complements the concepts in the CFO Act. GPRA was followed by GMRA, which made permanent the pilot program in the CFO Act for annual audited agency-level financial statements, expanded this requirement to all CFO Act agencies, and established a requirement for the preparation and audit of governmentwide consolidated financial statements. In 1996, FFMIA built on the foundation laid by the CFO Act by reflecting the need for CFO Act agencies to have systems that can generate reliable, useful, and timely information with which to make fully informed decisions and to ensure accountability on an ongoing basis. The Clinger-Cohen Act of 1996 (also known as the Information Technology Management Reform Act of 1996) sets forth a variety of initiatives to support better decision making for capital investments in information technology, which has led to the development of the Federal Enterprise Architecture and better-informed capital investment and control processes within agencies and across government. ATDA required most executive agencies that were not otherwise required by statute or exempted by OMB, to prepare annual audited financial statements and to submit such statements to the Congress and the Director of OMB. Finally, IPIA has increased visibility over improper payments by requiring executive agency heads, based on guidance from the OMB, to identify programs and activities susceptible to significant improper payments, estimate amounts improperly paid, and report on the amounts of improper payments and their actions to reduce them. The combination of reforms ushered in by these laws, if successfully implemented, provides a solid foundation to improve the accountability of government programs and operations as well as to routinely produce valuable cost and operating performance information.

The five key financial management improvements that we have noted from a governmentwide perspective are as follows.

- Achieving Cultural Change—We have seen true cultural change in how financial management is viewed. This has been accomplished through a lot of hard work by OMB and the agencies and continued


15OMB’s guidance defines significant improper payments as those in any particular program that exceed both 2.5 percent of program payments and $10 million annually.
strong support and oversight by the Congress. At the top level, federal financial management reform has gained momentum through the committed support of top federal leaders. For example, improved financial performance is one of the governmentwide initiatives in the President’s Management Agenda (PMA). Under this initiative, agency CFOs share responsibility—both individually and through the efforts of the CFO Council—for improving the financial performance of the government. The Executive Branch Management Scorecard, developed as part of the PMA, has been an effective tool to monitor progress and help drive much needed improvements.

- **Establishing a Governmentwide Leadership Structure**—The Joint Financial Management Improvement Program (JFMIP)\(^{16}\) Principals—the Secretary of the Treasury, the Director of OMB, the Director of OPM, and myself, the Comptroller General—have provided leadership by holding periodic meetings that have resulted in unprecedented substantive deliberations and agreements focused on key reform issues such as improving accounting for and reporting on social insurance, accelerating issuance of audited agency financial statements, and advocating audit committees. GAO has led by example in this regard, by establishing an audit advisory committee to help us in overseeing the effectiveness of our current financial reporting and audit processes.

As established by the CFO Act, the Office of Federal Financial Management (OFFM), the OMB organization with governmentwide responsibility for federal financial management for executive agencies, has demonstrated leadership by undertaking a number of initiatives related to improving financial management capabilities ranging from requiring the use of commercial off-the-shelf financial systems to the promotion of cost accounting to improve the availability of management information for decision making. In addition to assessing the status of agencies’ progress in improving financial performance for the PMA, OFFM has also issued bulletins, circulars, and other guidance.

\(^{16}\)JFMIP was originally formed under the authority of the Budget and Accounting Procedures Act of 1950 and was a joint and cooperative undertaking of the Government Accountability Office, the Department of the Treasury, OMB, and OPM, working in cooperation with each other to improve financial management practices in the federal government. A JFMIP Program Management Office developed federal financial management systems requirements, and tested core federal financial management systems. In a December 2004 memorandum, OMB announced a realignment of JFMIP’s responsibilities for financial management policy and oversight in the federal government.
to provide a broad-based foundation for transforming agencies’ financial management operations.

- **Strengthening Internal Control**—In December 2004, OMB revised its Circular No. A-123, *Management’s Responsibility for Internal Control*, to provide guidance to federal managers on improving the accountability and effectiveness of federal programs and operations by establishing, assessing, correcting, and reporting on management controls. Requiring federal managers, at the executive level, to focus on internal control demonstrates a renewed emphasis on identifying and addressing internal control weaknesses. As we testified in 2005, many internal control problems have been identified and fixed, especially at the lower levels where internal control assessments were performed and managers could take focused actions to fix relatively simple problems. As a recent case in point, based on our 2006 assessment of high-risk programs, two programs previously designated as high risk, largely due to financial management weaknesses, were removed from the list.

Agencies have also made progress in implementing processes and controls to identify, estimate, and reduce improper payments. After passage of IPIA, OMB established Eliminating Improper Payments in 2005 as a new program-specific initiative under the PMA. This separate PMA program initiative was established in this manner to ensure that agency managers are held accountable for meeting the goals of IPIA and are, therefore, dedicating the necessary attention and resources to meeting IPIA requirements. OMB also issued guidance in August 2006 to help clarify and update requirements to support governmentwide IPIA compliance.

- **Improving Financial Management Systems and Operations**—Since enactment of financial management reform legislation, federal financial management systems requirements have been developed for the core financial system; managerial cost system; and other administrative and programmatic systems, such as grants, property, revenue, travel, and loans, which are part of an overall financial management system. After

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the realignment of the JFMIP Program Management Office, OFFM has continued the practice of issuing these requirements. Beginning in 1999, OMB required agencies to purchase commercial off-the-shelf software that had been tested and certified by the federal government against the systems requirements that I just mentioned. With these requirements, the federal government has better defined the functionality needed in its financial management systems, which has helped the vendor community understand federal agencies’ needs.

OMB continues to move forward on initiatives that support the PMA with the further development of the financial management line of business to promote leveraging shared service solutions to enhance the government’s performance and services. The financial management line of business initiative is modeled after the consolidation of agencies processing payroll, which were dramatically reduced from 22 to 4 systems. OMB, in conjunction with an interagency task force, estimated that these efforts could save billions of taxpayer dollars. Ultimately, this initiative is expected to (1) reduce the number of systems that each individual agency must support, (2) promote standardization, and (3) reduce the duplication of efforts.

- **Preparing Auditable Financial Statements**—Unqualified audit opinions for CFO Act agencies’ financial statements have grown from 6 in fiscal year 1996 to 19 in fiscal year 2006. Improvements in timeliness have been even more dramatic over the years. Agencies were able to issue their audited financial statements within the accelerated reporting time frame—all 24 CFO Act agencies issued their audited financial statements by the November 15, 2006, deadline, set by OMB, just 45 days after the close of the fiscal year. Just a few years ago, most considered this accelerated time frame unrealistic and unachievable.

Another definitive example of progress made to date is the establishment of the Federal Accounting Standards Advisory Board (FASAB). In conjunction with the passage of the CFO Act, the OMB Director, Secretary of the Treasury, and the Comptroller General established FASAB to develop accounting standards and principles for

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20The independent auditors for the Department of State’s fiscal year 2006 financial statements issued a disclaimer of opinion on November 14, 2006, because the department could not provide evidential matter in a timely manner to meet the November 15, 2006, reporting deadline. After receiving adequate documentation to support the amounts on the financial statements, the auditors issued an unqualified opinion on the Department of State’s fiscal year 2006 financial statements on December 12, 2006.
the newly required financial statements. The concepts and standards are the basis for OMB’s guidance to agencies on the form and content of their financial statements and for the government’s consolidated financial statements. FASAB is comprised of a 10-member advisory board of 4 knowledgeable individuals from government and 6 nonfederal members selected from the general financial community, the accounting and auditing community, and academia to promulgate proposed accounting standards designed to meet the needs of federal agencies and other users of federal financial information. The mission of FASAB is to develop accounting standards after considering the financial and budgetary information needs of congressional oversight groups, executive agencies, and other users. These accounting and reporting standards are essential for public accountability and for an efficient and effective functioning of our democratic system of government. The standards developed by FASAB have been recognized by the American Institute of Certified Public Accountants as generally accepted accounting standards for federal entities.

Financial Management Challenges Facing the Federal Government

While there has been marked progress in federal financial management, a number of challenges still remain. The principal challenges remaining are (1) transforming financial management and business practices at DOD, (2) improving financial and performance reporting, (3) modernizing financial management systems, (4) tackling long-standing internal control weaknesses, (5) building a financial management workforce for the future, and (6) strengthening consolidated financial reporting. Fully meeting these challenges will enable the federal government to provide the world-class financial management anticipated by the CFO Act and other management reform legislation. While there continues to be much focus on the agency and governmentwide audit opinions, getting a clean audit opinion, though important in itself, is not the end goal. The end goal is the establishment of a fully functioning CFO operation that includes (1) modern financial management systems that provide reliable, timely, and useful information to support day-to-day decision making and oversight, and for the systematic measurement of performance; (2) sound internal controls that safeguard assets and help ensure proper accountability; and (3) a cadre of highly qualified CFOs and supporting staff.

Transforming DOD’s Financial and Business Management Practices

DOD’s long-standing financial and business management difficulties are pervasive, complex, and deeply rooted in virtually all business operations throughout the department. Resolution of these serious problems is essential to improving financial management governmentwide and achieving an opinion on the U.S. government’s consolidated financial
statements. Of the 27 areas on GAO's high-risk list, DOD has 8 of its own high-risk areas and shares responsibility for 7 governmentwide high-risk areas. These weaknesses adversely affect the department’s and the federal government’s ability to control costs; ensure basic accountability; anticipate future costs and claims on the budget; measure performance; maintain funds control; prevent fraud, waste, and abuse; and address pressing management problems. Additionally, the department invests billions of dollars each year to operate, maintain, and modernize its business systems. But despite this significant annual investment, the department has been continually confronted with the difficult task of implementing business systems on time, within budget, and with the promised capability.

We also have concerns about the reasonableness, reliability, and transparency of DOD’s budget requests, especially the supplemental budget requests the department has submitted to the Congress in recent years. Reasonableness and reliability are critical factors not only for financial information, but also for budget data. As I testified last year, our prior work found numerous problems with DOD’s processes for recording and reporting costs for the Global War on Terrorism (GWOT), the funding for which has been provided through regular appropriations as well as supplemental appropriations. These problems included long-standing deficiencies in DOD’s financial management systems and business processes, the use of estimates instead of actual cost data, and the lack of adequate supporting documentation. As a result, neither DOD nor the Congress have reliable information on GWOT costs or the use of appropriated funds and also lack historical data useful in considering future funding needs.

The nature and severity of DOD’s financial management, business operations, and system deficiencies not only affect financial reporting, but also impede the ability of DOD managers to receive the full range of information needed to effectively manage day-to-day operations. Such weaknesses have adversely affected the ability of DOD to control costs, ensure basic accountability, and prevent fraud. The following examples illustrate DOD’s continuing problems.

21 GAO-07-310.

We found that hundreds of separated battle-injured soldiers were pursued for collection of military debts incurred through no fault of their own, including 74 soldiers whose debts had been reported to credit bureaus, private collection agencies, and the Treasury Offset Program at the time we initiated our audit. Overpayment of pay and allowances (entitlements), pay calculation errors, and erroneous leave payments caused 73 percent of the reported debts.

Over the past several years, we have reported on significant pay problems experienced by mobilized Army National Guard and Army Reserve (Army Guard and Reserve) soldiers in the wake of the September 11, 2001, terrorist attacks. These reports included examples of hundreds of soldiers receiving inaccurate and untimely payroll payments due to a paper-intensive, error-prone pay process and the lack of integrated pay and personnel systems. In response to our reports, DOD has taken some action to improve controls designed to pay Army Guard and Reserve soldiers accurately and on time, especially those who had become sick or injured in the line of duty.

In March 2006, we reported that DOD’s policies and procedures for determining, reporting, and documenting cost estimates associated with environmental cleanup or containment activities were not consistently followed. Further, none of the military services had adequate controls in place to help ensure that all identified contaminated sites were included in their environmental liability cost estimates.

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estimates. These weaknesses not only affected the reliability of DOD’s environmental liability estimate, but also that of the federal government as a whole.

- In May 2005, we reported\textsuperscript{26} that DOD did not have management controls in place to assure that excess inventory was reutilized to the maximum extent possible. We found significant waste and inefficiency because new, unused, and excellent condition items were transferred and donated outside of DOD, sold for pennies on the dollar, or destroyed. Root causes for the waste and inefficiency included (1) unreliable excess property inventory data; (2) inadequate oversight and physical inventory control; and (3) outdated, nonintegrated excess inventory and supply management systems.

The department is provided billions of dollars annually to operate, maintain, and modernize its stovepiped, duplicative, legacy business systems. Despite this significant investment, the department is severely challenged in implementing business systems on time, within budget, and with the promised capability. Many of the problems related to DOD’s inability to effectively implement its business systems can be attributed to its failure to implement the disciplined processes\textsuperscript{27} necessary to reduce the risks associated with these projects to acceptable levels.\textsuperscript{28} Disciplined processes have been shown to reduce the risks associated with software development and acquisition efforts and are fundamental to successful systems acquisition. The weaknesses that we found in DOD business systems implementations such as the Defense Travel System,\textsuperscript{29} the Logistics Modernization Program,\textsuperscript{30} and the Navy’s Enterprise Resource


\textsuperscript{27}Disciplined processes include a wide range of activities, including project planning and management, requirements management, risk management, quality assurance, and testing.

\textsuperscript{28}Acceptable levels refer to the fact that any systems acquisition effort will have risks and will suffer the adverse consequences associated with defects in the processes. However, effective implementation of disciplined processes reduces the possibility of the potential risks actually occurring and prevents significant defects from materially affecting the cost, timeliness, and performance of the project.


Planning (ERP) efforts illustrate the types of system acquisition and investment management controls that need to be effectively implemented in order for a given investment to be successfully acquired and deployed.

*Meeting the Challenge of Transforming DOD Financial and Business Management Practices.* Successful reform of DOD’s fundamentally flawed financial and business management operations must simultaneously focus on its systems, processes, and people. DOD’s top management has demonstrated a commitment to transforming the department and has launched key initiatives to improve its financial management processes and related business systems such as the Financial Improvement and Audit Readiness (FIAR) Plan. However, DOD still lacks two key elements that are needed to ensure a successful and sustainable transformation effort.

- As we have previously recommended, DOD should develop and implement an integrated and strategic business transformation plan. Since 1999, we have recommended the need for a comprehensive, integrated strategy and action plan for reforming DOD’s major business operations and support activities. Critical to the success of DOD’s ongoing transformation efforts will be top management attention and structures that focus on transformation from a broad perspective and a clear, comprehensive, integrated, and enterprisewide plan that, at a summary level, addresses all of the department’s major business areas.

- Because of the complexity and long-term nature of DOD’s business transformation efforts, we again reiterate the need for a chief management officer (CMO) to provide sustained leadership and

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maintain momentum, as we have previously testified.\textsuperscript{33} The National Defense Authorization Act for Fiscal Year 2006\textsuperscript{34} directs the department to study the feasibility of a CMO position in DOD. In this regard, the Institute for Defense Analysis issued its report in December 2006 and, among other things, called upon the Congress to establish a Deputy CMO (level III official) at the department. Further, in May 2006, the Defense Business Board recommended, among other things, the creation of a Principal Under Secretary of Defense, as a level II official with a 5-year term appointment, to serve as CMO. I strongly support a level II official and believe that someone at this level is needed to be successful given the magnitude of the challenge and the need to effect change across the department. It is important to note that a CMO would not assume the responsibilities of the undersecretaries of defense, the service secretaries, or other DOD officials for the day-to-day management of the department. Rather, the CMO would be responsible and accountable for planning, integrating, and executing the overall business transformation effort. The reason I am so passionate about the need for a CMO at DOD is that progress at DOD has historically been painfully slow. A host of well-intended past improvement initiatives has largely failed. I am concerned that without a CMO who is responsible and accountable for demonstrable results and sustained success, history will continue to repeat itself.

In the area of agency financial and performance reporting, I see obtaining unqualified opinions on financial statements at all CFO Act agencies as the primary challenge. While significant progress has been made by many CFO Act agencies to prepare timely annual financial statements that can pass the scrutiny of a financial audit, several agencies continue to struggle to reach this milestone. For fiscal year 2006, five CFO Act agencies—DOD,


DHS, National Aeronautics and Space Administration (NASA), and the Departments of Energy and Transportation—failed to meet this basic requirement. Problems at NASA and the Department of Energy stem from deficiencies in those agencies’ implementation of new financial management systems, among other things. The Department of Transportation auditors cited significant problems with a key accounting practice at the Federal Aviation Administration as the underlying cause for qualifying their opinion on the department’s financial statements. As I previously discussed, the problems faced by DOD are so pervasive that in accordance with section 1008 of the fiscal year 2002 National Defense Authorization Act, for the sixth year, DOD acknowledged that its systems could not support material amounts on DOD’s fiscal year 2006 financial statements and accordingly, the auditors did not perform auditing procedures and disclaimed an opinion. At DHS, the auditors recognized that the department has not yet established the infrastructure and internal control necessary and disclaimed an opinion on its financial statements. Problems at these agencies also significantly impact our ability to provide an opinion on the U.S. government’s consolidated financial statements.

Meeting the Challenge of Improved Financial and Performance Reporting. Addressing the financial and performance reporting weaknesses that impede CFO Act agencies from obtaining unqualified or clean opinions on the respective agency financial statements will vary depending upon the circumstances at the agency. Developing and implementing corrective action plans to address the identified problems are time-honored methods for resolving such problems. For example, the DOD Comptroller launched the FIAR Plan to guide improvements to address financial management deficiencies and achieve clean financial statement audit opinions. This plan incorporates our prior recommendations and ties planned improvement activities at the component and department levels together with accountable personnel, milestones, and required resources. We view the incremental line item approach, integration plans, and oversight structure outlined in the FIAR plan for examining DOD’s operations and preparing for an audit as a

35 For fiscal year 2006, only the Consolidated Balance Sheet and Statement of Custodial Activity were subjected to audit, and the auditor was unable to express an opinion on these two financial statements.

36 For fiscal year 2006, only the Consolidated Balance Sheet of the Department of Energy was subjected to audit, and the auditor qualified its opinion on this statement.

significant improvement over prior financial improvement initiatives. However, we continue to stress that the effectiveness of DOD's FIAR plan will ultimately be measured by the department’s ability to provide timely, reliable, and useful information for day-to-day management and decision making.

Since the passage of the CFO Act and FFMIA, there has been progress in achieving the financial systems requirements of these landmark laws. While improvements have been made throughout government, much work remains to fulfill the underlying goals of the CFO Act and FFMIA. In fiscal year 1997, 20 agencies were reported as having systems that were not in substantial compliance with at least one of the three FFMIA systems requirements, while in fiscal year 2006, auditors for 17 of the CFO Act agencies reported that the agencies' financial management systems did not substantially comply with at least one of the three FFMIA requirements. The major barrier to achieving compliance with FFMIA continues to be the inability of agencies to meet federal financial management systems requirements, which involve not only core financial systems, but also administrative and programmatic systems. While the problems are much more severe at some agencies than at others and progress has been made in addressing financial management systems’ weaknesses, the lack of substantial compliance with the three requirements of FFMIA, and the associated deficiencies, indicates that the financial management systems of many agencies are still not able to routinely produce reliable, useful, and timely financial information. Consequently, the federal government’s access to relevant, timely, and reliable data to effectively manage and oversee its major programs, which is the ultimate objective, was and continues to be restricted.

What is most important is that the problem has been recognized. Across government, agencies have efforts under way to implement new financial management systems or to upgrade existing systems. Agencies expect that the new systems will provide reliable, useful, and timely data to support day-to-day managerial decision making and assist taxpayer and congressional oversight. Whether in government or the private sector, implementing and upgrading information systems is a difficult job and brings a degree of new risk. Organizations that follow and effectively

Modernizing Financial Management Systems

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FFMIA requires CFO Act agencies financial management systems to comply substantially with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the U.S. government standard general ledger at the transaction level.
implement accepted best practices in systems development and implementation (commonly referred to as disciplined processes) can manage and reduce these risks to acceptable levels. For example, as part of our work at DOD, NASA, and other agencies that have experienced significant problems in implementing new financial management systems, we have consistently found that these agencies were not following the necessary disciplined processes, human capital practices, and information technology management practices for efficient and effective development and implementation of such systems.

Challenges also exist in implementing OMB's financial management line of business initiative that is aimed at significantly improving the financial data government managers need to make timely and successful decisions and reduce the cost of government operations. For example, as we reported in March 2006, the requirements for agencies and private sector firms to become shared service providers and the services they must provide have not been adequately documented or effectively communicated to agencies and the private sector. We made several recommendations that focused on reducing the risk of this important initiative. During 2006, OMB addressed some of the weaknesses by issuing an initial version of migration planning guidance and publishing competition guidance for shared service providers and agencies. However, as OMB acknowledged in the Federal Financial Management Report 2007, it has not yet developed several critical elements needed to minimize risk, provide assurance, and develop understandings with software vendors, shared service providers, and agencies on topics such as standard business processes and common accounting codes. Further, a


governmentwide concept of operations has not been developed that would identify interrelationships among federal financial systems and which financial management systems should be operated at an agency level and which should be operated at a governmentwide level and how those would integrate. In addition, processes have not been put in place to facilitate agency decisions on selecting a provider or focusing investment decisions on the benefits of standard processes and shared service providers.

Meeting the Challenge of Modernizing Financial Systems. As the federal government moves forward with ambitious financial management system modernization efforts that identify opportunities to eliminate redundant systems and enhance information reliability and availability, adherence to disciplined processes, sound human capital practices, and proven information technology management practices is crucial to reduce risks to acceptable levels.

- To help address the underlying problems agencies face in implementing financial management systems that will help them adhere to the requirements of the CFO Act and FFMIA, we have made numerous specific recommendations to agencies to address the specific shortcomings we identified. For example, at NASA we made a total of 45 recommendations aimed at addressing weaknesses we identified in NASA’s acquisition and implementation strategy for a new integrated financial management system.

- The key to avoiding these long-standing problems is to provide specific guidance to agencies that incorporate the best practices identified by the Software Engineering Institute, the Institute of Electrical and Electronic Engineers, and other experts. Toward this end, we have recommended that OMB develop such guidance to help minimize the waste of scarce resources from modernization failures.

- We have also made a number of recommendations to OMB to help it provide a solid foundation for the financial management line of business initiative. OMB has projects under way to develop standard business processes, a common accounting code, and specific measures to assess the performance of the shared service providers to help address some shortcomings we identified. While all of these projects are important, developing a concept of operations is an important step because it lays the foundation for many subsequent decisions.

Addressing Long-standing Internal Control Weaknesses

While continuing progress has been made in strengthening internal control, at the same time, the federal government faces numerous internal
control problems, some of which are long-standing and are well-
documented at the agency level and governmentwide. As we have reported
for a number of years in our audit reports on the U.S. government’s
consolidated financial statements, the federal government continues to
have material weaknesses and reportable conditions in internal control
related to property, plant, and equipment; inventories and related
property; liabilities and commitments and contingencies; cost of
government operations; and disbursement activities, just to mention a few
of the problem areas. Particularly problematic to the U.S. government’s
consolidated financial statements is the lack of internal controls to
adequately account for and reconcile intragovernmental activity and
balances between federal agencies. Although OMB and Treasury require
the CFOs of 35 executive departments and agencies to reconcile
intragovernmental activity and balances on a quarterly basis, and report
annually to GAO and others on reconciliation efforts at the end of the
fiscal year, a substantial number of agencies did not adequately perform
these reconciliations. To help address this problem, OMB worked with
Treasury and the CFO Council to revise the business rules for
intragovernmental transactions. Because these new rules became effective
on October 1, 2006, it is too soon to tell if they will have the desired effect
of strengthening internal controls. Resolving the intragovernmental
transactions problem remains a difficult challenge and will require a
strong commitment by agencies to fully implement the recently issued
business rules and continued strong leadership by OMB.

As we testified\textsuperscript{42} in February 2005, we support OMB’s efforts to revitalize
internal control assessments and reporting through the December 2004
revisions to Circular No. A-123. These revisions recognize that effective
internal control is critical to improving federal agencies’ effectiveness and
accountability and to achieving the goals established by the Congress.
They also considered the internal control standards issued by GAO,\textsuperscript{43}
which provide an overall framework for establishing and maintaining
internal control and for identifying and addressing major performance and
management challenges and areas at greatest risk of fraud, waste, abuse,
and mismanagement. OMB reported in its \textit{Federal Financial Management
Report 2007}, that CFO Act agencies identified new financial reporting
material weaknesses under this revised guidance, which is an important

\textsuperscript{42}GAO, \textit{Financial Management: Effective Internal Control is Key to Accountability}, GAO-

\textsuperscript{43}GAO/AIMD-00-21.3.1.
first step. As agencies expand their assessments and all agencies complete a full-scope assessment of internal control over financial reporting, they will develop a better understanding of the full nature and extent of material weaknesses.

Effective internal control, as envisioned in the revised Circular No. A-123, inherently includes a successful strategy for addressing improper payments. Attacking improper payment problems requires a strategy appropriate to the organization involved and its particular risks. We have found that entities using successful strategies to address their improper payment problems shared a common focus of improving the internal control system—the first line of defense in safeguarding assets and preventing and detecting errors and fraud. The Congress acted strongly to address the improper payment problem by passing IPIA and in fiscal year 2005, OMB began to separately track the elimination of improper payments under the PMA. As I pointed out in testimony before this Subcommittee in December 2006, while agencies are making progress in reporting under IPIA, three major challenges remain in meeting the goals of the act. First, the existing reporting was incomplete because some agencies still had not instituted systematic methods to review all programs and some program estimates were not based on a valid statistical sampling methodology as required. Second, 10 risk-susceptible programs with outlays totaling over $234 billion in fiscal year 2005 had not provided improper payment estimates. Finally, OMB's implementing guidance includes specific criteria that limit the disclosure and transparency of agencies' improper payments.

Meeting the Challenge of Addressing Internal Control Weaknesses. Actions can be taken on several fronts to help resolve internal control weaknesses.

- As pointed out in our February 2005 testimony on internal controls, there are six issues critical to effectively implementing the changes to Circular No. A-123—specifically, the need for: (1) development of supplemental guidance and implementation tools to help ensure that agency efforts are properly focused and meaningful; (2) vigilance over

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45GAO-05-321T.
the broader range of controls covering program objectives; (3) strong
support from managers throughout the agency, and at all levels; (4)
risk-based assessments and an appropriate balance between the costs
and benefits of controls; (5) management testing of controls in
operation to assess if they are designed adequately and operating
effectively, and to assist in formulating corrective actions; and (6)
management accountability for control breakdowns.

- Addressing the multitude of problems in financial reporting internal
controls, including reconciling intragovernmental activity and balances,
that have been identified to date will require a significant effort over a
long time. Many of these problems have been around for years and
have proven resistant to actions to resolve them. Continuous
monitoring by top agency management and OMB along with oversight
by the Congress will be critical to successfully resolving these material
weaknesses and enhancing financial management.

- The ultimate success of efforts to reduce improper payments depends,
in part, on each agency’s continuing diligence and commitment to
meeting the requirements of IPIA and the related OMB guidance. Full
and reasonable disclosure of the extent of the problems could be
enhanced by modifying the act’s underlying criteria used to identify
which programs and activities are susceptible to significant improper
payments and we asked\(^46\) the Congress to consider amending IPIA to do
so. We also recommended that OMB’s implementing guidance be
strengthened in several areas.

**Building a Financial Management Workforce for the Future**

The financial management workforce plays a critical role in government
because the scale and complexity of federal activities requiring financial
management and control are monumental. The federal government has
always faced the challenge of sustaining the momentum of transformation
because of the limited tenure of key administration officials. The current
administration’s PMA has served as a driver for governmentwide financial
management improvements. It has been clear from the outset that the
current administration is serious about improved financial management.
We have been fortunate that, since the passage of the CFO Act, all three
administrations have been supportive of financial management reform
initiatives. And, as I discussed earlier, we have seen a positive cultural

shift in the way the federal government conducts business. Given the long-term nature of the comprehensive changes needed and challenges still remaining to fully realize the goals of the CFO Act, it is unlikely they will all occur before the end of the current administration’s term. Therefore, sustaining a commitment to transformation in future administrations will be critical to ensure that key management reforms, such as the CFO Act, are fully attained.

Changing the way business is done in a large, diverse, and complex organization like the federal government is not an easy undertaking. According to a survey of federal CFOs, federal finance organizations of the future will have fewer people, with a greater percentage of analysts, as opposed to accounting technicians. However, today most functions within federal finance organizations are focused primarily on (1) establishing and administering financial management policy; (2) tracking, monitoring, and reconciling account balances; and (3) ensuring compliance with laws and regulations. While they recognize the need for change, according to the CFOs surveyed, many questions remain unanswered regarding how best to facilitate such changes.

When it comes to world-class financial management, our study of nine leading private and public sector financial organizations found that leading financial organizations often had the same or similar core functions (i.e., budgeting, treasury management, general accounting, and payroll) as the federal government. However, the way these functions were put into operation varied depending on individual entity needs. Leading organizations reduced the number of resources required to perform routine financial management activities by (1) consolidating activities at a shared service center and (2) eliminating or streamlining duplicative or inefficient processes. Their goal was not only to reduce the cost of finance but also to organize finance to add value by reallocating finance resources to more productive and results-oriented activities like measuring financial performance, developing managerial cost information, and integrating financial systems.


The federal financial workforce that supports the business needs of today is not well-positioned to support the needs of tomorrow. A JFMIP study\(^49\) indicated that a significant majority of the federal financial management workforce performs transaction support functions of a clerical and technical nature. These skills do not support the vision of tomorrow’s business which will depend on an analytic financial management workforce providing decision support. A 2005 survey of senior level federal CFO executives\(^50\) noted that the respondents still believed that mid- and lower-level personnel lack the skills needed for modern financial management. The 2005 survey indicated that the federal CFO community thought that overly complex civil service rules made it difficult to recruit entry-level talent and nearly impossible to hire middle managers from outside the government. Our work has shown that staffing shortages, particularly at key agencies such as DOD, DHS, and Treasury, can adversely impact financial management operations. For example, as part of our work on the U.S. government’s consolidated financial statements, we found that personnel at Treasury’s Financial Management Service had excessive workloads that required an extraordinary amount of effort and dedication to compile the consolidated financial statements and that there were not enough personnel with specialized financial reporting experience to help ensure reliable financial reporting by the reporting date.\(^51\)

**Meeting the Challenge of Building the Financial Management Workforce.**

We have previously identified several factors that are critical to resolving financial management human capital issues.

- Part of the commitment to transformation is the establishment of skilled and sustained leadership through the creation of a chief management officer (CMO) at selected federal agencies. The CMO would serve as the strategic, enterprisewide integrator of efforts to transform agency business operations, including financial management. While we have called for the creation of such a position specifically at DOD and DHS, in July 2006, a major global consulting firm


\(^{51}\)See GAO’s audit report on its audit of the federal government’s fiscal year 2006 financial statements that was incorporated in the *2006 Financial Report of the U.S. Government* published by Treasury.
Building a world-class financial workforce will require a workforce transformation strategy devised in partnership between CFOs and agency human resource departments, now established in law as Chief Human Capital Officers, working with OMB and OPM. Agency financial management leadership must identify current and future required competencies and compare them to an inventory of skills, knowledge, and current abilities of current employees. Then they must strategically manage to fill gaps and minimize overages through informed hiring, development, and separation strategies. This is similar to the approach that we identified when we designated strategic human capital management as a high-risk area in 2001.\textsuperscript{53} Achieving a successful financial management vision of the future will be directly determined by the workforce that supports it. In our view, adequate succession planning to ensure these positions and other key senior-level financial management positions are promptly filled with highly qualified staff will be a key success factor to help transform federal financial management.

As you know, GAO is responsible for auditing the consolidated financial statements included in the \textit{Financial Report of the United States Government (Financial Report)}, but we have been unable to express an opinion on them for the 10th year in a row because the federal government could not demonstrate the reliability of significant portions of the financial statements, especially in connection with major financial management challenges that I discussed earlier regarding DOD. The lack of effective internal controls to adequately account for and reconcile intragovernmental activity and balances is another primary challenge that impedes our ability to provide an opinion on the consolidated financial statements. The third major impediment that prevents us from rendering an opinion on the consolidated financial statements is the federal government’s ineffective process for preparing the consolidated financial statements. As I previously discussed, addressing the first two impediments will be difficult challenges. Resolving the weaknesses in the


\footnote{\textsuperscript{53}GAO-05-207.}
systems, controls, and procedures for preparing the consolidated financial statements is also a formidable challenge.

While further progress was demonstrated in fiscal year 2006, the federal government continued to have inadequate 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 U.S. generally accepted accounting principles. Most of the issues we identified in fiscal year 2006 existed in fiscal year 2005, and many have existed for a number of years. In addition, Treasury could not provide the final fiscal year 2006 consolidated financial statements and supporting documentation in time for us to complete all of our planned auditing procedures. During our fiscal year 2006 audit, we found the following:

- Treasury showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies’ audited financial statements and that the Balance Sheet and the Statement of Net Cost were consistent with federal agencies’ financial statements prior to eliminating intragovernmental activity and balances. However, Treasury’s process for compiling the consolidated financial statements did not ensure that the information in the remaining three 2006 principal financial statements and notes were fully consistent with the underlying information in federal agencies’ audited financial statements and other financial data.

- To make the fiscal years 2006 and 2005 consolidated financial statements balance, Treasury recorded net decreases of $11 billion and $4.1 billion, respectively, to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled “Other - Unmatched transactions and balances.”54 An additional net $10.4 billion and $3.2 billion of unmatched transactions were recorded in the Statement of Net Cost for fiscal years 2006 and 2005, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.

- The federal government did not have an adequate process to fully identify and report items needed to reconcile the operating results,

54 Although Treasury was unable to determine how much of the unmatched transactions and balances, if any, relate to operations, it reported this amount as a component of net operating cost in the accompanying consolidated financial statements.
which for fiscal year 2006 showed a net operating cost of $449.5 billion, to the budget results, which for the same period showed a unified budget deficit of $247.7 billion.

We also noted other deficiencies related to the adequacy of required disclosures and whether amounts reported are complete. Treasury continued to make progress in addressing certain other internal control weaknesses in its process for preparing the consolidated financial statements. However, internal control weaknesses continued to exist involving a lack of (1) appropriate documentation of certain policies and procedures for preparing the consolidated financial statements, (2) adequate supporting documentation for certain adjustments made to the consolidated financial statements, and (3) effective management reviews.

As in previous years, Treasury did not have adequate systems and personnel to address the magnitude of the fiscal year 2006 financial reporting challenges it faced, such as (1) the Governmentwide Financial Report System (GFRS) undergoing further development\textsuperscript{55} and not yet being fully operational, and (2) weaknesses in Treasury’s process for preparing the consolidated financial statements noted above. One of the underlying causes of these weaknesses, as I discussed earlier, is the lack of sufficient personnel with specialized financial reporting experience to help ensure reliable financial reporting by the reporting date.

*Meeting the Challenge of Strengthening Consolidated Financial Reporting.* During fiscal year 2006, Treasury, in coordination with OMB, developed and began implementing corrective action plans and milestones for short-term and long-range solutions for certain internal control weaknesses we have previously reported regarding the process for preparing the consolidated financial statements. In April 2006, we reported\textsuperscript{56} in greater detail on these issues and provided recommendations.

\textsuperscript{55}GFRS uses a closing package methodology that has been developed to capture each federal agency’s information and link the agencies’ audited financial statements to the governmentwide consolidated financial statements. See GAO, *Financial Management Systems: Lack of Disciplined Processes Puts Effective Implementation of Treasury’s Governmentwide Financial Report System at Risk*, GAO-06-413 (Washington, D.C.: Apr. 21, 2006).

to OMB and Treasury. Resolving some of these internal control weaknesses will require a strong commitment from Treasury and OMB as they execute and implement their corrective action plans.

Overcoming current challenges will be difficult, but after a decade of reporting at the governmentwide level perhaps now is an appropriate time to step back and consider the need for further revisions to the current federal financial reporting model, which would affect both consolidated and agency financial reporting. While the current reporting model recognizes some of the unique needs of the federal government, a broad reconsideration of the federal financial reporting model could address the following types of questions.

- What kind of information is most relevant and useful for a sovereign nation?

- Do traditional financial statements convey information in a transparent manner?

- What is the role of the balance sheet in the federal government reporting model?

- How should items that are unique to the federal government, such as social insurance commitments and the power to tax, be reported?

Engaging in a reevaluation of this nature could stimulate discussion that would bring about a new way of thinking about the federal government’s financial and performance reporting needs. To understand various perceptions and needs of stakeholders for federal financial reporting, a wide variety of stakeholders from the public and private sector should be consulted. Ultimately, the goal of such a reevaluation would be reporting enhancements that can help the Congress deliberate strategies to address the federal government’s challenges, including those of our growing long-term fiscal imbalance.

More specifically, we continue to support several specific improvements to federal financial reporting. For example, the federal government’s financial reporting should be expanded to disclose the reasons for significant changes during the year in scheduled social insurance benefits and funding. It should also include a Statement of Fiscal Sustainability—providing a long-term look at the sustainability of current federal fiscal policy in the context of all major federal spending programs and tax
policies. The reporting on fiscal sustainability should include additional information that will assist in understanding the sustainability of current social insurance and other federal programs, including key measures of fiscal sustainability and intergenerational equity, projected annual cash flows, and changes in fiscal sustainability during the reporting period. We believe that such reporting needs to reflect the significant commitments associated with the Social Security and Medicare programs while recognizing a liability for the net assets (principally investments in special U.S. Treasury securities) of the “trust funds.” We support the current efforts of the Federal Accounting Standards Advisory Board (FASAB) to begin a project on fiscal sustainability reporting. In addition, an easily understandable summary annual report should be prepared and published that includes in a clear, concise, and transparent manner, key financial and performance information embodied in the Financial Report. Later in this statement, I offer other suggestions for improved reporting that will help in this regard.

Fiscal Stewardship Is an Increasingly Critical Challenge

Successfully addressing the six primary challenges I just described will undoubtedly help strengthen the federal government’s financial and performance reporting and resolve many accountability and stewardship challenges. This will become increasingly important, because as I stated in our audit report included in the Financial Report, testified before the Congress, and emphasized in numerous speeches, the nation’s current fiscal path is unsustainable and tough choices by the President and the Congress are necessary to address the nation’s large and growing long-term fiscal imbalance.

The federal government’s financial condition and fiscal outlook are worse than many may understand. We are currently experiencing strong economic growth and yet running large on-budget (operating) deficits that are largely unrelated to the Global War on Terrorism. Despite an increase in revenues in fiscal year 2006 of about $255 billion, the federal government reported that its costs exceeded its revenues by $450 billion (i.e., net operating cost) and that its cash outlays exceeded its cash receipts by $248 billion (i.e., unified budget deficit). Further, as of September 30, 2006, the U.S. government reported that it owed (i.e., liabilities) more than it owned (i.e., assets) by almost $9 trillion. In

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57Intergenerational equity assesses the extent to which different age groups may be required to assume financial burdens to sustain federal responsibilities.
addition, the present value of the federal government’s major reported long-term “fiscal exposures”—liabilities (e.g., debt), contingencies (e.g., insurance), and social insurance and other commitments and promises (e.g., Social Security, Medicare)—rose from about $20 trillion to over $50 trillion in the last 6 years.

The federal government faces large and growing structural deficits in the future due primarily to known demographic trends and rising health care costs. These structural deficits—which are virtually certain given the design of our current programs and policies—will mean escalating and ultimately unsustainable federal deficits and debt levels. Based on various measures—and using reasonable assumptions—the federal government’s current fiscal policy is unsustainable.

The Long-Term Fiscal Outlook

In addition to considering the federal government’s current financial condition, it is critical to look at other measures of the long-term fiscal outlook of the federal government. An evaluation of the nation’s long-term fiscal outlook should include not only liabilities included in the Financial Report but also the implicit promises embedded in current policy and the timing of these longer-term obligations and commitments in relation to the resources available under various assumptions.

Over the next few decades, the nation’s fiscal outlook will be shaped largely by known demographic trends and rising health care costs. As the baby-boom generation retires, federal spending on current retirement and health care programs—Social Security, Medicare, and Medicaid—will grow dramatically. A range of other federal fiscal commitments, some explicit and some representing implicit public expectations, also bind the nation’s fiscal future. Absent policy changes, a growing imbalance between expected federal spending and tax revenues will mean escalating and ultimately unsustainable federal deficits and debt levels.

There are various ways to consider and assess the long-term fiscal outlook, including

- the Statement of Social Insurance,
- major reported long-term fiscal exposures, and
- long-term fiscal simulations.
Statement of Social Insurance. The Statement of Social Insurance in the Financial Report displays the present value of projected revenues and expenditures for scheduled benefits of certain benefit programs that are referred to as social insurance (e.g., Social Security, Medicare). For Social Security and Medicare alone, projected expenditures for scheduled benefits for the next 75 years exceed earmarked revenues (e.g., dedicated payroll taxes, premiums, and existing government bonds in the trust funds) for the same period by approximately $39 trillion in present value terms. Stated differently, one would need approximately $39 trillion invested today to deliver on the currently promised benefits for the next 75 years. Table 1 shows a simplified version of the Statement of Social Insurance by its primary components.

Table 1: Simplified Statement of Social Insurance as of January 1, 2006

<table>
<thead>
<tr>
<th></th>
<th>Social Security</th>
<th>Medicare Hospital Insurance (Part A)</th>
<th>Medicare Supplementary Medical Insurance – Part B</th>
<th>Medicare Supplementary Medical Insurance – Part D</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of future revenue (earmarked contributions, taxes, and premiums)</td>
<td>$32</td>
<td>$11</td>
<td>$5</td>
<td>$2</td>
<td>$50</td>
</tr>
<tr>
<td>Present value of expenditures for scheduled future benefits(^a)</td>
<td>(39)</td>
<td>(22)</td>
<td>(18)</td>
<td>(10)</td>
<td>(89)</td>
</tr>
<tr>
<td>Present value of future expenditures in excess of future revenue(^b)</td>
<td>($7)</td>
<td>($11)</td>
<td>($13)</td>
<td>($8)</td>
<td>($39)</td>
</tr>
</tbody>
</table>

Source: The Department of the Treasury.

\(^a\)These amounts include administrative expenses for the programs.

\(^b\)Under current law, Social Security and Federal Hospital Insurance (Medicare Part A) payments are limited to amounts available to the respective trust funds.

Note: Data are from the fiscal year 2006 Financial Report.
Major Reported Long-Term Fiscal Exposures. GAO developed the concept of “fiscal exposures” to provide a framework for considering the wide range of responsibilities, programs, and activities that explicitly or implicitly expose the federal government to future spending.

The concept of fiscal exposures is meant to provide a broader perspective on long-term costs. Major reported long-term fiscal exposures in fiscal year 2006 with a present value totaling over $50 trillion consisted of $10 trillion of liabilities reported on the Balance Sheet, $1 trillion of other commitments and contingencies, and the $39 trillion of social insurance responsibilities, the last two of which are reported elsewhere in the Financial Report. This $50 trillion compares to about $20 trillion in fiscal year 2000.

These large numbers are difficult to comprehend. Table 2 seeks to translate them into several figures and ratios that are more understandable.

Table 2: Understanding the Size of Major Reported Fiscal Exposures

<table>
<thead>
<tr>
<th>Source</th>
<th>2000</th>
<th>2006</th>
<th>Percentage increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Major fiscal exposures</td>
<td>$20.4 trillion</td>
<td>$50.5 trillion</td>
<td>147%</td>
</tr>
<tr>
<td>Total household net worth</td>
<td>$42.0 trillion</td>
<td>$53.3 trillion</td>
<td>27%</td>
</tr>
<tr>
<td>Ratio of fiscal exposures to net worth</td>
<td>49 percent</td>
<td>95 percent</td>
<td>94%</td>
</tr>
<tr>
<td>Burden</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per person</td>
<td>$70,000</td>
<td>$170,000</td>
<td>132%</td>
</tr>
<tr>
<td>Per full-time worker</td>
<td>$165,000</td>
<td>$400,000</td>
<td>143%</td>
</tr>
<tr>
<td>Per household</td>
<td>$190,000</td>
<td>$440,000</td>
<td>134%</td>
</tr>
<tr>
<td>Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median household income</td>
<td>$41,990</td>
<td>$46,326</td>
<td>10%</td>
</tr>
<tr>
<td>Disposable personal income per capita</td>
<td>$25,127</td>
<td>$31,519</td>
<td>25%</td>
</tr>
<tr>
<td>Ratio of household burden to median income</td>
<td>4.5</td>
<td>9.5</td>
<td>112%</td>
</tr>
</tbody>
</table>

Sources: GAO analysis of data from the Department of the Treasury, Federal Reserve Board, U.S. Census Bureau, and Bureau of Economic Analysis.

Note: Percentage increases reflect actual data and may differ from calculation of rounded numbers presented in table.

Long-Term Fiscal Simulations. Another way to assess the U.S. government’s long-term fiscal outlook and the sustainability of federal programs is to run simulations of future revenues and costs for all federal programs, based on a continuation of current or proposed policy. The
simulations GAO has published since 1992 are designed to do that. As shown in figure 1, GAO’s long-term simulations—which are neither forecasts nor predictions—continue to show ever-increasing long-term deficits resulting in a federal debt level that ultimately spirals out of control. The timing of deficits and the resulting debt buildup varies depending on the assumptions used, but under either optimistic (“Baseline extended”) or more realistic assumptions, the federal government’s current fiscal policy is unsustainable.

![Figure 1: Unified Surpluses and Deficits as a Share of GDP under Alternative Fiscal Policy Simulations](image)

Over the long term, the nation’s growing fiscal imbalance stems primarily from the aging of the population and rising health care costs. Absent significant changes on the spending or revenue sides of the budget or both, these long-term deficits will encumber a growing share of federal resources and test the capacity of current and future generations to afford both today’s and tomorrow’s commitments. Continuing on this unsustainable path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our domestic tranquility and national security.
If, for example, as shown in figure 2, it is assumed that recent tax reductions are made permanent and discretionary spending keeps pace with the growth of our economy, our long-term simulations suggest that by 2040 federal revenues may be adequate to pay little more than interest on debt held by the public and some Social Security benefits. Neither slowing the growth in discretionary spending nor allowing the tax provisions, including the tax cuts enacted in 2001 and 2003, to expire—nor both together—would eliminate the imbalance.

Figure 2: Potential Fiscal Outcomes under Alternative Simulation: Discretionary Spending Grows with GDP after 2007 and All Expiring Tax Provisions Are Extended

Percent of GDP

Note: Alternative Minimum Tax (AMT) exemption amount is retained at the 2006 level through 2017 and expiring tax provisions are extended. After 2017, revenue as a share of GDP is held constant—implicitly assuming that action is taken to offset increased revenue from real bracket creep, the AMT, and tax-deferred retirement accounts.

At some point, action will need to be taken to change the nation’s fiscal course. The sooner appropriate actions are taken, the sooner the miracle
of compounding will begin to work for the federal budget rather than against it. Conversely, the longer that action to deal with the nation's long-term fiscal outlook is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing. Acting sooner rather than later will give us more time to phase in gradual changes, while also providing more time for those likely to be most affected to make compensatory changes.

The “fiscal gap” is a quantitative measure of long-term fiscal imbalance. Under GAO’s more realistic simulation, assuming debt held by the public remains at the current share of the economy (i.e., GDP), closing the fiscal gap would require spending cuts or tax increases equal to 8 percent of the entire economy each year over the next 75 years, or a total of about $61 trillion in present value terms. To put this in perspective, closing the gap would require an immediate and permanent increase in federal tax revenues of more than 40 percent or an equivalent reduction in federal program spending (i.e., in all spending except for interest on the debt held by the public, which cannot be directly controlled).

A Possible Way Forward

Although the long-term fiscal outlook is driven primarily by rising health care costs and known demographics, we cannot ignore other government programs and activities. There is a need to engage in a fundamental review, reprioritization, and reengineering of the base of government. Aligning the federal government to meet the challenges and capitalize on the opportunities of the 21st century will require a fundamental review of what the federal government does, how it does it, and how it is financed. Many of the federal government’s current policies, programs, functions, and activities are based on conditions that existed decades ago, are not results-based, and are not well aligned with 21st century realities. We need to address the growing costs of the major entitlement programs and also review and reexamine all other major programs, policies, and activities on both the spending and the revenue side of the budget. Programs that run through the tax code—sometimes referred to as tax expenditures—must be reexamined along with those that run through the spending side. As we move forward, the federal government needs to start making tough choices in setting priorities and linking resources and activities to results.

In addition to the reported net cost, the federal government foregoes tax revenues as a result of preferential provisions, such as tax exclusions, credits, and deductions. These revenue losses are referred to as tax expenditures.
Meeting our nation’s large, growing, and structural fiscal imbalance will require a multipronged approach:

- increasing transparency and enhancing the relevancy of key financial, performance, and budget reporting and estimates to highlight our long-term fiscal challenges;

- reinstating and strengthening budget controls for both spending and tax policies to deal with both near-term and longer-term deficits;

- strengthening oversight of programs and activities, including creating approaches to better facilitate the discussion of integrated solutions to crosscutting issues; and

- reengineering and reprioritizing the federal government’s existing programs, policies, and activities to address 21st century challenges and capitalize on related opportunities.

In my January 2007 testimony,\(^5^9\) I proposed a number of ideas for consideration to improve the transparency of long-term costs. In November 2006, I provided the congressional leadership with recommendations, based on the work of GAO, for consideration for the agenda of the 110th Congress.\(^6^0\) These recommendations focused on three areas: (1) targets for near-term oversight, (2) policies and programs that are in need of fundamental reform and reengineering, and (3) governance issues. One of the areas I pointed out that warranted congressional attention was the development of a portfolio of outcome-based key national indicators (e.g., economic, security, social, environmental) to help measure progress toward national outcomes, assess conditions and trends, and help communicate complex issues. The Congress could take a leadership role in highlighting the need for a U.S. national indicator system to inform strategic planning, enhance performance and accountability reporting, inform congressional oversight and decision making, and stimulate greater citizen engagement. In my view, this should include consideration of a public/private partnership to help make this key concept a reality sooner rather than later.


In order to effectively address our long-term fiscal imbalance, fundamental reform of existing entitlement programs is essential. However, entitlement reform alone will not get the job done. We also need to reprioritize and constrain other federal government spending and generate more revenues—hopefully through a reformed tax system. GAO's *21st Century Challenges: Reexamining the Base of the Federal Government* contains a suggested list of specific federal activities for reexamination, illustrative reexamination questions, and perspectives on various strategies, processes, and approaches for congressional consideration stemming from our audit and evaluation work that can be used in reexamining the federal base. Answers to these questions may draw on the work of GAO and others; however, only elected officials can and should decide which issues to address as well as how and when to address them. Addressing these problems will require tough choices, and our fiscal clock is ticking. As a result, the time to start is now, to help save our future.

**Concluding Remarks**

In closing, given the federal government’s current financial condition and growing long-term fiscal imbalance, the need for the Congress and the President to have timely, reliable, and useful financial and performance information is greater than ever. Sound decisions on the current results and future direction of vital federal government programs and policies are more difficult without such information. Until the problems discussed in this testimony are effectively addressed, they will continue to have adverse implications for the federal government and the taxpayers.

Since enactment of federal financial management reform legislation, we have seen continuous movement toward the ultimate goals of accountability laid out in the different financial management statutes. While early on some were skeptical, these laws have dramatically changed how financial management is carried out and the value placed on good financial management across government. Across government, financial management improvement initiatives are underway, and if effectively implemented, have the potential to greatly improve the quality of financial management information as well as the efficiency and effectiveness of agency operations. By the end of my term as Comptroller General, I would like to see the civilian CFO Act agencies routinely producing not only annual financial statements that can pass the scrutiny of a financial audit,

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but also quarterly financial statements and other meaningful financial and performance data to help guide decision makers on a day-to-day basis. For DOD, my expectations are not as high given the current status of DOD’s financial management practices, yet it is realistic for at least major portions of DOD’s financial information to become auditable by the end of my term. Moreover, progress on developing meaningful financial and performance reporting on the federal government will be a key area that I will continue to champion. I am determined to do whatever I can to help ensure that we are not the first generation to leave our children and grandchildren a legacy of failed fiscal stewardship and the hardships that would bring.

Finally, I want to emphasize the value of sustained congressional interest in these issues, as demonstrated by this Subcommittee’s leadership. It will be key that going forward, the appropriations, budget, authorizing, and oversight committees hold agency top leadership accountable for resolving the remaining problems and that they support improvement efforts that address the challenges for the future I highlighted today. The federal government has made tremendous progress, and sustained congressional attention has been and will continue to be a critical factor to ensuring achievement of the goals and objectives of management reform legislation.

Mr. Chairman, this completes my prepared statement and I want to thank you for the opportunity to participate in this hearing and for the strong support of this Subcommittee in addressing the need for financial management reform and accountability. I would be happy to respond to any questions you or other members of the Subcommittee may have at this time.

Contacts and Acknowledgments

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