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Mr. Charles R. Christopherson, Jr.
Chief Financial Officer
Department of Agriculture

The Honorable Phyllis K. Fong
Inspector General
Department of Agriculture

Subject: *Financial Audit: Restatements to the Department of Agriculture's Fiscal Year 2003 Consolidated Financial Statements*

As you know, the Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget (OMB), is required to annually prepare and submit audited financial statements of the U.S. government to the President and Congress. We are required to audit these consolidated financial statements (CFS) and report on the results of our work.[1] An issue meriting concern and close scrutiny that emerged during our fiscal year 2004 CFS audit was the growing number of Chief Financial Officers (CFO) Act agencies that restated[2] certain of their financial statements for fiscal year 2003 to correct errors.[3] Errors in financial statements can result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. Further, when restatements do occur, it is important that financial statements clearly communicate, and readers of the restated financial statements understand, that the financial statements originally issued by management in the previous year and the opinion thereon should no longer be relied on and instead the restated financial statements and related auditor's opinion should be used.

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[1]The Government Management Reform Act of 1994 has required such reporting, covering the executive branch of government, beginning with financial statements prepared for fiscal year 1997. 31 U.S.C. § 331 (e). The federal government has elected to include certain financial information on the legislative and judicial branches in the CFS as well.

[2]A financial statement restatement occurs when an entity either voluntarily or prompted by its auditors or regulators revises public financial information that has previously been reported.

[3]According to Federal Accounting Standards Advisory Board, Statement of Federal Financial Accounting Standards (SFFAS) No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, prior period financial statements presented should be restated only to correct errors that caused such statements to be materially misstated.

Eleven of the 23 CFO Act agencies[4] restated certain of their financial statements for fiscal year 2003. Five CFO Act agencies had restatements in fiscal year 2003 covering their fiscal year 2002 financial statements. Three CFO Act agencies had restatements covering both years. We noted that the extent of the restatements to CFO Act agencies' fiscal year 2003 financial statements varied from agency to agency, ranging from correcting two line items on one agency's balance sheet to correcting numerous line items on several of another agency's financial statements. In some cases, the net operating results of an agency were affected by the restatement. The amounts of the agencies' restatements ranged from several million dollars to more than $91 billion.

Nine of the 11 agencies that had restatements for fiscal year 2003 received unqualified opinions on their originally issued fiscal year 2003 financial statements. The auditors for 6 of these 9 agencies issued unqualified opinions on the restated financial statements, replacing the previous unqualified opinions on the respective agencies' original fiscal year 2003 financial statements. The auditors for 2 of these 9 withdrew their unqualified opinions on the fiscal year 2003 financial statements and issued other than unqualified opinions on the respective agencies' restated fiscal year 2003 financial statements because they could not determine whether there were any additional misstatements and the effect of any such misstatements on the restated fiscal year 2003 financial statements. For the remaining agency, the principal auditor of the agency's fiscal year 2004 financial statements was not the principal auditor of the agency's fiscal year 2003 financial statements, and an audit opinion on the agency's restated fiscal year 2003 financial statements was not issued.

Our review focused on the nine agencies with restatements for fiscal year 2003 that received unqualified opinions on their originally issued fiscal year 2003 financial statements.[5] These were the Department of Agriculture (USDA), Department of State, Department of Justice, Department of Transportation, Department of Health and Human Services, General Services Administration, National Science Foundation, Nuclear Regulatory Commission, and Office of Personnel Management.

Because of the varying nature and circumstances surrounding the restatements, we are issuing a number of separate reports on the matter. This report communicates our observations regarding USDA's fiscal year 2003 restatements. Going forward, we hope that the lessons learned from the fiscal year 2003 restatements, together with our recommendations, will help (1) USDA avoid the need for restatements to its future financial statements and ensure the adequacy of the disclosure and presentation of audit results and any restatements and (2) ensure that USDA's Office

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[4]The Federal Emergency Management Agency (FEMA) was transferred to the Department of Homeland Security (DHS) effective March 1, 2003. With this transfer, FEMA was no longer required to prepare and have audited stand-alone financial statements under the CFO Act, leaving 23 CFO Act agencies for the remainder of fiscal year 2003 and for fiscal year 2004. The DHS Financial Accountability Act, Pub. L. No. 108-330, 118 Stat. 1275 (Oct. 16, 2004), added DHS to the list of CFO Act agencies, increasing the number of CFO Act agencies again to 24 beginning in fiscal year 2005.

[5]The two agencies that had restatements for fiscal year 2003 but did not receive unqualified opinions on their originally issued fiscal year 2003 financial statements were the Department of Defense and the Small Business Administration.

of Inspector General (OIG) and other auditors apply appropriate audit procedures in future audits so that similar errors, which caused the original fiscal year 2003 financial statements to be misstated, as noted in this report, are identified before the financial statements are issued.

We reviewed four key areas with respect to the restatements of USDA's fiscal year 2003 financial statements: (1) the nature and cause of the errors that necessitated the restatements, including planned corrective actions by the agency and its auditors; (2) the timing of communicating the material misstatement to users of the financial statements; (3) the extent of transparency[6] exhibited in disclosing the nature and impact of the material misstatement in the financial statements and the reissued auditor's report; and (4) audit issues that contributed to the failure to detect the errors that necessitated the restatements during the audit of the agency's fiscal year 2003 financial statements.

Results in Brief

Material errors identified at three of USDA's component agencies led to the restatement of four of the five statements in USDA's originally issued fiscal year 2003 consolidated financial statements.[7] The material errors resulted from the lack of or ineffective implementation of several key internal control procedures related to (1) recording appropriations, (2) the proper reporting of material items on the Statement of Financing, and (3) processing nonroutine journal vouchers. We believe that more effective audit procedures applied by USDA's auditors could have detected the material errors noted in this report.

In addition, certain aspects of the footnote disclosure and financial statement presentation relating to the restatements could be misinterpreted. Specifically, the footnote disclosure related to the restatements was titled Prior Period Adjustments, which could be misinterpreted since most of the corrections discussed in the note were not prior period adjustments.[8] USDA's presentation of its fiscal year 2004 Consolidated Statement of Changes in Net Position may also be misinterpreted because the fiscal year 2004 beginning balances did not agree with the restated fiscal year 2003 ending balances. Further, USDA asserted in its fiscal year 2004 Management Discussion and Analysis (MD&A) that the agency has sustained

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[6]Transparency is the full, accurate, and timely disclosure of information.

[7]USDA restated certain of its originally issued fiscal year 2003 consolidated financial statements to correct for material errors identified at its Food and Nutrition Service, Forest Service, and Risk Management Agency's Federal Crop Insurance Corporation. According to USDA officials, since USDA was already restating the fiscal year 2003 financial statements for material errors, it also decided to correct for less significant errors that had been identified. Specifically, certain less significant errors identified at Animal and Plant Health Inspection Service, Credit Commodity Corporation, Forest Service, Natural Resources Conservation Service, and the departmentwide level were also included in the restatement note disclosure.

[8]SFFAS No. 21 defines a prior period adjustment as a correction for an error that occurred in and whose cumulative effect is attributable to periods not presented in the current financial statements.

unqualified or "clean" opinions on its financial statements since fiscal year 2002 but did not specifically acknowledge in its MD&A that it restated both originally issued fiscal years 2003 and 2002 financial statements for material errors. In addition, USDA did not completely disclose in the MD&A the nature and extent of the restatements to its originally issued fiscal year 2003 financial statements. We believe that not including this information in the MD&A could be misleading. Although the OIG told us that it believed disclosure of such information in its audit report was not necessary, in our view, such disclosure could have reduced the potential for a reader to be misled.

We are making three recommendations on this matter, including two recommendations to USDA's CFO. We recommend that USDA's CFO ensure (1) that procedures to prevent any similar errors from occurring and going undetected in future years are effectively implemented and (2) for future years, the adequacy of the disclosure and presentation of audit results and any restatements. We are also making a recommendation to USDA's Inspector General to ensure, in conjunction with the contracted independent public accountant (IPA) if one is used, that audit procedures are effectively implemented to test for any (1) improperly recorded appropriations transactions in the general ledger, (2) improperly reported material items on the Statement of Financing, and (3) incorrect nonroutine journal vouchers.

In commenting on a draft of this report, USDA's CFO expressed confidence that his office's current plans and efforts would ensure that its consolidated financial statements are accurate and timely and contain adequate disclosure. In a separate letter, the Inspector General concurred with our recommendations.

Background

In conducting the fiscal year 2004 audit of the CFS, we reviewed the 23 CFO Act agencies' performance and accountability reports for possible restatements and identified 11 agencies that had restated certain of their audited fiscal year 2003 financial statements.

The primary intended users of federal agencies' financial reports are citizens, Congress, federal executives, and federal program managers.[9] Each of these groups may use federal agencies' financial statements to satisfy their specific needs. Citizens are interested in many aspects of the federal government, particularly federal programs that affect their financial well-being. Congress is interested in monitoring and assessing the efficiency and effectiveness of federal programs. Federal executives, such as central agency officials at OMB and the Department of the Treasury (Treasury), are interested in federal financial statements to assist the President of the United States. OMB assists the President in overseeing the preparation of the federal budget by formulating the President's spending plans, evaluating the effectiveness of agency programs, assessing competing funding

[9]Federal Accounting Standards Advisory Board, Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*.

demands among agencies, and setting funding priorities. Treasury assists the President in managing the finances of the federal government and prepares the CFS, which are based on audited financial statements prepared by federal agencies. We audit the CFS and report on the results of our audit. Finally, federal program managers use agency financial statements as tools for managing their operations within the limits of the spending authority granted by Congress.

The primary accounting and auditing standards that apply to restatement disclosures by federal entities are Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards (SFFAS) No. 21, and the American Institute of Certified Public Accountants' (AICPA) Codification of Auditing Standards, AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*[10]

Objective, Scope, and Methodology

The objective of our review of restatements of USDA's fiscal year 2003 consolidated financial statements was to determine the nature and cause of the errors, the transparency and timing of communicating the material misstatements, any audit issues relating to such misstatements, and any actions being taken to help preclude similar errors from occurring in the future.

We reviewed the nature and causes of the restatements, and we also examined corrective actions taken by USDA to help preclude similar errors from occurring in the future. We interviewed the preparers and auditors of USDA's fiscal year 2003 consolidated and certain component agencies' financial statements, including staff from the agency's OIG, and we obtained and reviewed relevant audit documentation. Because USDA's OIG contracted with various IPAs for the audits of certain USDA component agencies' financial statements, such as the Forest Service and Risk Management Agency's Federal Crop Insurance Corporation, we also had to expand our contacts to include such IPAs. Our work was not designed to and we did not test the accuracy or appropriateness of the restatements.

In our review, we considered certain accounting and auditing standards, including SFFAS No. 21; OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*;[11] the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 16, *Prior Period Adjustments*; and the AICPA Codification of Auditing Standards, AU section 329, *Analytical Procedures,* AU section 420, *Consistency of Application of Generally Accepted Accounting Principles*, AU section 508, *Reports on Audited Financial Statements*, and AU section 561.

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[10]Generally accepted government auditing standards incorporate AICPA reporting standards and Statements on Auditing Standards unless the Comptroller General of the United States excludes them by formal announcement.
[11]Office of Management and Budget, Bulletin 01-09, *Form and Content of Agency Financial Statements* (Washington, D.C.: Sept. 25, 2001).

We performed our review of the restatements of USDA's fiscal year 2003 consolidated financial statements from December 2004 to October 2005 in accordance with U.S. generally accepted government auditing standards.

We requested comments on a draft of this report from USDA's CFO and Inspector General or their designees. Written comments from USDA's CFO and Inspector General are reprinted in enclosures I and II, respectively, and are discussed in the Agency Comments section.

Issues Related to Restatements of USDA's Fiscal Year 2003 Consolidated Financial Statements

USDA restated four of the five statements in its originally issued fiscal year 2003 consolidated financial statements to reflect material errors detected at three of its component agencies. These errors affected USDA's originally issued fiscal year 2003 Consolidated Statement of Changes in Net Position, Consolidated Balance Sheet, Combined Statement of Budgetary Resources, and Consolidated Statement of Financing.

During our review of the restatements, we identified the following areas that need improvement:

- internal control procedures over recording appropriations,
- internal control procedures related to the proper reporting of material items on the Statement of Financing,
- internal control procedures over processing nonroutine journal vouchers,
- audit procedures for detecting errors similar to those discussed throughout this report, and
- disclosure and presentation of the restatements.

These issues are discussed in detail below.

<u>Material Error in Recording Certain Appropriations General Ledger Accounts</u>

USDA restated its originally issued fiscal year 2003 Consolidated Statement of Changes in Net Position and its Consolidated Balance Sheet for an incorrect recording of *Appropriations Used* in fiscal year 2003 by its Food and Nutrition Service (FNS). In our view, the approximately $4.7 billion error was not detected by FNS due to a lack of key internal control procedures over recording appropriations.

USDA and USDA's OIG officials provided us the following perspectives on the events that led to the needed restatements. FNS incorrectly recorded a transfer of intragovernmental funds as *Unexpended Appropriations – Transfers – In* during fiscal year 2003, expended those moneys during the fiscal year, and incorrectly recorded the expenditures as *Unexpended Appropriations – Used* in its general ledger. FNS recorded the transfer of intragovernmental funds in such a manner because FNS's general ledger at that time did not have the standard general ledger account *Nonexpenditure Financing Sources – Transfers – In*. Later in fiscal year

2003, the Office of the Chief Financial Officer (OCFO) implemented this standard general ledger account to account for transfers of intragovernmental funds. In late October 2003, FNS discovered and corrected the transfer recording error by reclassifying the transfer of intragovernmental funds from *Unexpended Appropriations – Transfers – In* to *Nonexpenditure Financing Sources – Transfers – In*.[12] However, FNS did not correct the accounting entries related to expending those funds, which led to the need to restate USDA's originally issued fiscal year 2003 Consolidated Statement of Changes in Net Position and Consolidated Balance Sheet. It was not until October 2004, during FNS's year-end analysis of its fiscal year 2004 financial statements that FNS determined that the fiscal year 2003 recording errors were not fully corrected.

A USDA OIG official told us that it was first notified of the material error by FNS at the end of fiscal year 2004 and subsequently informed USDA's OCFO that USDA would need to restate its originally issued fiscal year 2003 Consolidated Statement of Changes in Net Position and Consolidated Balance Sheet for the material error detected at FNS.[13] The error caused the ending balances for *Cumulative Results of Operations* and *Unexpended Appropriations* on the fiscal year 2003 Consolidated Statement of Changes in Net Position and Consolidated Balance Sheet to be materially overstated and understated by approximately $4.7 billion, respectively.[14] Although *Total Net Position* was unchanged, these two accounts represent distinct components of net position. Specifically, according to Statements of Federal Financial Accounting Concepts No. 2, *Cumulative Results of Operations* generally includes the amounts accumulated over the years by an entity from its financing sources less its expenses and losses, while *Unexpended Appropriations* represents appropriations not yet obligated or expended, including undelivered orders.

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[12]According to Treasury's *U.S. Standard General Ledger* (USSGL) *Supplement No. S2 Treasury Financial Manual* (Hyattsville, Md.: September 2002), the *Unexpended Appropriations – Transfers – In* represents the amount of unexpended appropriations from current or prior years that were transferred in during the fiscal year, while *Nonexpenditure Financing Sources – Transfers – In* represents funds transferred in, or to be transferred in, that occur as a result of a nonexchange nonexpenditure transaction. According to Federal Accounting Standards Advisory Board, *Original Pronouncements*, a nonexchange transaction occurs when one party involved in a transaction (1) receives value without giving or promising value in return or (2) gives or promises value without receiving value in return. GAO's *Glossary of Terms Used in the Federal Budget Process*, GAO-05-734SP, states that for accounting and reporting purposes, a nonexpenditure transfer includes transactions between appropriation and fund accounts that do not represent payments for goods and services received or to be received but rather serves only to adjust the amounts available in the accounts for making payments.

[13]USDA officials stated that once notified of the error, they researched whether other USDA component agencies had similar errors. According to the officials, their research identified that USDA's Animal and Plant Health Inspection Service and Natural Resources Conservation Service had similar situations where they had improperly recognized *Appropriations Used* in the approximate amounts of $311 million and $478 million, respectively.

[14]This is because the material error caused the *Appropriations Used* component of *Cumulative Results of Operations* and the *Appropriations Used* component of *Unexpended Appropriations* on USDA's originally issued fiscal year 2003 Consolidated Statement of Changes in Net Position to be materially overstated and understated by approximately $4.7 billion, respectively.

Material Error Was Not Detected Due to a Lack of Key Internal Control Procedures over Recording Appropriations

USDA officials told us that the FNS error was not detected during fiscal year 2003 because the department did not have internal control procedures requiring (1) a reconciliation of current year appropriations reported in USDA's general ledger with Treasury's record of USDA's appropriations accounts and (2) that any exceptions identified during the reconciliation be adequately researched and resolved. According to the *Treasury Financial Manual* (TFM),[15] agencies (1) must compare their *Fund Balance with Treasury* account[16] in their internal ledgers with reports furnished by Treasury[17] and (2) should use guidelines in the TFM supplement, *Fund Balance with Treasury Reconciliation Procedures*,[18] as a basis for tailoring procedures for their own operations. Specifically, this supplement outlines generic operating procedures for reconciling the *Fund Balance with Treasury* account, including performing a reconciliation that involves comparing an agency's current year appropriations reported in the agency's general ledger to Treasury's record of the agency's appropriations accounts. Such a reconciliation and effective research would have identified *Nonexpenditure Financing Sources – Transfers – In* that were inappropriately classified as *Unexpended Appropriations – Transfers – In*, which in turn, could have led to the identification of the recording error in *Unexpended Appropriations – Used*. According to the TFM, failure to implement effective and timely reconciliation procedures could (1) increase the risks of fraud, waste, and mismanagement of funds; (2) affect the federal government's ability to effectively monitor budget execution; and (3) affect the federal government's ability to accurately measure the full cost of its programs.

According to USDA officials, USDA formally established procedures in June 2005 requiring monthly reconciliations of certain[19] current year appropriations reported in USDA's general ledger with Treasury's record of USDA's appropriations accounts and resolution of any identified differences. This procedure is intended to provide reasonable assurance, on a timely basis, that USDA's appropriations transactions are properly recorded in its general ledger, by detecting and correcting errors similar to those that led to the fiscal year 2003 restatement.

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[15]Department of the Treasury, *Treasury Financial Manual*, vol. 1, pt. 2, ch. 5100, I TFM 2-5100 (Hyattsville, Md.: Oct. 18, 1999).

[16]The *Fund Balance with Treasury* account is an asset account representing the future economic benefits of moneys that agencies can spend for future authorized transactions. Transactions, such as nonexpenditure transfers, affect the *Fund Balance with Treasury* account.

[17]Treasury's Financial Management Service maintains a summary account for each appropriation and fund showing transactions relating to appropriations. For example, at the close of each month, agencies are furnished FMS 6653, a ledger for each appropriation and fund account. The ledger shows the opening balance, classified transactions for the month, and the resultant closing balance as well as appropriation warrants issued.

[18]Department of the Treasury, *Fund Balance with Treasury Reconciliation Procedures A Supplement to the Treasury Financial Manual*, I TFM 2-5100 (November 1999).

[19]According to a USDA official, USDA's Controller Operations Division Financial Reporting Branch performs the reconciliation for all of the USDA component agencies it services.

Audit Procedures Were Not Adequately Designed to Detect the Material Error in Certain Recorded Appropriations

USDA's OIG officials stated that the OIG's fiscal year 2003 audit procedures did not detect the material error in *Appropriations Used*. In addition, according to an OIG official, FNS did not timely notify the OIG that the OCFO had implemented the above-noted standard general ledger account. The OIG official stated that FNS informed the OIG that no changes in accounting operations were made and that the OIG's various audit procedures did not identify any information that contradicted what FNS had told the OIG.

According to the *Financial Audit Manual* (FAM),[20] the auditor should perform audit procedures to test for all significant assertions[21] in significant financial statement line items and accounts. An OIG official stated that the OIG performed audit procedures on funds FNS received during its fiscal year 2003 audit, which included tracing funds to source documents, but its procedures did not detect the material error.

The official stated that if an appropriate analytical procedure had been performed during fiscal year 2003, then the material error would have been detected. The FAM states that as required by AU 329, *Analytical Procedures*, auditors must perform overall analytical procedures in order to determine if the auditor has obtained an adequate understanding of all fluctuations and relationships in the financial statements. According to AU 329, analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The OIG official stated that the analytical procedure that could have detected this material error was not performed during fiscal year 2003, but that the OIG included such an analytical procedure during its fiscal year 2004 and fiscal year 2005 audits. Specifically, according to an OIG official, the OIG performed an analytical procedure to calculate the cumulative results of operations independently and then compared the expected results with amounts reported in the financial statements.

Material Error Due to Improperly Reported Material Items on the Statement of Financing

In fiscal year 2004, USDA restated its originally issued fiscal year 2003 Combined Statement of Budgetary Resources and Consolidated Statement of Financing to address a material error that occurred at USDA's Risk Management Agency's Federal Crop Insurance Corporation (FCIC) when FCIC tried to correct, per OMB's advisement, the way it recorded *Obligations Incurred*.

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[20]GAO/President's Council on Integrity and Efficiency, *Financial Audit Manual*, GAO-01-765G (Washington, D.C.: July 2001), updated by GAO-04-1015G and GAO-04-942G (July 2004).
[21]Financial statement assertions are management representations that are embodied in financial statement components. The assertions can be either explicit or implicit and can be classified into the following categories: (1) existence or occurrence, (2) completeness, (3) rights and obligations, (4) valuation or allocation, and (5) presentation and disclosure.

According to an FCIC official, FCIC received a letter from OMB, dated December 19, 2002, requesting that FCIC properly record insurance fund program obligations incurred during the fiscal year when individual claims are approved to be paid for insured events. According to OMB's letter, FCIC instead was recording estimated obligations during the fiscal year in which the insured event occurred, which potentially placed FCIC in the untenable position of violating the Anti-Deficiency Act[22] should actual claims exceed estimates. The FCIC official stated that as a result of OMB's letter, FCIC modified the way it recorded *Obligations Incurred* before the fiscal year 2002 financial statements were issued; however, FCIC failed to remove all of its estimated accrued obligations (i.e., claims not yet approved to be paid for insured events) from the fiscal year 2002 beginning obligated balance. The FCIC official told us that as a result, an incorrect fiscal year 2002 ending obligated balance was carried forward to become the fiscal year 2003 beginning balance. This material error caused the *Beginning of Period Obligated Balance*, *Net* and *Beginning of Period Unobligated Balance* on FCIC's originally issued fiscal year 2003 Statement of Budgetary Resources to be materially overstated and understated by approximately $1.2 billion, respectively. In addition, due to the same error, *Obligations Incurred* on FCIC's originally issued fiscal year 2003 Statement of Budgetary Resources and Statement of Financing were materially understated by approximately $1.2 billion.[23]

According to OMB Bulletin 01-09, the Statement of Financing (1) is the bridge between an entity's budgetary and proprietary[24] accounting[25] and (2) articulates the relationships between net obligations derived from an entity's budgetary accounts and net cost of operations derived from the entity's proprietary accounts by identifying and explaining key differences between the two numbers. As stated in SFFAS No. 7, the Statement of Financing reconciles the budgetary resources obligated for a federal entity's programs and operations (i.e., *Obligations Incurred*) to the net cost of operating that entity (i.e., *Net Cost of Operations)*. As a result, because *Obligations Incurred* was materially understated, the *Net Cost of Operations* reported on FCIC's draft of its fiscal year 2003 Statement of Financing did not match the *Net Cost of Operations* reported on FCIC's draft of its fiscal year 2003 Statement of Net Cost. According to an FCIC official, in fiscal year 2003, FCIC was aware that the *Net Cost of Operations* as reported on both draft statements did not match but did not research the issue to determine the exact accounting entries

[22]31 U.S.C. § 1341.
[23]This is because there is a relationship between *Beginning of Period Obligated Balance*, *Net* and *Obligations Incurred* such that if there is an overstatement of the *Beginning of Period Obligated Balance*, *Net*, then, provided no other errors have occurred on the Statement of Budgetary Resources, *Obligations Incurred* would be understated.
[24]Proprietary accounts provide the information for the financial statements based on Federal Accounting Standards Advisory Board standards and are intended to provide an economic, rather than a budgetary, measure of operations and resources.
[25]Certain transactions affect both proprietary and budgetary accounts. Although budgetary and proprietary accounting information are complementary, both the types of information and the timing of their recognition are different, which is caused by differences in the basis of accounting. For example, under budgetary accounting, a federal entity records an obligation when it places a purchase order or signs a contract. Under proprietary accounting, liabilities are recognized when goods and services are received or are recognized based on an estimate of work completed under a contract or agreement.

necessary to correct the error. The official stated that instead of researching the issue, FCIC made an unsupported adjustment to *Other Components Requiring or Generating Resources in Future Periods* on the Statement of Financing in order to force the *Net Cost of Operations* reported on FCIC's draft of its fiscal year 2003 Statement of Financing to match *Net Cost of Operations* reported on FCIC's draft of its fiscal year 2003 Statement of Net Cost. While this adjustment eliminated the imbalance between *Net Cost of Operations* reported on the two statements, it also caused *Other Components Requiring or Generating Resources in Future Periods* to be overstated by approximately $1.2 billion.

The material error at FCIC also affected USDA's consolidated financial statements. Specifically, the material error caused the same line items, as noted above, to be materially misstated on USDA's originally issued fiscal year 2003 Combined Statement of Budgetary Resources and Consolidated Statement of Financing. This material error resulted in USDA's originally issued fiscal year 2003 Combined Statement of Budgetary Resources showing that USDA had fewer budgetary resources than it actually did.

Material Error Resulted from a Lack of Key Internal Control Procedures Related to the Proper Reporting of Material Items on FCIC's Statement of Financing

FCIC's IPA's audit report, dated November 4, 2004, found that FCIC's preparation of its Statement of Financing needed improvements. Specifically, the IPA found that FCIC made unsupported adjustments to its originally issued fiscal year 2003 Statement of Financing instead of performing research and taking corrective action. In this case, the fiscal year 2003 year-end unsupported adjustment, which was made in order to force the *Net Cost of Operations* reported on FCIC's draft of its fiscal year 2003 Statement of Financing to match *Net Cost of Operations* reported on FCIC's draft of its fiscal year 2003 Statement of Net Cost, was incorrect.

FCIC's IPA noted in its independent auditor's report that this material error resulted from FCIC's lack of key internal control procedures related to the proper reporting of material items on the Statement of Financing. Specifically, the IPA noted that FCIC did not have procedures requiring its accounting staff to research and identify why *Net Cost of Operations* as reported on FCIC's draft of its fiscal year 2003 Statement of Financing did not match *Net Cost of Operations* as reported on FCIC's draft of its fiscal year 2003 Statement of Net Cost. As a result, FCIC made the unsupported manual adjustment to force the *Net Cost of Operations* reported on the two draft statements to match. If such above-noted research procedures had been performed, we believe that FCIC could have identified and corrected the error in *Beginning of Period Obligated Balance, Net* and *Beginning of Period Unobligated Balances*, which caused *Obligations Incurred* to be materially understated and, in turn, could have prevented the need to make an unsupported adjustment to *Other Components Requiring or Generating Resources in Future Periods* on the Statement of Financing, which created an additional error.

According to our *Internal Control Management and Evaluation Tool*,[26] when assessing whether necessary control activities are in place and being applied, agencies should consider if timely action is taken on exceptions, implementation problems, or information that requires follow-up. Such consideration may have identified that FCIC lacked key internal control procedures requiring timely action be taken to investigate and resolve identified exceptions, such as the above-noted exception that led to FCIC's fiscal year 2003 material error. Failure to timely investigate and resolve exceptions, implementation problems, or information that requires follow-up could, among other things, (1) increase the risks of fraud, waste, and mismanagement of funds and (2) result in materially inaccurate reporting of financial information.

In April 2005, FCIC established internal control procedures related to reporting of material items on FCIC's Statement of Financing. These procedures require FCIC's financial management staff to (1) prepare supporting documentation for manual adjustments to FCIC's Statement of Financing; (2) increase their review of the financial statements, including incorporating analytical analyses of the relationships among balances into the review process; and (3) attend additional training on budgetary accounting and the related statements. In addition, the newly established procedures require an accountant to review FCIC's Statement of Financing for consistency and accuracy with other financial statements, such as FCIC's Statement of Net Cost and Statement of Budgetary Resources. These procedures are intended to support the proper reporting of material line items on FCIC's Statement of Financing so that errors, similar to those noted above, are identified and corrected before the financial statements are issued.

Audit Procedures Did Not Detect the Material Error on FCIC's Statement of Financing

FCIC's IPA for fiscal year 2003 stated that its audit procedures did not detect the material error in FCIC's fiscal year 2003 reported unobligated and obligated beginning account balances. FCIC's IPA for fiscal year 2003 stated that it was not the IPA for fiscal year 2002. Accordingly, FCIC's IPA for fiscal year 2003 told us that it reviewed the predecessor auditor's working papers to determine the nature, timing, and extent of the fiscal year 2003 audit procedures that the IPA would perform over opening balances. FCIC's IPA for fiscal year 2003 told us that it relied upon the work of the previous auditor with respect to the fiscal year 2002 ending obligated and unobligated balances that were, in turn, the beginning balances for fiscal year 2003, which were subsequently determined to be materially overstated and understated, respectively.

In addition, FCIC's IPA for fiscal year 2003 stated that it had designed and applied audit procedures in fiscal year 2003 to analyze differences between budgetary and proprietary accounts. However, FCIC's IPA for fiscal year 2003 stated that such audit procedures did not identify the material error in *Obligations Incurred*, which

[26] GAO, *Internal Control Management and Evaluation Tool*, GAO-01-1008G (Washington, D.C.: August 2001).

resulted from improperly recorded obligations in fiscal year 2002. Although we requested FCIC's IPA's audit documentation related to its review of FCIC's fiscal year 2003 Statement of Financing, we were not provided with such information. Without documentation of the IPA's audit procedures in this area, we are unable to determine whether the lack of detection of the material error was a result of inadequate design or implementation of audit procedures.

We believe that analytical procedures could also have detected the error. Specifically, as previously mentioned, the FAM states that as required by AU 329, the auditor must perform overall analytical procedures in order to determine if the auditor has obtained an adequate understanding of all fluctuations and relationships in the financial statements. The FAM states that the auditor should understand the causes of fluctuations and determine if its understanding is consistent with other audit evidence; if the auditor is unable to do so, the auditor should perform appropriate procedures to obtain an understanding or to resolve any inconsistencies. According to the FAM, one such analytical procedure involves comparing current year amounts in the financial statements with comparative financial information (i.e., amounts reported in prior years). We believe that this type of analytical procedure could have identified the significant increase in *Other Components Requiring or Generating Resources in Future Periods*, which resulted from the above-noted unsupported adjustment. Specifically, the reported balance for *Other Components Requiring or Generating Resources in Future Periods* on the Statement of Financing increased from $148 million for fiscal year 2002 to $1,520 million for fiscal year 2003. In our view, an investigation of the cause of this increase could have detected the above-noted material error.

Both FCIC's IPA and USDA's OIG stated that they plan to dedicate more resources to ensure the proper reporting of material items on the Statement of Financing. However, it is going to be important that in future years, audit procedures are performed to identify and investigate any material unsupported adjustments made to FCIC's as well as USDA's consolidated financial statements.

USDA Restated Its Combined Statement of Budgetary Resources Due to an Incorrect Nonroutine Journal Voucher

In fiscal year 2004, USDA restated its originally issued fiscal year 2003 Combined Statement of Budgetary Resources to correct for a material accounting error made by USDA's Forest Service (FS).[27] According to an FS official, the restatement to USDA's fiscal year 2003 Combined Statement of Budgetary Resources corrected an approximately $178 million overstatement of the ending unobligated balance, an approximately $16 million overstatement of *Net Transfers*, and an approximately $193 million understatement of *Total Obligated Balance, Net, End of Period.* The FS

[27]USDA's consolidated financial statements were also corrected for less significant errors identified at FS. According to the OIG's audit report, FS corrected errors for alignment of budgetary and proprietary account relationships and posting errors, unsupported balances in various suspense and deposit clearing funds, Fund Balance with Treasury and associated custodial liability, and certain revenue transactions. According to FS, the IPA, and the OIG, of the errors that were corrected, only the nonroutine journal voucher, noted above, was material.

official stated that the error was caused by an incorrect, nonroutine journal voucher[28] processed by FS in October 2003 and recorded in the general ledger activity for fiscal year 2003.

Material Error Resulted from Ineffective Internal Control Procedures over Processing Nonroutine Journal Vouchers

FS's IPA stated that as a result of FS's fiscal year-end 2003 account analyses, FS processed several nonroutine journal vouchers, including one that incorrectly adjusted three budgetary accounts and led to the restatement of USDA's originally issued fiscal year 2003 Combined Statement of Budgetary Resources. According to an FS official, inexperienced FS personnel used a nonroutine journal voucher to adjust an out-of-balance condition between FS's budgetary accounts and the corresponding financial information submitted to Treasury without identifying the underlying cause of the out-of-balance condition and without sufficient approval. In an FS memo to its IPA dated November 12, 2004, FS noted that it did not have properly designed and/or effective internal control procedures to prevent and/or detect errors in the processing of its financial transactions, primarily related to the processing and approval of nonroutine transactions through the use of journal vouchers.

According to our *Standards for Internal Control in the Federal Government*,[29] control activities, such as internal control procedures, help to ensure that transactions are completely and accurately recorded. Properly designed and effectively implemented internal control procedures over processing nonroutine journal vouchers, which according to FS's IPA is an inherently high-risk area, could have prevented or detected the material error that led to the restatement of USDA's originally issued fiscal year 2003 Combined Statement of Budgetary Resources. Failure to have properly designed and effective internal control procedures over processing nonroutine journal vouchers could, among other things, (1) increase the risks of fraud, waste, and mismanagement of funds and (2) result in materially inaccurate reporting of financial information.

An FS official stated that during fiscal year 2004, FS established new internal control procedures requiring multiple supervisory reviews of nonroutine journal vouchers with final approval by FS's CFO. These procedures, if effectively implemented, should help ensure that nonroutine journal vouchers are appropriate. According to FS's IPA, as of October 30, 2005, FS had not processed any nonroutine journal vouchers during fiscal year 2005.

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[28]According to an FS official, FS's nonroutine journal vouchers do not follow the USSGL posting model logic, since nonroutine journal vouchers allow for posting increases and decreases to any account in the general ledger. The USSGL provides basic standard posting logic for financial events across the federal government and illustrates both proprietary and budgetary entries for each accounting event.

[29]GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

Audit Procedures Were Not Effectively Implemented to Detect FS's Material Error

According to FS's IPA, its staff selected and reviewed the nonroutine journal voucher that resulted in the material error, but did not identify the above-noted problems related to the material error. According to the FAM, there are many aspects of an audit that require technical judgments, and the auditor should ensure that persons with adequate technical expertise are available to make such decisions. FS's IPA stated that starting in fiscal year 2004, it has staffed the audit with personnel more experienced in budgetary accounting and reporting and plans to continue staffing the FS audit with similarly experienced personnel.

In addition, FS's IPA noted in its fiscal year 2004 audit documentation that throughout fiscal year 2004, it tested FS's new internal control procedures for processing nonroutine journal vouchers by sampling nonroutine journal vouchers to determine whether they were accurately prepared, properly supported, correctly posted, and properly reviewed and approved. As a result of its internal control testing, FS's IPA found that (1) some journal vouchers were not accurately prepared, properly supported, and correctly posted and (2) in some instances, FS personnel had already identified the errors and made corrections. FS's IPA also noted that it discussed all errors disclosed by its test work with FS, and FS made appropriate corrections.

Disclosure and Presentation of USDA's Restatements Could Be Misinterpreted

Certain aspects of the footnote disclosure and financial statement presentation relating to the restatements could be misinterpreted. Specifically, the notes to USDA's comparative fiscal years 2004 and 2003 consolidated financial statements included a note disclosure titled Prior Period Adjustments, which could be misinterpreted since most of the corrections discussed in the note were not prior period adjustments as defined by SFFAS No. 21. In addition, we found that USDA's presentation of the restatements in its comparative fiscal years 2004 and 2003 consolidated financial statements could also be misinterpreted. Specifically, on USDA's fiscal years 2004 and 2003 comparative Consolidated Statement of Changes in Net Position, the fiscal year 2004 beginning balances did not agree with the restated fiscal year 2003 ending balances, and amounts were reported in the fiscal year 2004 column as prior period adjustments to the fiscal year 2004 beginning balances to reflect the restated fiscal year 2003 ending balances. We believe that a clearer presentation on USDA's fiscal years 2004 and 2003 comparative Consolidated Statement of Changes in Net Position would have been to carry forward the restated fiscal year 2003 ending balances and present them as the fiscal year 2004 beginning balances instead of presenting prior period adjustments in the fiscal year 2004 column.

Other Matters Related to the Disclosure of the Restatements

According to SFFAS No. 15, *Management's Discussions and Analysis*, management should have great discretion regarding what to say in its MD&A, but the pervasive requirement is that the MD&A not be misleading. USDA asserted in its fiscal year 2004 MD&A that an unqualified financial statement audit opinion indicates that a department's financial statements are free of significant errors or misstatements. USDA also stated in its MD&A that "in fiscal year 2002, USDA—and all its agencies—achieved their first unqualified consolidated financial audit opinion in the Department's 140-year history … USDA's clean audit opinion was sustained in fiscal years 2003 and 2004." However, USDA did not specifically acknowledge in the MD&A that its fiscal year 2003 and its fiscal year 2002 consolidated financial statements, as originally issued, were both materially misstated and subsequently restated. Furthermore, in its MD&A, USDA did not completely disclose the nature and extent of the restatements to its originally issued fiscal year 2003 financial statements. Specifically, USDA disclosed in the MD&A only one of the three restatements discussed in this report. We believe not including the above-noted information in the MD&A could be misleading. Although the OIG told us that it believed disclosure of such information in its audit report was not necessary, in our view, such disclosure could have reduced the potential for a reader to be misled.

Conclusions

The material errors in USDA's originally issued fiscal year 2003 consolidated financial statements could have been detected by more effective internal controls and audit procedures. USDA corrected the errors and issued restated financial statements. Going forward, it will be important for USDA to ensure that corrective actions are taken to prevent any similar errors from going undetected. In addition, for future years, USDA should ensure the adequacy of the disclosure and presentation of audit results and any restatements. Further, it will be important that USDA's OIG and other auditors effectively implement audit procedures to detect any similar errors in the future.

Recommendations for Executive Action

We are making three recommendations on this matter, including two recommendations to USDA's CFO. We recommend that USDA's CFO ensure (1) that procedures to prevent any errors similar to those that resulted in the need to restate USDA's originally issued fiscal year 2003 financial statements are effectively implemented and (2) for future years, the adequacy of the disclosure and presentation of audit results and any restatements.

We also recommend that USDA's Inspector General, in conjunction with the IPA if one is used, ensure that audit procedures are effectively implemented to test for any (1) improperly recorded appropriations transactions in the general ledger,

(2) improperly reported material items on the Statement of Financing, and (3) incorrect nonroutine journal vouchers.

Agency Comments

USDA's CFO and Inspector General provided written comments on a draft of this report. (See encs. I and II.) The CFO expressed confidence that his office's current plans and efforts would ensure that the financial statements are accurate and timely and contain adequate disclosures. The Inspector General agreed with our recommendations and stated that her office has instituted, in conjunction with the IPAs, strengthened quality control measures over its audit procedures.

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Within 60 days of the date of this report, we would appreciate receiving a written statement on actions taken to address these recommendations.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Homeland Security and Governmental Affairs; the Subcommittee on Federal Financial Management, Government Information, and International Security, Senate Committee on Homeland Security and Governmental Affairs; the House Committee on Government Reform; and the Subcommittee on Government Management, Finance and Accountability, House Committee on Government Reform. In addition, we are sending copies to the Fiscal Assistant Secretary of the Treasury and the Controller of OMB. This report is also available at no charge on GAO's Web site at www.gao.gov.

We appreciate the courtesy and cooperation extended to us by your staff throughout our work. We look forward to continuing to work with your offices to help improve financial management in the federal government. If you have any questions about the contents of this report, please contact me at (202) 512-3406 or engelg@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

Gary T. Engel

Gary T. Engel
Director
Financial Management and Assurance

Enclosure I: Comments from the Chief Financial Officer, Department of Agriculture

USDA

United States Department of Agriculture

Office of the Chief Financial Officer

1400 Independence Avenue, SW

Washington, DC 20250

JAN 18 2006

Mr. Gary T. Engel
Director
Financial Management and Assurance
Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Engel:

The Department of Agriculture's Office of the Chief Financial Officer (OCFO) appreciates the opportunity to comment on the draft audit report no. GAO-06-254R, dated December 15, 2005, relating to your Financial Audit: Restatements to the Department of Agriculture's Fiscal Year 2003 Consolidated Financial Statements. We have no comments regarding your report except to thank you for your efforts.

OCFO is confident that our current plans and efforts will assure that our consolidated financial statements are accurate and timely and will contain clear and full disclosures in accordance with requirements.

Sincerely,

Charles R. Christopherson, Jr.
Chief Financial Officer

Enclosure II: Comments from the Inspector General, Department of Agriculture

USDA

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250

JAN - 9 2006

Mr. Gary T. Engel
Director
Financial Management and Assurance
Government Accountability Office
441 G Street NW.
Washington, D.C. 20548

Dear Mr. Engel:

The following is the Department of Agriculture's (USDA) Office of Inspector General (OIG) response to the U.S. Government Accountability Office (GAO) draft audit report GAO-05-595R, dated December 15, 2005, relating to your review of the fiscal year (FY) 2003 restatements to USDA's financial statements. We generally agree with the facts as presented.

Recommendations to OIG for Executive Action

GAO recommended that the USDA Inspector General, in conjunction with the independent public accountants (IPA), ensure that audit procedures are effectively implemented to test for any (1) improperly recorded appropriation transactions in the general ledger, (2) improperly reported material items on the Statement of Financing, and (3) incorrect non-routine journal vouchers.

OIG Response

We agree with the recommendations addressed to OIG. Our office has instituted, in conjunction with the IPAs, strengthened quality control measures over our audit procedures. Specifically, analytical procedures detecting fluctuations in general ledger account balances and relationships between financial statements are being employed extensively in all of the financial statement audits performed by OIG and in conjunction with the IPAs.

Thank you for the opportunity to provide our comments to GAO's report of USDA's restatements to USDA's FY 2003 consolidated financial statements. If you have any questions, please contact me at (202) 720-8001, or Mr. Robert W. Young, Assistant Inspector General for Audit, at (202) 720-6945.

Sincerely,

for Phyllis K. Fong
Inspector General

(198397)

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