America's Financial Condition and Fiscal Imbalance: Truth, Transparency and Accountability

The Honorable David M. Walker, CPA
Comptroller General of the United States
United States Government Accountability Office
August 2, 2004
GAO’s Strategic Plan

SERVING THE CONGRESS AND THE NATION

GAO’S STRATEGIC PLAN FRAMEWORK

MISSION
GAO exists to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of the American people.

THEMES

- Long-Term Fiscal Imbalance
- National Security
- Global Interdependence
- Changing Economy
- Demographics
- Science and Technology
- Quality of Life
- Governance

GOALS & OBJECTIVES

Provide Timely, Quality Service to the Congress and the Federal Government to...

Address Current and Emerging Challenges to the Well-Being and Financial Security of the American People related to...

- Health care needs and financing
- Education and protection of children
- Work opportunities and worker protection
- Retirement income security
- Effective system of justice
- Viable communities
- Natural resources use and environmental protection
- Physical infrastructure

Respond to Changing Security Threats and the Challenges of Global Interdependence involving...

- Emerging threats
- Military capabilities and readiness
- Advancement of U.S. interests
- Global market forces

Help Transform the Federal Government’s Role and How It Does Business to Meet 21st Century Challenges by assessing...

- Roles in achieving federal objectives
- Government transformation
- Key management challenges and program risks
- Fiscal position and financing of the government

Maximize the Value of GAO by Being a Model Federal Agency and a World-Class Professional Services Organization in the areas of...

- Client and customer satisfaction
- Strategic leadership
- Institutional knowledge and experience
- Process improvement
- Employer of choice

CORE VALUES

- Accountability
- Integrity
- Reliability

Source: GAO.
Selected Key Concepts for GAO

MISSION
Improve performance and assure accountability, both for today and tomorrow

MEANS
Oversight, insight, and foresight

METHODS
Leading by example and promoting best practices

• Observing protocols
• Employing a constructive engagement approach with entities we audit and evaluate
• Partnering with fellow accountability and selected “good government” organizations
Four Key Institutional Success Elements

- Results
- Clients
- People
- Partnerships
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<tr>
<th>High Risk Areas</th>
<th>Designated High Risk</th>
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<td><strong>Addressing Challenges in Broad-based Transformations</strong></td>
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<td>Strategic Human Capital Management*</td>
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<td>U.S. Postal Service Transformation Efforts and Long-Term Outlook*</td>
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<td><strong>Ensuring Major Technology Investments Improve Services</strong></td>
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<td>FAA Air Traffic Control Modernization</td>
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<td>IRS Business Systems Modernization</td>
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<td><strong>Providing Basic Financial Accountability</strong></td>
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<td><strong>Reducing Inordinate Management Program Risks</strong></td>
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<td>Medicare Program*</td>
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<td>Collection of Unpaid Taxes</td>
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<td>DOD Inventory Management</td>
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<td>Student Financial Aid Programs</td>
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<td>HUD Single-Family Mortgage Insurance and Rental Assistance Programs</td>
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<td>Earned Income Credit Noncompliance</td>
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<td>DOD Support Infrastructure Management</td>
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<td>Medicaid Program*</td>
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<td>Pension Benefit Guaranty Corporation Single-Employer Insurance Program*</td>
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<td><strong>Managing Large Procurement Operations More Efficiently</strong></td>
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<td>DOD Weapon Systems Acquisition</td>
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<td>Department of Energy Contract Management</td>
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<td>NASA Contract Management</td>
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<td>DOD Contract Management</td>
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*Additional authorizing legislation is likely to be required as one element of addressing this high risk area.
The Case for Change

Government is on a “burning platform,” and the status quo way of doing business is unacceptable for a variety of reasons, including:

– Past fiscal trends and significant long-range challenges
– Rising public expectations for demonstrable results and enhanced responsiveness
– Selected trends and challenges having no boundaries
– Additional resource demands due to recent terrorism events in the United States
– Government performance/accountability and high risk challenges, including the lack of effective human capital strategies
Composition of Federal Spending

1964
- Defense: 33%
- Net interest: 7%
- Social Security: 14%
- All other spending: 46%

1984
- Defense: 30%
- Net interest: 13%
- Social Security: 9%
- All other spending: 27%

2004*
- Defense: 33%
- Net interest: 7%
- Social Security: 19%
- Medicare & Medicaid: 21%
- All other spending: 20%

*Current services estimate.

Federal Spending for Mandatory and Discretionary Programs

1964

- Net Interest: 7%
- Discretionary: 67%
- Mandatory: 26%

1984

- Net Interest: 13%
- Discretionary: 45%
- Mandatory: 42%

2004*

- Net Interest: 7%
- Discretionary: 39%
- Mandatory: 54%

*Current services estimate.

Debt Held by the Public as Share of GDP (Fiscal Years 1797-2003)

Note: Data until 1929 are shown as a percent of gross national product (GNP); data from 1930 to present are shown as a percent of GDP. Source: GAO analysis of data from the Department of Commerce, Office of Management and Budget, and Congressional Budget Office.
Surplus or Deficit as a Share of GDP (Fiscal Years 1797-2003)

Note: Data until 1929 are shown as a percent of gross national product (GNP); data from 1930 to present are shown as a percent of GDP.
Source: Department of Commerce, Office of Management and Budget, and Congressional Budget Office.
Surplus or Deficit as a Share of GDP (Fiscal Years 1962-2004)

Source: Congressional Budget Office.
### Selected Fiscal Exposures: Sources and Examples

*(End of 2003)*

<table>
<thead>
<tr>
<th>Type</th>
<th>Example (dollars in billions)</th>
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<tr>
<td>Explicit liabilities</td>
<td>Publicly held debt ($3,913)</td>
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<td>Military and civilian pension and post-retirement health ($2,857)</td>
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<td>Veterans benefits payable ($955)</td>
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<td>Environmental and disposal liabilities ($250)</td>
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<td>Loan guarantees ($35)</td>
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<td>Explicit financial commitments</td>
<td>Undelivered orders ($596)</td>
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<td>Long-term leases ($47)</td>
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<td>Financial contingencies</td>
<td>Unadjudicated claims ($9)</td>
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<td>Pension Benefit Guaranty Corporation ($86)</td>
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<td>Other national insurance programs ($7)</td>
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<td>Government corporations e.g., Ginnie Mae</td>
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<tr>
<td>Exposures implied by current policies or the public’s expectations</td>
<td>Debt held by government accounts ($2,859)&lt;sup&gt;b&lt;/sup&gt;</td>
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<tr>
<td>about the role of the government</td>
<td>Future Social Security benefit payments ($3,699)&lt;sup&gt;c&lt;/sup&gt;</td>
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<td>Future Medicare Part A benefit payments ($8,236)&lt;sup&gt;c&lt;/sup&gt;</td>
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<td></td>
<td>Future Medicare Part B benefit payments ($11,416)&lt;sup&gt;c&lt;/sup&gt;</td>
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<tr>
<td></td>
<td>Future Medicare Part D benefit payments ($8,119)&lt;sup&gt;c&lt;/sup&gt;</td>
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<td></td>
<td>Life cycle cost including deferred and future maintenance and operating costs (amount unknown)</td>
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<td></td>
<td>Government Sponsored Enterprises e.g., Fannie Mae and Freddie Mac</td>
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*a* All figures are for end of fiscal year 2003, except Social Security and Medicare estimates, which are end of calendar year 2003.

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

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

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

Updated 3/30/04.
Another Way to Think About These Numbers

As of the End of FY 03

• Debt held by the public—$3.9T
• Trust fund debt—$2.9T
• Gross debt—$6.8T
• Gross debt per person—about $24,000
• If we add everything on the previous slide that is not included in gross debt, the burden per person rises to over $140,000. Alternatively, it amounts to a total unfunded burden of more than $40 trillion in current dollars, which is about 18 times the current annual federal budget or more than 3 ½ times the current annual GDP.

Note: The calculations only consider a 75-year horizon for Social Security and Medicare.
Composition of Spending as a Share of GDP
Under Baseline Extended

Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2014 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2014, revenue as a share of GDP is held constant.

Source: GAO's March 2004 analysis.
Composition of Spending as a Share of GDP
Assuming Discretionary Spending Grows with GDP after 2004

Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2014 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2014, revenue as a share of GDP is held constant.

Source: GAO’s March 2004 analysis.
Composition of Spending as a Share of GDP
Assuming All Expiring Tax Provisions are Extended

Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2014 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2014, revenue as a share of GDP is held constant.

Source: GAO’s March 2004 analysis.
Composition of Spending as a Share of GDP

Assuming Discretionary Spending Grows with GDP After 2004 and All Expiring Tax Provisions Are Extended

Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2014 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2014, revenue as a share of GDP is held constant.

Source: GAO’s March 2004 analysis.
Current Fiscal Policy Is Unsustainable

- **The “Status Quo” Is Not an Option**
  - We face large and growing structural deficits largely due to known demographic trends and rising health care costs.
  - GAO’s simulations show that balancing the budget in 2040 could require actions as large as
    - Cutting total federal spending by about 60 percent or
    - Raising taxes to about 2.5 times today’s level

- **Faster Economic Growth Can Help, but It Cannot Solve the Problem**
  - Closing the current long-term fiscal gap based on responsible assumptions would require real average annual economic growth in the double digit range every year for the next 75 years.
  - During the 1990s, the economy grew at an average 3.2 percent per year.
  - As a result, we cannot simply grow our way out of this problem. Tough choices will be required.

- **The Sooner We Get Started, the Better**
  - Less change would be needed, and there would be more time to make adjustments.
  - The miracle of compounding would work with us rather than against us.
  - Our demographic changes will serve to make reform more difficult over time.
The Way Forward

• Implement new accounting and reporting approaches and new budget control mechanisms for considering and controlling the impact of spending and tax policies and decisions over the long term

• Develop new metrics for measuring the impact of policies and decisions over the long term (e.g., key national indicators to measure our Nation’s position and progress over time and in relation to other countries)

• Reexamine the base—question existing programs, policies, functions, and activities
Long-term Fiscal Challenges
Demand New Metrics, Mechanisms, and Processes

• Accounting and reporting policies for trust funds, Social Security, Medicare, Veterans benefits, among other things, need to be reviewed and revised.

• The current budget time horizon [2-year, 5-year, 10-year] does not capture many long-term costs—e.g. Social Security, Medicare, pension insurance—and other major tax and spending provisions

• Cash and obligations-based budgeting is misleading for insurance and some benefit programs

• Budget controls have expired—and we need to go beyond “holding the line” to “changing the base” in spending and tax policies
Improved Metrics, Measures and Processes: Some Ideas

• Provide information on long-term costs of major spending and tax proposals before they are voted on, including showing long-term costs even for proposals that sunset

• Establish an OMB annual report on fiscal exposures, including appropriate measures and how to address them

• Consider fiscal targets, triggers, sunset provisions and points of order with focus on limiting growth of long-term commitments

• Move to accrual budgeting for employee pension, retiree health; disclose “risk assumed” [missing premium] for insurance

• Reinstitute budget controls (caps & PAYGO)
We Need a 3-Pronged Approach

- Restructure existing entitlement programs
- Reexamine the base of discretionary and other spending
- Review and revise our tax policy and enforcement programs
Selected GAO-Related Activities

- Speeches and Outreach Efforts
- Financial Literacy Efforts
- CG Forum
- High Risk Update
- 21st Century Challenges Publication
- Various Congressional Consultation and Assistance Efforts
- Public Education Assistance
Accountability Environment

• The credibility of auditing and financial reporting has suffered in the last several years as a result of the accountability failures in the private sector.

• Forces that led to the corporate scandals and audit failures include:
  – individual and corporate greed
  – Inadequate corporate governance system
  – ineffective regulation and oversight of the accounting and auditing profession,
  – inadequate accounting/reporting standards
  – Audit-related expectation gaps
  – financial managers and advisors working to achieve certain reporting results and focusing on the legal form versus the economic substance of the transactions
  – auditors and financial professionals doing what was minimally required and actively fighting tighter standards
  – confusion over who the auditors work for
  – auditors delivering services to clients that impaired independence
Current Reforms

- The Sarbanes-Oxley Act of 2002 included reforms in corporate governance and the accounting profession intended to
  - improve corporate financial reporting and internal control
  - strengthen audit committees
  - change the relationship between the auditor and client
  - improve auditor independence
  - provide additional auditor assurance over internal control
  - provide oversight and regulation for auditors of publicly traded companies

- Reforms are currently being implemented, and final impact is still uncertain.
Sarbanes-Oxley Act Provisions with Implications for Government

New audit standards and oversight—PCAOB

- Audit committees with defined responsibilities
- Specific communications between auditors and audit committees
- CEO and CFO certification of financial reports
- Enhanced disclosures of off-balance sheet transactions
- Code of ethics for senior financial officers
- Management attestation on the effectiveness of internal control over financial reporting
- Auditor opinion on the effectiveness of internal control over financial reporting
Excerpts From the 103rd American Assembly Report:  
The Future of the Accounting Profession

- Structural Challenges Facing the Accounting Profession:
  - Rules-based versus principles-based standards
  - A revised and expanded financial reporting model
  - New and enhanced audit and attestation standards
  - The number of major accounting/audit firms
  - A balanced approach to auditor liability and accountability
  - Valuing quality audits and audit personnel
  - Reinvigorating audit committees
  - Preparing for the future—the talent search
For any system to work, it must address three fundamental issues.

- First, provide incentives for people to do the right thing.
- Second, provide transparency to help assure that people do the right thing.
- Finally, have effective accountability mechanisms if people don’t do the right thing.

Restoring public trust will require that every participant in the corporate reporting supply chain embrace and live by the following core concepts:

1. **A spirit of transparency**—stop playing games with financial and performance data. Use full disclosure.
2. **A culture of accountability**—management, staff, boards, auditors, and stakeholders. High quality, unbiased information to support decision-making.
3. **People of integrity**—commitment to individual integrity.

*Excerpts from Building Public Trust: The Future of Corporate Reporting, Samuel DiPiazza, Jr. and Robert G. Eccles, 2002*
GAO’s Work to Modernize the Accountability Profession

GAO is actively working to modernize and transform the accountability profession both inside the government and in the private sector, and to lead by example in this area.

- opinion on system of internal control
- Independence Standard issued in 2002
- assistance to the Congress in evaluating accountability profession issues and needed reforms prior to the Sarbanes-Oxley Act
- 2003 revision of *Government Auditing Standards*
- creation of the U.S Auditing Standards Coordinating Forum (i.e., GAO, PCAOB, ASB)
- coordination with accountability organizations around the world (e.g., INTOSAI)
- comment on proposed standards
- monitor implementation of the Sarbanes-Oxley Act
- Sarbanes-Oxley studies on accounting firm consolidation from Big 8 to Big 4 and on mandatory audit firm rotation
- definition of success in financial management: clean opinion, no major weaknesses in controls or compliance, and financial systems that produce timely, accurate and useful information for management
- enhance federal financial management, reporting, and accountability
Selected Federal Government Reporting Challenges

- Financial and Performance Reporting
  - long-range fiscal challenges (e.g., per capita burden)
  - “trust funds” (e.g., restricted vs. unrestricted revenues, intra-governmental obligations)
  - DOD assets, liabilities, and contingencies
  - performance reporting

- Audit Reporting
  - system of internal control
  - financial vs. performance vs. other information
The Future Accounting/Reporting and Audit Reporting Model

- We need to review and revise the existing accounting/reporting model to reflect several dimensions:
  - Generic provisions
  - Industry information
  - Entity-specific information (i.e., value and risk)

- We need to recognize the difference between certain types of financial and other information:
  - Historical cost
  - Readily marketable assets
  - Non-readily marketable assets
  - Projection information
  - Performance information
The Future Accounting/Reporting and Audit Reporting Model

- We need to review and revise the existing audit reporting model to accomplish at least two objectives:
  - Recognize that the opinion should address whether the financial statements are fairly presented in all material respects and in accordance with generally accepted accounting principles
  - Update the audit reporting model to link it with the new financial reporting model, and provide appropriate degrees of assurance for each type of information

- We need to ultimately go global in connection with all major accounting and audit matters

- We need to coordinate domestic efforts in the interim (e.g., auditing standards coordinating forum)
Key Concepts in the Accountability Profession

- Public vs. personal interests
- Recognizing the difference between the floor (e.g., law, accounting standards) and the ceiling (e.g., principles, values)
- Doing what is right vs. what is acceptable
- Economic substance vs. legal form
- Being concerned with both fact and appearance (e.g., independence)
- Using judgment vs. completing checklists
- Recognizing that continuing improvement in today’s rapidly changing world is essential
- Trust is hard to earn, but easy to lose
Three Key Personal Attributes Needed for These Challenging and Changing Times

- Leadership
- Integrity
- Innovation
THE 10th World Congress of Accounting Historians

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