



United States General Accounting Office
Washington, DC 20548

Comptroller General
of the United States

B-285019

March 28, 2000

The President
The President of the Senate
The Speaker of the House of Representatives

Implementation of important legislative reforms remains underway to promote greater accountability in managing the finances of our national government. These reforms include requirements for annual audited financial statements for 24 major departments and agencies as well as preparation of the financial statements of the U.S. government, which GAO is required to audit. The report on our audit of these financial statements for fiscal year 1999 is enclosed.

These financial reporting requirements are prompting steady improvements in federal financial accountability, and there has been progress toward meeting the related legislative objectives. The President has designated financial management improvement as a priority management objective and efforts are underway across government to address the pervasive, generally long-standing financial management problems discussed in our accompanying report. Thus far, 13 of 24 major agencies have received unqualified opinions on their fiscal year 1999 financial statements and others have resolved certain previously reported financial statement deficiencies. For example, the Department of Energy resolved its previously reported deficiency related to its environmental and disposal liability associated with nuclear weapons. Also, in October 1999, the American Institute of Certified Public Accountants recognized federal accounting standards as a generally accepted basis of accounting, which represents a major milestone for the federal government.

At the same time, several major departments are not yet able to produce auditable financial statements on a consistent basis. There are several major obstacles to overcome, both at the agency level and in preparing reliable financial statements for the U.S. government. The deficiencies discussed in our accompanying report prevented us from being able to form an opinion on the reliability of the accompanying fiscal year 1999 financial statements, as was the case in our fiscal years 1998 and 1997 audits. These deficiencies continue to significantly impair the federal government's ability to

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adequately safeguard certain significant assets, properly record various transactions, and comply with selected provisions of laws and regulations related to financial reporting. Additionally, (1) the government is unable to determine the full extent of improper payments—estimated to total billions of dollars annually—and therefore cannot develop effective strategies to reduce them, (2) serious, long-standing computer security weaknesses expose the government's financial and other sensitive information to inappropriate disclosure, destruction, modification, and fraud, and critical operations to disruption, and (3) material control weaknesses affect the government's tax collection activities.

The executive branch recognizes that, because of the extent and severity of the financial management deficiencies, addressing them will require concerted improvement efforts across government. With a concerted effort, the federal government, as a whole, can continue to make progress toward achieving accountability and generating reliable financial and management information on a timely basis and in an ongoing manner. Annual financial audits represent an important means to assure continued progress in connection with improving federal financial management.

While obtaining unqualified “clean” audit opinions on federal financial statements is an important objective, it is not an end in and of itself. The key is to take steps to continuously improve internal control and underlying financial and management information systems as a means to assure accountability, increase the economy, improve the efficiency, and enhance the effectiveness of government. These systems must generate timely, accurate, and useful information on an ongoing basis, not just as of the end of the fiscal year. Unfortunately, for fiscal year 1999, the financial management systems of almost all agencies were again found not to be in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996. In addition, while some attention to delineating core competencies and training has occurred, a great deal more needs to be done to improve financial management human capital.

Reliable financial information is essential for analyzing the government's financial condition and helping inform budget deliberations by providing additional information beyond that provided in the budget. The budget of the federal government is primarily formulated on a cash basis, which also is generally the basis for calculating the annual budget surplus or deficit. The financial statements are prepared generally on the accrual basis of accounting. The most significant difference between the budget and accrual basis of accounting is the timing of recognition and measurement of revenues and costs.

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Accrual information can be used with budgetary information to provide a valuable perspective on the costs of agency programs and the government's assets and long-term commitments. This is especially important given current demographic trends and the fiscal challenges that will result.

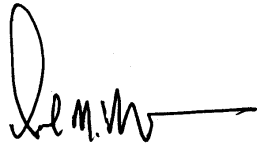
Last year we discussed the Year 2000 challenge in our report. The federal government has met the "date change" challenge. The leadership exhibited by the legislative and executive branches and the partnerships formed by a myriad of public, private, and international organizations were critical factors behind this success.

The accompanying Financial Report and our report include certain information concerning the Social Security and Medicare (Part A) trust funds, such as projected contributions and expenditures, dates when expenditures are expected to exceed contributions, and dates when such funds are expected to be exhausted. Such information is as of January 1, 1999 for Social Security and as of September 30, 1999 for Medicare (Part A), the most recent information publicly reported by the government. The government plans to issue, on March 30, 2000, updated information as of January 1, 2000. The government's issuance of dated information in this Financial Report at about the same time that it issues more current information may cause confusion to the Congress and the public. Steps should be taken, in future years, to ensure that the government's Financial Report contains up-to-date information as of no earlier than the end of the most recent fiscal year. Because current information on the solvency of the Social Security and Medicare programs is critical to assessing the financial condition of the federal government, aiding in budget deliberations, and fostering public debate, we will include the updated information on these two important federal programs in a report that will also contain the Fiscal Year 1999 Financial Report of the United States Government.

We appreciate the cooperation and assistance we received from the Chief Financial Officers and Inspectors General throughout government, as well as Department of the Treasury and Office of Management and Budget officials, in carrying out our responsibility to audit the government's financial statements. We look forward to continuing to work with these officials and the Congress to achieve the goals and objectives associated with financial management reform.

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Our report was prepared under the direction of Jeffrey C. Steinhoff, Acting Assistant Comptroller General for Accounting and Information Management, and Robert F. Dacey, Director, Consolidated Audit and Computer Security Issues. If you have any questions, please contact me on (202) 512-5500 or them on (202) 512-3317.

A handwritten signature in black ink, appearing to read 'D.M. Walker', with a long horizontal stroke extending to the right.

David M. Walker
Comptroller General
of the United States



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The President
The President of the Senate
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The Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget (OMB), is required to annually submit financial statements for the U.S. Government to the President and the Congress.¹ GAO is required to audit these statements. This is our report on our audit of the financial statements of the U.S. government for fiscal year 1999.²

In summary, certain significant financial systems weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal control, including computer controls, continue to prevent the government from accurately reporting a significant portion of its assets, liabilities, and costs. Some of these deficiencies primarily relate to specific major agencies; others, such as intragovernmental transactions, affect the entire government. These deficiencies affect the reliability of the accompanying financial statements and much of the related information in the Fiscal Year 1999 Financial Report of the United States Government, as well as the underlying financial information. They also affect the government's ability to accurately measure the full cost and financial performance of certain programs and effectively manage related operations.

¹The Government Management Reform Act of 1994 requires such reporting beginning with financial statements prepared for fiscal year 1997.

²Our report on the fiscal year 1998 financial statements is entitled Financial Audit: 1998 Financial Report of the United States Government (GAO/AIMD-99-130, March 31, 1999).

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Major problems included the federal government's inability to:

- properly account for and report (1) material amounts of property, equipment, materials, and supplies and (2) certain stewardship assets, primarily at the Department of Defense;
- properly estimate the cost of certain major federal credit programs and the related loans receivable and loan guarantee liabilities, primarily at the Department of Agriculture;
- estimate and reliably report material amounts of environmental and disposal liabilities and related costs, primarily at the Department of Defense;
- determine the proper amount of various reported liabilities, including postretirement health benefits for military employees and accounts payable and other liabilities for certain agencies;
- accurately report major portions of the net cost of government operations;
- ensure that all disbursements are properly recorded; and
- properly prepare the federal government's financial statements, including balancing the statements, accounting for substantial amounts of transactions between governmental entities, properly and consistently compiling the information in the financial statements, and reconciling the results of operations to budget results.

Such deficiencies prevented us from being able to form an opinion on the reliability of the accompanying fiscal year 1999 financial statements, as was the case in our fiscal years 1998 and 1997 audits. These deficiencies continue to significantly impair the federal government's ability to adequately safeguard certain significant assets, properly record various transactions, and comply with selected provisions of laws and regulations related to financial reporting. Additionally, (1) the government is unable to determine the full extent of improper payments—estimated to total billions of dollars annually—and, therefore, cannot develop effective strategies to reduce them, (2) serious, long-standing computer security weaknesses expose the government's financial and other sensitive information to inappropriate disclosure, destruction, modification, and fraud, and critical operations to disruption, and (3) material control weaknesses affect the government's tax

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collection activities. Further, the financial management systems of almost all agencies were again found not to be in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996.

Our audit and the Inspectors General (IG) audits of major component agencies' financial statements for fiscal year 1999 continue to result in (1) an identification and analysis of deficiencies in the government's recordkeeping, financial reporting, and control systems and (2) recommendations to correct them. Fixing these problems represents a significant challenge because of the size and complexity of the government and the discipline and human capital needed to follow sound financial management and reporting practices.

This report provides our (1) disclaimer of opinion on the government's fiscal year 1999 financial statements, (2) report on internal control, and (3) report on compliance with selected provisions of laws and regulations related to financial reporting. It also provides illustrations of the identified material deficiencies. A more complete discussion of these issues may be found in individual agency reports. Additionally, the report highlights certain long-term financing issues facing government. The objectives, scope, and methodology of our work are discussed in the appendix to this report. We provided a draft of this report to Department of the Treasury and OMB officials, who expressed their commitment to address the deficiencies this report outlines. We did our work in accordance with generally accepted government auditing standards.

DISCLAIMER OF OPINION

Because we were unable to determine the reliability of significant portions of the accompanying financial statements for the reasons outlined above and described in more detail below, we are unable to, and we do not, express an opinion on the accompanying fiscal year 1999 financial statements.

Because of the serious deficiencies in the government's systems, recordkeeping, documentation, financial reporting, and controls, readers are cautioned that amounts reported in the financial statements and related notes may not be a reliable source of information for decision-making by the government or the public. These deficiencies also affect the reliability of information contained in the accompanying Management's Discussion and Analysis and any other financial management information--including information used to manage the government day-to-day and certain budget information reported by agencies--which is taken from the same data sources as the financial statements.

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Further, while we have not audited and do not express an opinion on the Stewardship Information, Supplemental, or Other Information included in the accompanying Financial Report, we noted certain material omissions related to the presentation of national defense assets and issues related to the reconciliation of the results of operations to budget results, which are discussed below.

The accompanying Financial Report and our report include certain information concerning the Social Security and Medicare (Part A) trust funds, such as projected contributions and expenditures, dates when expenditures are expected to exceed contributions, and dates when such funds are expected to be exhausted. Such information is as of January 1, 1999 for Social Security and as of September 30, 1999 for Medicare (Part A), the most recent information publicly reported by the government. The government plans to issue, on March 30, 2000, updated information as of January 1, 2000. The government's issuance of dated information in this Financial Report at about the same time that it issues more current information may cause confusion to the Congress and the public. Steps should be taken, in future years, to ensure that the government's Financial Report contains up-to-date information as of no earlier than the end of the most recent fiscal year. Because current information on the solvency of the Social Security and Medicare programs is critical to assessing the financial condition of the federal government, aiding in budget deliberations, and fostering public debate, we will include the updated information on these two important programs in a report that will also contain the Fiscal Year 1999 Financial Report of the United States Government.

Material Deficiencies

The following sections describe material deficiencies that contribute to our disclaimer of opinion, discuss their effects on the financial statements and the management of government operations, and highlight certain corrective actions. Although the federal government has made steady progress, the fundamental nature of these deficiencies remains unchanged from our fiscal year 1998 and 1997 financial statement reports. Each of these deficiencies also constitutes a material weakness in internal control.³

³ A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors, fraud, or noncompliance in amounts that would be material to the financial statements may occur and not be detected on a timely basis by employees in the normal course of performing their duties.

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Property, Plant, and Equipment and Inventories and Related Property

The federal government--one of the world's largest holders of physical assets—does not have adequate systems and controls to ensure the accuracy of information about the amount of assets held to support its domestic and global operations. A majority of the \$472 billion of these reported assets is not adequately supported by financial and/or logistical records. Assets that are not adequately supported include: (1) buildings, structures, facilities, and equipment, (2) various government-owned assets that are in the hands of private sector contractors, and (3) operating materials and supplies comprised largely of ammunition, defense repairable items, and other military supplies. Also, the government cannot ensure that all assets are reported. For example, no Department of Defense (DOD) contractor-held personal property was reported. Further, national defense asset unit information reported as Stewardship Information was incomplete because (1) it did not include major national defense support equipment, such as uninstalled engines and communications equipment, and (2) amounts were reported in units, rather than in dollars as required by current generally accepted accounting principles. DOD, the largest holder of these assets, has acknowledged the challenges it faces to implement effective systems and accurately record data to properly account for and report its physical assets and has a number of initiatives underway that are intended to address this problem. These initiatives are expected to span several years.

Because the government lacks complete and reliable information to support its asset holdings, it could not satisfactorily determine that all assets were included in the financial statements, verify that reported assets actually exist, or substantiate the amounts at which they were valued. For example, periodic physical counts have shown that inventory records contain significant error rates. Further, weak controls significantly impair the government's ability to detect and investigate fraud or theft of assets.

Accurate asset information is necessary for the government to (1) know the assets it owns and their location and condition, (2) safeguard its assets from physical deterioration, theft, or loss, (3) account for acquisitions and disposals of such assets, (4) prevent unnecessary storage and maintenance costs or purchase of assets already on hand, and (5) determine the full costs of government programs that use these assets.

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Loans Receivable and Loan Guarantee Liabilities

As of the end of fiscal year 1999, the government reported \$184 billion of loans receivable and \$35 billion of liabilities for estimated losses related to estimated future defaults of guaranteed loans. Certain federal credit agencies, responsible for significant portions of the government's lending programs, were unable to properly estimate the cost of these programs in accordance with generally accepted accounting principles and budgeting requirements. As an example, the Department of Agriculture, which represents a significant portion of loans receivable, could not estimate the net loan amounts expected to be collected because it does not maintain some of the key historical data needed to predict borrower behavior, such as the amount and timing of future defaults and prepayments. Agriculture's lack of historical data is largely the result of system inadequacies. Certain affected agencies are in the process of implementing action plans intended to develop reliable loan and loan guarantee information. Reliable information about the cost of credit programs is important in supporting annual budget requests for these programs, making future budgetary decisions, managing program costs, and measuring the performance of credit activities. Federal credit programs include direct loans and loan guarantees for farms, rural utilities, low and moderate income housing, small businesses, veterans' mortgages, and student loans.

Environmental and Disposal Liabilities

Significant portions of the liability for remediation of environmental contamination and disposal of hazardous waste, reported at \$313 billion, lacked adequate support and may not be complete. For example, the estimated cost to remove unexploded ordnance and residual contaminants from training ranges, amounting to over 40 percent of DOD's recorded liability, is not adequately supported. Also, the cost of significant estimated liabilities associated with certain major weapons systems and training ranges, initially recorded in fiscal year 1999, was reported as a current year cost, rather than as a prior period adjustment as required by generally accepted accounting principles.

Properly stating environmental and disposal liabilities and improving internal control supporting the process for their estimation could assist in determining priorities for cleanup and disposal activities and allow for appropriate consideration of future budgetary resources needed to carry out these activities. DOD, which has significant exposure for environmental and disposal liabilities, improved its initial estimate in fiscal

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year 1999 by including additional categories of liabilities, such as nuclear weapons systems. Also, DOD has a project in progress that is intended to better identify and document all additional environmental and disposal liabilities.

Liabilities

Adequate systems and cost data were not available to accurately estimate the reported \$196 billion military postretirement health benefits liability included in federal employee and veteran benefits payable. Information used to develop such estimates did not include the full cost of providing health care benefits. In addition, some of the underlying patient workload data were not reliable. DOD is evaluating methods to develop a reliable estimate of this liability. Also, some agencies do not maintain adequate records or have systems to ensure that accurate and complete data were used to estimate a reported \$86 billion of accounts payable and a reported \$169 billion in other liabilities. For example, a liability was not reported for certain amounts owed to contractors that, under the terms of the contracts, were held by the government pending the acceptance of goods or services. Further, the government was unable to provide adequate information to determine whether commitments and contingencies were complete and properly reported. These problems significantly affect the determination of the full cost of the government's current operations, the value of its assets, and the extent of its liabilities.

Cost of Government Operations

The government was unable to support significant portions of the \$1.76 trillion reported as the total net cost of government operations. The previously discussed material deficiencies in reporting assets and liabilities and the lack of effective cash disbursement reconciliations and deficiencies in financial statement preparation, as discussed below, affect reported net costs. Further, we were unable to determine whether the amounts reported in the individual net cost categories on the Statement of Net Cost and in the subfunction detail in Supplemental Information were properly classified. Accurate cost information is important to the federal government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required.

Cash Disbursement Activity

Several major agencies are not effectively reconciling cash disbursements. These reconciliations are intended to be a key control to detect and correct errors and other

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misstatements in financial records in a timely manner--similar in concept to individuals reconciling personal checkbooks with a bank's records each month. Although improvements in some agency reconciliation processes have been noted, there continued to be billions of dollars of unreconciled differences between agencies' and Treasury records of cash disbursements as of the end of fiscal year 1999. As a result, the government is unable to ensure that all disbursements are properly recorded. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by agencies for inclusion in the President's budget concerning fiscal year 1999 obligations and outlays.

Preparation of Financial Statements

The government does not have sufficient systems, controls, or procedures to properly prepare financial statements for the U.S. government. Such deficiencies, described below, impair the government's ability to (1) properly balance the government's financial statements and account for billions of dollars of transactions between governmental entities, (2) properly and consistently compile the information in the financial statements, and (3) effectively reconcile the results of operations reported in the financial statements with budget results. Also, certain financial information required by generally accepted accounting principles was omitted from the financial statements.

Unreconciled Transactions. To make the financial statements balance, Treasury recorded a net \$24 billion item on the Statement of Operations and Changes in Net Position, which it labeled unreconciled transactions. Treasury attributes this net out-of-balance amount to the government's inability to properly identify and eliminate transactions between federal government entities, to agency adjustments that affected net position, and to errors. An additional net \$12 billion of unreconciled transactions was improperly recorded in net cost. These unreconciled transactions result in material misstatements of assets, liabilities, revenues, and/or costs.

Agencies' accounts can be out of balance with each other, for example, when one or the other of the affected agencies does not properly record a transaction with another agency or the agencies record the transactions in different accounting periods. These out-of-balance conditions can be detected and corrected by instituting procedures for reconciling transactions between agencies on a regular basis and in a timely manner.

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In fiscal year 1999, the government required agencies to reconcile certain intragovernmental accounts. Some of these accounts, such as those related to employee benefits, could not be reconciled. Also, in fiscal year 1999, the government gathered, for the first time, the detail of certain intragovernmental accounts by “trading partner” agency. Using this information, we estimated that the amounts reported for agency trading partners for these specific intragovernmental accounts were out-of-balance by more than \$350 billion. With trading partner information, the government can begin to analyze the nature of these intragovernmental account differences and develop effective solutions. Solutions will also be required for significant differences reported in other intragovernmental accounts, primarily related to appropriations. The government stated that it plans to require agencies to reconcile additional intragovernmental accounts in fiscal year 2000 and has formed task forces to recommend solutions to this long-standing problem.

Unreconciled transactions also may arise because the government does not have effective controls over reconciling net position. The net position reported in the financial statements is derived by subtracting liabilities from assets, rather than through balanced accounting entries. Also, certain adjustments and eliminations do not balance. Such control weaknesses, combined with unbalanced transactions and the significant volume of transactions and number of reporting entities, result in misstatements in the financial statements, hinder the ability of the government to identify misstatements that may exist, and may contribute to the amount of reported unreconciled transactions.

Financial Statement Compilation. The federal government cannot ensure that the information in the financial statements of the U.S. government is properly and consistently compiled. To prepare the federal government’s financial statements, about 70 agencies submit data to Treasury on approximately 2,000 separate reporting components, each having many account balances. In fiscal year 1999, the Department of Treasury, which prepares the accompanying financial statements, implemented a new process for reconciling these financial statements with the related agency financial statements. While the process identified the nature of certain inconsistencies, the government was unable to reconcile all amounts included in these financial statements with agency financial statements. Further, material adjustments and reclassifications were required to (1) make the financial statements more consistent with agency financial statements, (2) correct identified inconsistencies in reporting similar transactions, (3) conform footnote information to related financial statement line items, and (4) record other audit adjustments. We identified over \$350 billion of adjustments and

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reclassifications which the government subsequently recorded, such as financial statement compilation errors that had resulted in a \$66 billion overstatement of interest cost and a \$70 billion overstatement of Medicare costs.

These problems are compounded by the substantial volume of information submitted and limitations in the federal government's general ledger (SGL) account structure. For example, some SGL accounts must be split between different financial statement line items. As a result, additional misclassifications and misstatements in the government's financial statements could exist. Also, the extensive manual intervention required to compile the federal government's financial statements requires significant resources which lessens the government's ability to perform effective financial analysis of the information. For example, because of SGL limitations, the government separately collects additional information needed to compile the financial statements. However, such additional information, historically, is initially inconsistent with the related SGL account balances by hundreds of billions of dollars. After substantial effort, such inconsistencies were reduced to an immaterial amount.

Reconciling the Results of Operations With Budget Results. The federal government does not yet have a process to obtain information to effectively reconcile the reported \$77 billion excess of revenue over net cost and a reported unified budget surplus of \$124 billion. Consequently, it could not identify all of the items needed to reconcile these amounts. Certain differences are expected to occur because the financial statements of the U.S. government are to be prepared on the accrual basis in accordance with generally accepted accounting principles, which is a different basis than the budget. Under accrual accounting, transactions are reported when the events giving rise to the transactions occur, rather than when cash is received or paid. By contrast, federal budgetary reporting is generally on the cash basis in accordance with accepted budget concepts and policies.

Beginning in fiscal year 1998, 24 major agencies were required to reconcile their reported net costs to budget information, which could provide a basis for preparing the reconciliation. However, significant amounts reported in certain agency reconciliations, including unliquidated obligations and certain other budget information, lacked adequate supporting information and may be unreliable. For example, significant amounts of DOD transactions were not applied or were incorrectly applied to specific budget appropriations, which could misstate certain reported budget information. Once the federal government produces reliable financial statements, an effective reconciliation could help provide additional assurance of the reliability of budget results.

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INEFFECTIVE INTERNAL CONTROL

Because of the effects of the material weaknesses discussed below, the federal government has not maintained effective internal control to ensure that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements and stewardship information in accordance with generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition and (2) transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements. Individual agency financial statement audit reports describe the effects of such weaknesses on specific agencies and identify additional internal control weaknesses, some of which are material to individual agencies.

In addition to the material weaknesses related to the deficiencies discussed in our disclaimer on the financial statements, we found that (1) the government's inability to determine the full extent of improper payments impairs the effective reduction of such improper payments, (2) widespread and serious computer control weaknesses affect virtually all federal agencies and significantly contribute to many of the material deficiencies discussed above, and (3) material control weaknesses affect the government's tax collection activities. Due to the deficiencies noted throughout this report, additional material weaknesses may exist that have not been reported.

Improper Payments

The government is unable to determine the full extent of improper or erroneous payments, which include payments made for unauthorized purposes, for excessive amounts, such as overpayments to program recipients or contractors and vendors, and/or not in accordance with applicable laws and regulations. Across government, improper payments occur in a variety of programs and activities, including those related to contract management, federal financial assistance, and tax refunds. Reported estimates of improper payments total billions of dollars annually.

The Department of Health and Human Services (HHS) has been reporting a national estimate of improper Medicare Fee-for-Service payments since fiscal year 1996. In fiscal year 1999, HHS reported estimated improper Medicare Fee-for-Service payments of \$13.5 billion, or about 8 percent of such benefits—down from \$23.2 billion or 14 percent for fiscal year 1996. HHS' reporting and analysis of improper Medicare payments has

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helped lead to the implementation of several initiatives to identify and reduce such payments. Annual estimates of improper payments in future audited financial statements will provide information on the progress of these initiatives.

However, most agencies have not estimated the magnitude of improper payments in their programs, nor have they considered this issue in their annual performance plans. For example, the Earned Income Tax Credit (EITC) program—a refundable tax credit available to low income, working taxpayers—has historically been vulnerable to high rates of invalid claims. During fiscal year 1999, IRS examined about 573,000 suspicious tax returns claiming \$1.25 billion in EITCs and found that \$1.08 billion (86 percent) were invalid. Although the full extent of refunds resulting from invalid EITCs is unknown, the IRS has not disclosed any improper payment estimates in its financial statement reports. In another example, HHS has not reported an estimate of improper payments in its \$109 billion state-administered Medicaid program, but is currently studying methodologies for developing an estimate and has formed partnerships with various state auditors to share information on improper payments.

Improper payments can result from incomplete or inaccurate data used to make payment decisions, insufficient monitoring and oversight, or other deficiencies in agency information systems and weaknesses in internal control. The risk of improper payments is increased in programs involving (1) complex criteria for computing payments, (2) a significant volume of transactions, or (3) an emphasis on expediting payments. The reasons for improper payments range from inadvertent errors to fraud and abuse.

Without a systematic measurement of the extent of the problem, agency management cannot determine (1) if the problem is significant enough to require corrective action, (2) how much to invest in internal control, or (3) the success of efforts implemented to reduce improper payments. Developing mechanisms to identify, estimate, and report the nature and extent of improper payments in annual financial statements is only a first step for agencies. Without this fundamental knowledge, agencies cannot be fully informed about the magnitude or trends of improper payments, nor can they pinpoint or target mitigation strategies.⁴

⁴Financial Management: Increased Attention Needed to Prevent Billions in Improper Payments (GAO/AIMD-00-10, October 29, 1999).

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In October 1999, we recommended that OMB develop and implement a methodology for annually estimating and reporting improper payments and for addressing improper payments in agencies' annual performance and strategic plans and performance reports. OMB agrees with this recommendation. In this regard, the President has made estimating and preventing improper payments a priority management objective and OMB plans to require agencies to develop and implement procedures to estimate and report the nature and extent of material improper payments in annual financial statements and have such information audited.

Computer Security Weaknesses

Continuing serious and widespread computer security weaknesses are placing enormous amounts of federal assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. Significant computer security weaknesses in systems that handle the government's unclassified information have been reported in each of the major federal agencies. The most serious reported problem is inadequately restricted access to sensitive data. Other types of weaknesses pertain to not adequately segregating duties to help ensure that people do not conduct unauthorized actions without detection, preventing unauthorized software from being implemented, and mitigating and recovering from unplanned interruptions in computer service. In today's highly computerized and interconnected environment, such weaknesses are vulnerable to exploitation by outside intruders as well as authorized users with malicious intent. Recent media reports highlight the potential damage that can result from computer security breaches.

The government cannot estimate the full magnitude of actual damage and loss resulting from federal computer security weaknesses because it is likely that many such incidents are either not detected or not reported. GAO and agency reviews illustrate the potential for negative impacts. For instance, weaknesses in DOD information security continue to provide hackers and hundreds of thousands of authorized users the opportunity to modify, steal, and destroy DOD data including financial, procurement, logistics and other sensitive information. Also, identified weaknesses at HCFA, SSA, IRS, and VA place tax, medical and other sensitive records at risk of unauthorized disclosure, modification, and destruction. Unauthorized disclosure of sensitive information has led to instances of identity theft, in which individuals use such information to commit financial crimes, such as fraudulently establishing credit and running up debts. Likewise, serious and pervasive computer security problems at EPA increase the risk that mission-related systems and

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financial operations are vulnerable to tampering, disruption, and misuse. Further, pervasive weaknesses at the Department of the Treasury, which collects virtually all of the government's revenues and makes most of its disbursements, expose such collections and disbursements to significant risk of loss or fraud.

GAO and the IGs have issued numerous reports that identify information security weaknesses in the federal government and made recommendations to address them.⁵ Also, GAO has reported information security as a high-risk area across government since February 1997.⁶

Information security problems continue to persist, in large part, because agency managers have not fully established comprehensive security management programs. An effective program would include a central security function and effective procedures for assessing risks, establishing appropriate policies and related controls, raising employee awareness of prevailing risks and mitigating controls, and monitoring and evaluating the effectiveness of established controls. Such programs, if properly implemented, would provide the government with a solid foundation for resolving computer security problems and managing computer security risks on an ongoing basis.

The Congress continues to express concern about the significant risks to federal government systems and information that result from computer security weaknesses. Congressional hearings have focused on specific agency deficiencies and have clarified the problem across government. Further, S. 1993, the Government Information Security Act of 1999, recently introduced in Congress, seeks to strengthen information security practices throughout the federal government.

The Administration has recognized the importance of computer security and has taken some steps to prompt improvement from a governmentwide perspective. In January

⁵ See, for example, Critical Infrastructure Protection: Comprehensive Strategy Can Draw on Year 2000 Experiences (GAO/AIMD-00-1, October 1, 1999) and Information Security: Serious Weaknesses Place Critical Federal Operations at Risk (GAO/AIMD-98-92, September 23, 1998).

⁶ High-Risk Series: An Update (GAO/HR-99-1, January 1999), High-Risk Series: An Overview (GAO/HR-97-1, February 1997), and High-Risk Series: Information Management and Technology (GAO/HR-97-9, February 1997).

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2000, the President released the *National Plan for Information Systems Protection*,⁷ which calls for new initiatives to strengthen the nation's defenses against threats to public and private sector information systems that are critical to the country's economic and social welfare. In addition, the President designated computer security as a priority management objective.

Tax Collection Activities

The federal government continues to have material weaknesses in controls related to its tax collection activities, which affect its ability to efficiently and effectively account for and collect the government's revenue. This situation results in the need for extensive, costly, and time-consuming ad hoc programming and analysis, as well as material audit adjustments, to prepare basic financial information—an approach that cannot be used to prepare such information on a timely, routine basis to assist in ongoing decision-making. Additionally, the severity of the system deficiencies that give rise to the need to resort to such procedures for financial reporting purposes, as well as deficient physical safeguards, result in burden to taxpayers and lost revenue.

Serious financial management system deficiencies continue to affect the federal government's ability to effectively manage its taxes receivable and other unpaid assessments.⁸ The lack of appropriate subsidiary systems to track the status of taxpayer accounts affects the government's ability to make informed decisions about collection efforts. This weakness has resulted in the government pursuing collection efforts against individual taxpayers who had already paid their taxes in full. In addition, the government does not always pursue collection efforts against taxpayers owing taxes to the federal government. This could result in billions of dollars not being collected and adversely affect future compliance.

⁷ Defending America's Cyberspace: National Plan for Information Systems Protection: Version 1.0: An Invitation to a Dialogue. Released January 7, 2000. The White House.

⁸ Other unpaid assessments consist of amounts for which (1) neither the taxpayer nor a court has affirmed are owed or (2) the government does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency.

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The federal government also continues to be vulnerable to loss of tax revenue due to weaknesses in preventive and detective controls over disbursements for tax refunds. Although the government does have detective controls in place, they are not applied to millions of tax returns estimated to have billions of dollars in underreported tax liabilities. These conditions expose the government to potentially billions of dollars in losses due to inappropriate refund disbursements.

Also, the government does not perform sufficient up-front verification procedures to ensure the validity of amounts claimed by taxpayers as overpayments prior to making disbursements for refunds. Additionally, delays in recording tax amounts owed result in lost opportunities to retain or offset overpayments made by a taxpayer for one period to collect on outstanding amounts owed for another period, resulting in lost revenue. Finally, serious deficiencies in physical controls over cash, checks, and sensitive data received from taxpayers increase both the government's and the taxpayers' exposure to losses and increases the risk of taxpayers becoming victims of crimes committed through identity fraud.

IRS senior management has expressed a commitment to address many of these operational and financial management issues and has made a number of improvements to address some of these weaknesses. Successful implementation of long-term efforts to resolve these serious problems will require the continued commitment of IRS management as well as substantial resources and expertise.

NONCOMPLIANCE WITH CERTAIN LAWS AND REGULATIONS

Tests for compliance with selected provisions of laws and regulations related to financial reporting disclosed no instances of material noncompliance. However, other instances of noncompliance, some of which are material to individual federal agencies, are reported in the individual agency financial statement audit reports. Additionally, as described below, we noted that federal systems do not substantially comply with federal financial management systems requirements. We caution that noncompliance other than that discussed in our report may occur and not be detected by these tests and that our limited testing may not be sufficient for other purposes. Further, the scope of our tests was limited by the material deficiencies discussed above. Our objective was not to, and we do not, express an opinion on overall compliance with laws and regulations.

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Noncompliance With the Federal Financial Management Improvement Act of 1996

The Federal Financial Management Improvement Act (FFMIA) of 1996 requires auditors, as part of financial audits of certain major agencies, to report whether agencies' financial management systems comply substantially with federal accounting standards, financial systems requirements, and the government's standard general ledger at the transaction level. Thus far, for fiscal year 1999, agency financial auditors have reported that 19 of 22 major agencies' financial systems did not comply with the act's requirements. Systems of the remaining two major agencies that have not yet issued audited fiscal year 1999 financial statements did not comply with the act's requirements for fiscal years 1998 and 1997. Noncompliance with FFMIA, which we further discuss in our report, Financial Management: Federal Financial Management Improvement Act Results for Fiscal Year 1998 (GAO/AIMD-00-3, October 1, 1999), is indicative of the overall continuing poor condition of agency financial systems. Also, as we reported, agency remediation plans, required by FFMIA, may not adequately address the system deficiencies. Significant time and investment are needed for agencies to address and correct these long-standing financial management systems problems.

The majority of federal agencies' financial management systems do not meet systems requirements and cannot provide reliable financial information for managing day-to-day government operations and holding managers accountable. For many agencies, the preparation of financial statements requires considerable reliance on ad hoc programming and analysis of data produced by inadequate financial systems that are not integrated, reconciled, and often require significant adjustments. As a result, reliable financial information on a day-to-day basis is not available for effective financial management. For example, as discussed above, the IRS relies on extensive, costly, and time-consuming ad hoc programming and analysis, as well as material audit adjustments, to prepare basic financial information. The significant financial management deficiencies discussed throughout this report underscore the challenge.

FINANCIAL STATEMENTS AND BUDGET DECISIONS:
ADDING THE LONG-TERM PERSPECTIVE

A view of the long-term sustainability of fiscal policies can assist decisionmakers in considering the government's financial position and making decisions about resource

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allocation. Such a view requires projections of spending and revenues into the future. In this context, the sovereign power to tax and the commitments of social insurance programs—such as Social Security and Medicare—must be considered.

The accompanying Financial Report and our report include certain information concerning the Social Security and Medicare (Part A) trust funds, such as projected contributions and expenditures, dates when expenditures are expected to exceed contributions, and dates when such funds are expected to be exhausted. Such information is as of January 1, 1999 for Social Security and as of September 30, 1999 for Medicare (Part A), the most recent information publicly reported by the government. The government plans to issue, on March 30, 2000, updated information as of January 1, 2000. The government's issuance of dated information in this Financial Report at about the same time that it issues more current information may cause confusion to the Congress and the public. Steps should be taken, in future years, to ensure that the government's Financial Report contains up-to-date information as of no earlier than the end of the most recent fiscal year. Because current information on the solvency of the Social Security and Medicare programs is critical to assessing the financial condition of the federal government, aiding in budget deliberations, and fostering public debate, we will include the updated information on these two important federal programs in a report that will also contain the Fiscal Year 1999 Financial Report of the United States Government.

Commitments for the Social Security and Medicare programs are included in the Stewardship Information accompanying the financial statements. The government's 75 year estimates of the present value of expenditures in excess of contributions for the Social Security (Old Age Survivors and Disability Insurance (OASDI)) programs amounted to \$ 3.7 trillion, as of January 1, 1999, and for the Medicare (Part A) program amounted to \$3.1 trillion, as of September 30, 1999. The government's projections also indicate that Social Security and health care costs will absorb an increasing share of the federal budget.

In fiscal year 1999, Social Security trust funds reported surpluses of \$124.7 billion and Medicare (Part A) reported surpluses of \$21.5 billion, which included non-cash intragovernmental interest income of \$52.1 billion and \$9.3 billion, respectively. These surpluses contributed to the \$124.4 billion unified budget surplus. However, for example, as discussed in the accompanying Stewardship Information, using the government's best estimates as of January 1, 1999, cash disbursements of the Social

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Security trust funds (OASDI) are expected to exceed cash receipts beginning in fiscal year 2014.

When trust funds' receipts exceed disbursements, they are invested in Treasury securities and used to meet current cash needs of the government. These securities are assets to the trust funds and liabilities to the Treasury. In effect, one part of the government is lending to another. As disclosed in notes 10 and 19, both the investments and liabilities, which amounted to \$2 trillion at September 30, 1999, are netted out in the accompanying financial statements. Such investments are expected to increase to over \$4 trillion in the next 20 years.

Expected cash shortfalls in the trust funds will require them to redeem their investments in Treasury securities. When this occurs, the government must fund these redemptions through some combination of future surpluses, if available, lower relative spending for other federal programs, higher relative taxes, and/or greater relative borrowing from the public. Further, under the government's projections, absent any program or financing change, the Social Security trust funds and Medicare (Part A) Trust Fund will exhaust their Treasury security holdings in 2034 and 2015, respectively.

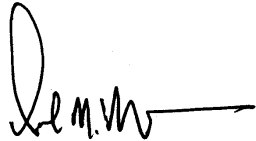
There is general recognition that the Social Security and Medicare (Part A) programs require major reforms to deal with the long-term solvency and sustainability of these two programs. The fact that Social Security is expected to draw down its Treasury securities holdings in less than 15 years, and that it is expected that Medicare will need to do so in less time, highlights the importance of acting soon in order to avoid more dramatic changes in the future.

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We are working with OMB, the Treasury, and other agencies across government to provide recommendations for fixing the major deficiencies cited in our audit. Considerable effort is now being exerted to address the problems, and several agencies, such as SSA, have made good progress toward achieving financial management reform goals. We have designated the most serious situations as high risk, including financial management at DOD, IRS, the Forest Service, and the Federal Aviation Administration, as well as information security.

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In addition, the continued coordinated efforts of the Treasury and OMB will be required to provide solutions for certain governmentwide deficiencies, such as the inability to properly identify and eliminate transactions between federal entities and the compilation of the financial statements. We will continue to provide suggestions for resolving governmentwide problems and to evaluate progress in overcoming them.

A handwritten signature in black ink, appearing to read "D.M.W." followed by a horizontal line extending to the right.

David M. Walker
Comptroller General
of the United States

March 20, 2000

APPENDIX

OBJECTIVES, SCOPE, AND METHODOLOGY

The federal government is responsible for

- preparing the annual financial statements in conformity with generally accepted accounting principles;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met⁹; and
- complying with applicable laws and regulations and FFMA requirements.

Our objective was to audit the fiscal year 1999 financial statements.

The Government Management Reform Act expanded on the requirements of the CFO Act by requiring that the IGs of 24 major federal agencies annually audit agencywide financial statements prepared by these agencies.¹⁰ Our work was performed in close coordination and cooperation with the IGs to achieve our joint audit objectives. This work included separate GAO audits of certain material agency components, as discussed below. Our audit approach focused on the Departments of the Treasury, Defense, and Health and Human Services and the Social Security Administration. These agencies comprise a major portion of the amounts reported in the federal government's financial statements. At other federal agencies, we focused largely on accounts that are material to the financial statements. Additionally, for two agencies, information has been included in these financial statements but the agencies have not, at this date, finalized their individual financial statements for fiscal year 1999. Therefore, we were unable to determine the reliability of the amounts included in the accompanying financial statements for these agencies. We performed sufficient audit work to provide our report on the financial statements, internal control, and compliance with laws and regulations.

⁹The FMFIA requires agency managers to evaluate and report annually to the President on the adequacy of their internal controls and accounting systems and what is being done to correct the problems.

¹⁰GMRA authorized OMB to designate agency components that also would receive a financial statement audit.

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We separately audited the following material agency components.

- We audited and expressed an unqualified opinion on the IRS statement of custodial activity for fiscal year 1999. IRS was able to reliably report on the results of its custodial activities, including nearly \$1.9 trillion of tax revenue, \$185 billion of tax refunds, and \$21 billion of net federal taxes receivable. However, we issued an opinion on the IRS balance sheet that was qualified for the components of net position, disclaimed an opinion on its statements of net cost, changes in net position, budgetary resources, and financing, and reported numerous material internal control weaknesses.¹¹
- We audited and expressed an unqualified opinion on the Schedule of Federal Debt Managed by Treasury's Bureau of the Public Debt for the fiscal year ended September 30, 1999.¹² This schedule reported (1) over \$3.6 trillion of federal debt held by the public comprising individuals, corporations, state or local governments, the Federal Reserve System, and foreign governments and central banks, (2) \$2 trillion of federal debt held by federal entities, such as the Social Security trust funds, and (3) \$230 billion of interest on federal debt held by the public.
- We performed audit procedures on cash balances maintained and internal controls over the cash receipts and disbursements processed by Treasury on behalf of the federal government. We provided the results of our work to the Treasury Office of Inspector General for consideration in its audit of the Treasury's fiscal year 1999 departmentwide financial statements.

¹¹Financial Audit: IRS' Fiscal Year 1999 Financial Statements (GAO/AIMD-00-76, February 29, 2000).

¹²Financial Audit: Bureau of the Public Debt's Fiscal Years 1999 and 1998 Schedules of Federal Debt (GAO/AIMD-00-79, March 1, 2000).

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- We audited and expressed unqualified opinions on the December 31, 1998, financial statements for the funds administered by the Federal Deposit Insurance Corporation (FDIC), including the Bank Insurance Fund, the Savings Association Insurance Fund, and the FSLIC Resolution Fund.¹³ In addition, we performed audit procedures and tests of internal controls for cash, investments, and other material balances of the funds administered by FDIC as of September 30, 1999.

At CFO Act agencies and other agencies, we reviewed the fiscal year 1999 financial statement audits performed by the IGs or their contractors and, for certain agencies, assisted in the development of audit plans for fiscal year 1999 audits. Financial statements and audit reports for these agencies provide additional information about the operations of each of these entities. For example, these audits have identified numerous internal control and accounting systems weaknesses and noncompliance with laws and regulations, some of which are material to the respective agencies or components. Further, as of the completion of our field work on March 20, 2000, 22 of the 24 CFO Act agencies had received audit opinions or disclaimers on their fiscal year 1999 financial statements. Of the 22 agencies, 13 received unqualified opinions. These agencies are the

Social Security Administration,
National Science Foundation,
General Services Administration,
Department of Energy
National Aeronautics and Space Administration,
Nuclear Regulatory Commission,
Department of Labor,
Small Business Administration,
Federal Emergency Management Agency,
Department of Commerce,
Department of Health and Human Services,
Department of Transportation, and
Department of Veterans Affairs.

¹³Financial Audit: Federal Deposit Insurance Corporation's 1998 and 1997 Financial Statements (GAO/AIMD-99-202, June 30, 1999).

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